RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Changes to the Banking Supervision Handbook

Commentary on new documents BPRs 130-134, 150, 151 and 160

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Contents

Purpose of the document 3
BPR130: Credit Risk RWAs Overview 5
BPR131: Standardised Credit Risk RWAs 6
BPR132: Credit Risk Mitigation 19
BPR133: IRB Credit Risk RWAs 29
BPR134: IRB Minimum System Requirements 39
BPR150: Standardised Operational Risk 45
BPR151: AMA Operational Risk 47
BPR160: Insurance, securitisation, and loan transfers 50

Purpose of the document

1. This document provides explanatory commentary on the following draft new capital adequacy documents:

    - BPR130: Credit Risk RWAs Overview
    - BPR131: Standardised Credit Risk RWAs
    - BPR132: Credit Risk Mitigation
    - BPR133: IRB Credit Risk RWAs
    - BPR134: IRB Minimum System Requirements
    - BPR150: Standardised Operational Risk
    - BPR151: AMA Operational Risk
    - BPR160: Insurance, Securitisation, and Loan Transfers

2. These draft documents have been reorganised and in a number of areas re-written from the current capital adequacy documents BS2A (Capital Adequacy Framework: Standardised Approach) and BS2B (Capital Adequacy Framework: Internal Models Based Approach) [1].

3. The purpose of this document is to explain the way that the new documents have been extracted from the sources, including providing interpretations of source material that is unclear, and explaining why certain sections from quite separate parts of the source material have been put together. In some cases new material has been drafted. Our intention is to clearly flag where we think that providing clarification or fixing errors may lead to an actual policy change, compared to what the current interpretation could be. Such changes are flagged in the main Consultation Paper "Changes to the Banking Supervision Handbook: Exposure Draft for Capital Review Changes" provided as part of the suite of consultation materials.

4. All of these documents have benefitted from feedback on earlier drafts from a number of banks that agreed to join an informal working group. We are very grateful for their help. The latest versions of the documents reflect their responses to a number of specific questions that were raised on earlier drafts. We are not asking further specific questions in this commentary, but welcome feedback on any area where respondents have concerns that the re-drafting has had unintended consequences, or could be further clarified.

5. In line with earlier comments, these versions of the BPRs include more use of abbreviations (such as "RWA") throughout. We are still considering how we can provide additional navigation aids such as flowcharts, for example on how Credit Risk Mitigation applies in different cases.

6. The Reserve Bank's capital adequacy framework is in most areas based closely on the 2006 Basel Committee framework known as "Basel II", with amendments from 2010 and 2012 known as Basel III. In many cases, the work of clarifying the policy intent of parts of BS2A and BS2B has been greatly helped by referring back to the Basel source documents, and also to documents issued by the Australian Prudential Regulation Authority (APRA) to implement the Basel capital framework in Australia. Some of the Basel framework and corresponding APRA material has now been superseded

[1] Available at http://www.rbnz.govt.nz/regulation-and-supervision/banks/banking-supervision-handbook .

by more recent policy changes, but since we have not implemented these in New Zealand, the earlier Basel and APRA sources are still the most useful comparison points for reworking BS2A and BS2B.

7. The relevant Basel and APRA source documents are referred to throughout this commentary. We provide links to them here. The main Basel source remains the June 2006 Basel II document, https://www.bis.org/publ/bcbs128.htm, with additional paragraphs inserted into that text by two subsequent Basel documents: the December 2010 Basel III paper (as revised June 2011) https://www.bis.org/publ/bcbs189.htm and the July 2012 paper "Capital requirements for bank exposures to central counterparties". https://www.bis.org/publ/bcbs227.htm. (The Basel Committee has recently issued a more accessible consolidated version of these documents, but that also includes subsequent policy revisions.)

8. The main APRA documents referred to are APS112 , (standardised credit risk), including material in a number of Attachments to APS112, and APS113 (internal ratings based credit risk). Also referred to are APS116, (Market Risk) and a draft version of APS180 APS180 (Counterparty Credit Risk). Links to the APRA documents on operational risk are given in the sections on BPR150 and BPR151 below.

9. The separate document "Correspondence Tables" is a companion piece to this commentary. It provides an item-by-item mapping to show where each section of the source documents has ended up in the new BPR documents. Conversely, in the draft BPR documents each section is marked (for consultation purposes only) to show where in the source documents it has come from. A certain amount of entirely new text has been provided to help clarify structure and links between different sections, and that is marked as such.

10. The following draft new BPR documents are covered in separate commentary documents:

    - BPR100, BPR110 and BPR120: these are where the main Capital Review policy implementation changes are reflected.

    - BPR140 and BPR001 (Glossary): these cover new documents that have not so far been aired with working groups banks, so include a number of specific questions.

BPR130: Credit Risk RWAs Overview

11. BPR130 is a short document that plays the role of a junction-box. BPR100 refers any bank to BPR130 to provide the definition of total credit risk RWAs, to feed into the various capital ratio calculations.

12. Much of BPR130 is new text, as it plays a role particularly for IRB banks that is not very clear in BS2A and BS2B. Even hitherto, IRB banks have had some credit exposures that do not belong to a portfolio for which an IRB model has been approved, and these must be risk-weighted using the standardised approach in BS2A: but this is not spelled out anywhere. With Capital Review changes, IRB banks will need to use the standardised risk-weighting treatment in a much wider range of situations, namely:

    - For counterparties in the sovereign and bank exposure classes, once they move to standardised-only treatment.

    - For all counterparties, one IRB banks have to calculate the standardised floor for credit risk RWAs.

13. Accordingly, Part C of BPR130 sets out the combinations of risk-weighting approaches from BPR131 and BPR133 that an IRB banks must use to calculate total credit risk RWAs.

14. Section A1.3 of BPR130 also aims to make it clearer than at present what is within the scope of credit risk risk-weighting generally. This also allows the impact of the loan transfers treatment in BPR160 to be spelt out where it most naturally seems to apply, namely at the level of credit exposures for both standardised and IRB banks. (See BPR130 section A1.2(2).) (This treatment comes from Part 8 of BS2A. As previously agreed, it should also be available for IRB banks, and appears to have been left out of BS2B inadvertently.)

BPR131: Standardised Credit Risk RWAs

15. BPR 131 is a re-worked version of BS2A Part 4, although Parts E, F and G also correspond to parts of BS2B.

16. Note that all of BPR131 will be applicable for an IRB bank when it is risk-weighting any of its credit exposures that are subject to the standardised approach. Once the standardised floor is in place for IRB banks, an IRB bank will also need to use it for calculating the standardised equivalent for a modelled exposure, in line with BPR130.

17. Note also that Parts E, F and G are relevant for an IRB bank for any counterparty with which the bank has derivative or SFT contracts outstanding that give rise to counterparty credit risk.

Part A: Standardised approach to credit risk

18. Part A: this is mainly new text, to provide an overview of the calculation of RWAs, apart from A1.3 which comes from existing BS2A text (subsections 15(2) and (3)). A1.2 aims to clarify that this also applies to IRB banks, in the cases specified in BPR130, and also to pin down the scope of the calculation more precisely (depending whether RWAs are being calculated for group or solo capital ratios).

19. Note that subsection A1.3(2)(b) carries forward an existing problem from BS2A subsection 15(3)(a), namely it is not specified whether “allowances for impairment loss” are meant to include only individually-assessed allowances for credit impairment, or also collectively-assessed allowances. We have not re-drafted the text at this point, but plan to review more generally how we need to update our regulatory requirements to take account of NZ IAS 39 being replaced by NZ IFRS 9.

20. The intention of summarising all the components of the RWA calculation in sections A1.4 to A1.8 is both to help provide certainty about what needs to be included, and also to make the whole document easier to navigate.

21. Note that we have made it clear that the CVA contribution to RWAs requires a multiplier of 12.5. This is not currently spelt out in BS2A, as the capital charge K for CVA, which is defined in section 55A of BS2A, is not included in the ratio definitions in Part 3 of BS2A, nor is it added to the “risk-weighted on- and off-balance sheet credit exposures” total. To get to an RWA equivalent amount, a multiplier of 12.5 is needed. This is consistent with both the Basel source material and APRA’s implementation of the CVA charge.

Part B: Standardised rating grades

22. Part B generally follows the order of Subpart 4A of BS2A, with a few clarifications where they seem necessary.

23. The first sentence of BS2A section 15(2) and all of BS2A section 15(3) have been moved up to Part A, as they deal with the general approach to calculating RWAs rather than credit ratings.

24. Concerning the guidance on section B1.2, the criteria for approving credit rating agencies are currently in BS1, but the plan is to move this material to a separate document specifically dealing with credit rating matters.

25. The wording of section B1.3 has been tightened up compared to the source (BS2A section 17 – only solicited ratings allowed). The point of referring to “issuer or rated counterparty” is now dealt with in the guidance box.

26. A key problem throughout the BS2A material for risk-weighting based on credit ratings (sections 19-34) is that "short-term" and "long-term" have varying and ambiguous meanings. The context makes it clear that there is no single maturity that defines a boundary between short and long term. Accordingly, in the new BPR131 text "short-term" and "long-term" are only used to refer to types of credit rating: short-term ratings are those on the rating agencies' short-term scales (A-1, P-1, F-1 etc), while long-term ratings are those on their general rating scales (AAA, BBB+, Aaa, Baa1, etc).

27. Section B1.5 (inferred assessments) has been re-ordered and revised from BS2A section 19, guidance has been added to try and make it clearer, and the common usage "credit rating" replaces "credit assessment", as follows:

    - The concept of "unassessed claim" has been moved from subsection 19(6) in BS2A to the top of the section (subsection B1.5(1)), so that it can be used in the following subsections. Subsection 19(1) is no longer needed.

    - The text from BS2A subsection 19(2) has been deleted. It is not clear from the context whether "short-term" means less than 3 months (as per the bank concession) or an issue with a short-term rating (available for banks and corporates). In any case, the approach here needs to be used to infer a credit rating for any unassessed claim. For example, a claim on a corporate with a 2 month original maturity that does not have an issue-specific rating should be given the general (long-term issuer) credit rating of the corporate if it has one. This is consistent with the Basel approach (Basel II paragraph 99), and also makes best sense. The risk-weighting treatment in Part C of BPR131 provides all the necessary floors and overrides.

    - Subsection B1.5(2) comes from subsection 19(5), but has been inverted into what seems a more logical order. This has also now been moved further up within the section, as this provides the "normal" case, under which a borrower has a long-term issuer credit rating, and that rating provides the inferred assessment for all senior claims on the borrower. The wording has also been made more general, in line with the Basel source, so that it allows for issuer ratings with different scopes. The guidance refers to the common case where the rating applies to senior unsecured claims.

    - Subsection B1.5(3) broadly matches subsection 19(3), but in light of previous points it now refers specifically to "long-term credit rating" rather than just "credit rating", to be consistent with subsection B1.5(4). It also now refers specifically to subsection (2), to clarify that this subsection is only required when there are claims that do not get an inferred assessment from the general issuer rating.

    - Subsection B1.5(4) comes from BS2A subsection 19(4), but slightly re-worded. The key point is that a short-term rating grade cannot be applied to unassessed claims. The re-wording is to refer to "unassessed claim" rather than "long-term claim" (which is not defined). We have also cut "except as specifically provided for": this case is not provided for anywhere, although it is possible for the risk-weighting on an unrated claim to be overridden by the risk-weighting for a claim with a short-term credit rating (see section C2.10(3) and (4)). We think it is unnecessary and confusing to include this proviso in B1.5(4) itself.

    - Guidance boxes have been added to help explain the intent of the section.

28. Section B1.7 (multiple ratings) is re-drafted slightly differently from BS2A section 21. In line with the Basel source, this clarifies that in any case where different ratings result in more than one risk weight, the bank must use the second lowest risk weight (ie the higher of the two if there are two, the higher of the two lowest risk weights if there are more than two). The current BS2A version could potentially

allow a bank to use the lowest risk weight, if the claim has two different rating grades that both require that risk weight.

29. Subpart B2 comes from sections 23 to 25 of BS2A. Section 22 of BS2A has been left out as it does not appear to add anything. We have added a guidance box after section B2.1, as it seems helpful to explain the types of case where a claim on an entity can end up being unrated even though the entity has a credit rating. Table B2.2 now describes the outputs as short-term rating grades.

Part C: Risk weights for credit exposures

30. Part C broadly corresponds to Subpart 4B of BS2A. However, the title of the Part and Subpart C2 have been revised to reflect the fact that the risk weights set out here apply equally to both on- and off-balance sheet exposures. The new "Overview" subpart C1 spells this out.

31. Subpart C2 has needed significant re-organisation to remove the ambiguities in BS2A about what "short-term" and "long-term" refer to (as discussed above).

32. Subsection C2.1(2) has been revised from BS2A subsection 27(2). BS2A says that cash items in process of collection must be treated as short-term claims. The sense of "short-term" here must clearly be the one that qualifies for the up-to-3-month risk-weighting concession, not for the short-term rating treatment, so that is spelt out accordingly.

33. Table 4.3 in BS2A has become BPR131 Table C2.2 and Table 4.5 has become Table C2.4. In both tables, the current row for "unrated, if risk weight for a short-term claim on the issuer is 150%" has been removed: there is no risk-weighting treatment for short-term claims in these cases, so this row in both tables can never apply.

34. Also, the wording of section C2.4(2) and the heading of Table C2.4 have been expanded (compared to BS2A section 30(2)) to clarify that "other" only refers to multilateral development banks not included in section C2.4(1): including unspecified "other international institutions" was an error. The list of entities in BS2A section 30(1) has been updated in BPR131 to align with the current Basel version (see Basel Framework CRE20.10, footnote 7), and given the specific title "lowest-risk multilateral development banks and supranationals".

35. Our risk-weighting treatment of claims on banks derives from the approach for banks in paragraphs 60-63 of Basel II (we use Option 2), and the approach for bank and corporate exposures with short-term credit ratings set out in paragraphs 103-106 of Basel II. The material in BS2A that reflects this has been reorganised to deal with the current short-term / long-term confusion, and to make it clear that:

    - there is a concessionary risk-weighting treatment for any claim on a bank that has an original effective maturity of 3 months or less.
    - a bank or corporate exposure which has an issue-specific short-term rating, where this refers to rating agencies' short-term grades (A-1, P-1, F-1, etc) is subject to a risk-weighting which is derived from that rating grade. (This is not dependent on the original maturity of the claim.)
    - these treatments mean that when an unrated claim on a bank has original maturity less than 3 months, and that bank also has some issues outstanding with issue-specific short-term credit ratings, the unrated claim gets worst-case treatment (see Section C2.11).
    - there are also two types of risk-weighting floor for unrated claims on banks and corporates: one relating to the sovereign territory where the entity is incorporated (see sections C2.6 and C2.8), and one relating to the existence of another claim on the entity which has a short-term rating corresponding to a risk-weighting of 50% or more (see section C2.10).

36. Risk weights for banks based on a long-term or general issuer rating grade are given in Table C2.5, which merges BS2A tables 4.7 and 4.8. This removes the expressions "long-term claim" and "short-term claim" altogether, and refers just to the over and under 3 month cut-off. The text of section C2.5 replaces the text of subsection 31(2) and section 32, significantly revised. (This clarifies that section C2.5 defines the risk-weighting for any claim that does not have a short-term issue-specific rating grade, ie the claim has one of the general rating grades from 1 to 6 or the "unrated" rating grade.)

37. The risk-weight floors for the "unrated" category which are in tables 4.7 and 4.8 are no longer shown by separate rows, but are now dealt with by cross-reference to the relevant sections. A cross-reference to the sovereign floor has been added as well (in BS2A, this is in section 33).

38. The treatments of claims on banks and corporates which have issue-specific short-term ratings have been grouped together and put later (see sections C2.9 to C2.11).

39. The sovereign risk-weight floors for bank and corporate claims provided by sections 33 and 35 of BS2A are largely preserved in sections C2.6 and C2.8, except that the term "ceiling" has been replaced by "floor" as that seems a more accurate description of something which sets a minimum value.

40. The new section C2.9 with Table C2.9 provides the risk-weighting treatment for claims on both banks and corporates that have a short-term issue-specific rating. This combines BS2A Tables 4.6 and 4.9, and the text from subsections 31(1) and 34(1). The last two rows of Table 4.9 are not needed, since a claim that has a short-term issue-specific rating grade cannot emerge from the process in Part B as "unrated".

41. The new section C2.10 replaces and expands on the rows in Tables 4.7, 4.8 and 4.10 that provide overrides for unrated claims, in the event that a bank or corporate borrower has another claim carrying a poor quality short-term rating. (This treatment is confirmed by reference to Basel II paragraph 104.)

42. Section C2.11 replaces section 31(3), dealing with the case of a claim that is up to 3 months maturity but does not have an issue-specific rating, but where the borrowing bank does have other issues with specific short-term ratings.

43. Finally, note that BS2A section 31(4) has not been kept in BPR131, since it makes no sense: a claim that has neither an original maturity of up to 3 months nor an issue-specific short-term rating does not fall into any definition of "short-term".

44. Guidance boxes have been added to sections C2.9, C2.10 and C2.11 to try and clarify the approach.

45. The risk-weighting approach for residential mortgage loans (RMLs) in Sections 36 to 39 of BS2A, along with related definitions from section 43, have now been moved into a separate Subpart C3, as the amount of material seems to justify this splitting out. This has been reorganised so that the various definitions and eligibility requirements come first, leading up to all the risk-weighting cases set out in Table 3.10 and the treatment of past due RMLs in section C3.11.

46. A key change in the RML material has been to break up the definition of loan-to-value ratio (LVR) to make it clear how the current definition of "property value" includes a number of embedded eligibility criteria: these are now set out in sections C3.6 to C3.8. BS2A does not specify what LVR to use if these criteria are not met: this is now set to 101%.

47. The remainder of subpart C2 includes the residual asset categories from BS2A sections 40-42, but this has now been expanded in BPR131 sections C2.12 to C2.18. These include: (1) the new treatment for right-of-use assets where the bank is the lessee, in line with the new financial reporting standard for leases NZ IFRS 16; and (2) some changes to reflect the fact that IRB banks will also be using BPR131

to risk-weight all assets that are not in a modelled IRB exposure class. This includes a clearer specification of how to value equity holdings (section C2.13).

48. Section C2.18 has been revised to refer to "on-balance sheet" assets, and guidance added to give examples of the types of assets included. The aim is to tighten up what "other asset" this should be taken to refer to. Note that this links to section A1.6 in the overview section, which refers explicitly to the "balance sheet (under the applicable scope of calculation)".

49. Most other defined terms from section 43 are now in the Glossary. The current definition of "corporate" in section 43(a) is unhelpful in that it specifies four sub-categories that the term includes: some readers have taken this to be an exhaustive list. We have not attempted to provide a full definition, but have clarified this point in the corporate risk-weighting treatment in section C2.7(3).

Part D: credit conversion factors for commitments etc.

50. Note that this part has equivalents in both BS2A and BS2B, but the IRB case is now dealt with separately and somewhat differently in BPR133 (see section C5.5). So Part D of BPR131 only applies to exposures under the standardised approach.

51. Section D1.1 is a revised version of BS2A section 44, to deal with the points that:

    - Part D does not in fact provide the risk-weighting calculation (that is set out in Part A).
    - The risk weight is in two cases determined by an entity other than the transaction counterparty (namely, the cases of an asset sale with recourse, and a forward asset purchase).

52. Subsection (3) of section D2.1 and the following guidance are new. This simply clarifies that if a commitment has been partly drawn down, the drawn portion is an on-balance sheet exposure, while the off-balance exposure only arises from any outstanding undrawn commitment. APRA have similar text (see APS112, Att B para 14), and we have also included something similar in BPR133 (section C5.5(5)).

53. The wording of subsection D2.2(1) aims to spell out the selection of the appropriate CCFs with a bit more precision than the BS2A version (subsection 46(1)), and likewise D2.2(2) should specify more clearly what it is that determines the choice of risk weight (with new guidance added to help clarify this further).

54. Table D2.2 has been created by merging BS2A Tables 4.14 and 4.15: there seems no good reason not to do this, and this also allows BS2A subsections 46(3) and 46(5) to be deleted.

Part E: Counterparty credit risk

55. Part E has been significantly restructured from the source material in BS2A Subpart 4D. Section E1.1 is derived from section 47 of BS2A, but has been expanded and clarified.

56. One of the problems with the BS2A material is the variety of terms used, ie "market-related contract", "over-the-counter derivative contract" and "forward transaction". The later CCP treatment also distinguishes "exchange-traded derivative transactions". Comparing this material with the Basel source material and with the way that APRA have implemented this suggests strongly that these are all referring to the same types of transaction, namely a derivative contract that gives rise to contracted future cash flow(s) where the cash flows are with a specified counterparty and where their value is dependent on market variables. The main distinction is between contracts that are settled bilaterally (which can in principle have been contracted on- or off-exchange) and those that are settled across a central counterparty. The CEA methodology in Part E applies to all of these cases, although concessionary risk-weights apply to transactions settled via a QCCP (as per Part G).

57. The guidance box after section E1.1 attempts to explain this. The defined terms in section 55 of BS2A have not been transferred to BPR 131, as they are now covered in the single Glossary. The term "market-related contracts" is no longer, and the title of Part E has been revised accordingly.

58. We also think it is helpful to follow APRA's approach of including the treatment of SFTs in this section. SFTs are not generally described as "derivatives" but are a form of market-related contract that give rise to counterparty credit risk.

59. Section E1.1 therefore now summarises what is in the other Subparts of Part E, namely:

    - Subpart E2, how to calculate the CEA of a single derivative contract (BS2A sections headed "Over-the-counter derivative contracts");
    - Subpart E3, how to calculate the CEA for a number of derivative contracts with a given counterparty, where the claims arising on those contracts are subject to a bilateral netting agreement (BS2A sections headed "Bilateral netting of market related contracts"); and
    - Subpart E4, the CEA for SFTs, whether netted, single, or non-qualifying, which is done mainly by cross-reference to other material.

60. Section E1.2 is new text. This is to clarify that a bank may recognise the benefit of collateral held against the counterparty credit risk on single or netted derivative contracts, using the standardised credit risk mitigation methodology. The methods are set out in the existing CRM material (see BS2A sections 64(3) and section 62, and BS2B section 4.37). This is now reproduced in the harmonised CRM document BPR132, in sections B2.2(2) and B3.2. For IRB banks, there are also sections C3.3(2) and C5.6 of BPR 133, to explain how this affects the calculation of EAD for a given counterparty.

61. The guidance box points out that collateral is not separately recognised for SFTs, but is an inherent part of the transaction, and is hence recognised in the CEA calculation for SFTs as a matter of course.

62. Section E1.3 is new text, mainly to explain the distinction between the standardised and IRB approaches in how the CEA feeds in to the RWA calculation, since Part E applies to both.

63. Section E1.4 is also new text, to note that the methodology set out in Part E is also relied on for: (1) the CEA amounts that go into the CVA calculation (see Part F) and (2) the calculation of "trade exposure" in the methodology for calculating exposures arising from transactions cleared across central counterparties (see Part G).

64. Section E2.1 comes broadly from BS2A section 48. The names of some of the components in the formula have been changed, partly to make them more accurate descriptions, partly as needed to ensure consistent terminology across the single contract and netted contract treatments (see Subpart E3 below), and partly to align better with APRA (see APRA's treatment of netted contracts in APS112, Att J, paragraph 26 onwards).

65. Sections E2.2 and E2.3 come from BS2A sections 49-51. The title of E2.2, and its scope as set out in E2.2(1) and E2.2(2) have been changed to deal with the following areas of confusion in BS2A:

    - in BS2A section 55 (interpretation) the definition of "OTC derivative" does not include credit derivatives, but the definition of "derivative" does. There is nothing to suggest that a credit derivative cannot be transacted over the counter. We think the distinction between E2.3 and E2.2 should simply be between (1) credit derivatives and (2) other derivative contracts of the types shown in Table E2.2, which exclude credit derivatives. The problems have also been addressed in the Glossary.

- it seems from the context, and from reference to the Basel sources, that the term "bilaterally netted forward transactions" (in BS2A subsection 49(1)(b)) is loosely used to refer to any derivative contracts with future cash flows which have been netted, not specifically to "forwards", which are one specific form of derivative. (See Basel II, Annex 4 paragraphs 96(i) and 96(iv).) The same issue arises with BS2A section 53(1).

- contrary to BS2A subsection 49(1)(b), the treatment for netted transactions is not set out in section 49 as such, but the conversion factors on individual contracts specified in section 49 are needed for the calculation for netted contracts specified in section 53. The wording of the corresponding subsection E2.2(2) now makes this clear.

66. The specification of conversion factors for calculating PFCE on credit derivatives in BS2A and BS2B has a number of problems. (See BS2A sections 50-51 and BS2B sections 4.78-4.80.) We have tried to deal with these as follows:

    - In our implementation of Basel II, we have never provided the full Basel definition of "trading book" (see paragraphs 685 to 689(iii) in the main Basel II document), or any other definition. As noted previously, we have only have very few references to the trading book in our capital adequacy framework. Feedback on the draft BPR132 suggests that banks generally understand what the term is intended to cover. Here, the purpose is to make it clear that only credit derivatives held for trading purposes are captured by the counterparty credit risk treatment.

    - The distinction between "qualifying" and "non-qualifying" reference obligations is not explained in BS2A or BS2B. The reason is that the applicable definition of "qualifying" comes from the treatment of "specific risk" in the Basel II market risk framework, which we have not implemented. A core part of the Basel and APRA definitions of "qualifying" is that the issuer has at least two investment-grade ratings from external rating agencies, and following feedback from some banks on this, and confirmation that this treatment is of limited applicability, we have adopted this definition in section E2.3(4).

    - The BS2A and BS2B presentation of the conversion factors currently requires two tables. In BPR131, we have compressed this to one table (Table E2.3) by making the last row of the table (the case where the bank has sold a credit default swap) subject to a caveat. The caveat is then explained by subsection E2.3(3). This is how the Basel source and APRA's version present this, and it seems to us easier to understand.

    - BS2A section 51 and BS2B section 4.80 are now incorporated into subsection (3)(a) of section E2.3. This relates to the amount of any unpaid premium on a credit derivative, and has been changed in two ways. First, our current text refers to a limit on the "exposure amount". This is ambiguous, and referring back to the Basel and APRA versions of this confirms that it is the amount of PFCE that should be capped at the total amount of any unpaid premium. Second, in the Basel source and APRA version it is clear that this is only meant to apply to the case in the last row of the table, not to all credit derivatives. This is explicit in BS2B but not at all clear in BS2A. It appears that the intention here is that when the bank sells a credit default swap and the condition in subsection (3)(a) is met, PFCE is the lesser of (notional principal of the swap x conversion factor from last row of the table) and (total unpaid premium on the swap).

67. Section E3.1 (conditions for bilateral netting) follows BS2A section 52 and BS2B section 4.81(a)-(f) closely. It does not seem clear to us what the current text "other than a payments netting contract" means in the opening sentence, so we have referred back to the Basel source: see Basel II, Annex 4, footnote 248 to paragraph 96(i). Based on this, we have replaced the current text with the guidance box

after Section E3.1. This seems best as guidance, since the real test remains the conditions in section E3.1(2).

68. Section E3.2 sets out the formulae for calculating the CEA of bilaterally netted market-related contracts. This has been significantly re-worked and expanded from the BS2A and BS2B source material. (An additional problem with BS2B is that this appears incorrectly as a further condition 4.81(g) for bilateral netting, following on from the conditions set out in subsections 4.81(a) to (f).)

   - We have moved closer to APRA's approach here, simply because all their terminology seems to provide better descriptions of what the terms represent. (See APRA's APS 112, Attachment J.) This also results in a more consistent approach between the stand-alone version of the formula (Subpart E2) and the netted version.

   - This includes using the abbreviation PFCE, which appears in the single transaction case, and then $PFCE_{Gross}$ and $PFCE_{adj}$ in the netting case, to make it clearer how individual transaction PFCEs add up to the gross total and then to the adjusted total.

   - We have added fuller instructions (and guidance) for calculating NGR and $PFCE_{Gross}$. This has identified that the current definition of A_{Gross} is wrong: it should not be the sum of "factors" (this makes no sense) but should be the sum of the exposure amounts, ie (factor x notional exposure). This is corrected in the definition of the corresponding new term $PFCE_{Gross}$.

   - For defining NGR (net-to-gross ratio), we have had to clarify what we mean by the current description of the denominator, "gross replacement cost". Basel and APRA give two options, but we think implicitly our approach was intended to use only the "counterparty-by-counterparty basis". This leads to the expanded description of GCCE (= gross replacement cost) in subsection E3.2(3). The guidance box also provides versions of GCCE and NCCE as mathematical formulae, to provide further certainty.

69. Section E3.3 expands on BS2B 4.82 and BS2A section 54 with the aim of clarifying what the point of this is. We believe the basic idea is that where gross sums need to be calculated (in section E3.2), effectively "pre-netting" is allowed for "matching transactions" as defined here. So we have clarified that this applies both to the summing of mark-to-market values for working out GCCE, and to the summing of future credit exposures for calculating $PFCE_{Gross}$. It does not need to apply to NCCE, since that nets across all MTM values in any case. The grounds for taking this approach are that it appears to be the most logical, in treating MTM values and PFCE values consistently.

70. This appears also to be consistent with what APRA's approach amounts to. (See APRA's APS 112, Attachment J, paragraph 32, and the cross-references from paragraphs 33 and 31 which go to paragraph 29 but should clearly go to paragraph 32.) This also follows quite closely the Basel source text, in Basel II, Annex 4, paragraph 96(v). We have added guidance after E3.3 to explain this approach.

71. Subpart E4 dealing with the treatment of SFTs is a new section. Currently the actual treatment is set out within the Credit Risk Mitigation part of BS2A (sections 64, 93 and other material), and within both the LGD and EAD treatments for corporates etc in BS2B (sections 4.38, 4.68(c) and elsewhere). Although Subpart E4 does not itself set out the treatment, it provides a single reference for the various methodologies applying, and falls within the standardised CEA calculation, which applies to both IRB and standardised banks in the case of SFTs.

72. Cross-references go from Subpart E4 to BPR132: Credit Risk Mitigation for the respective approaches for single SFTs or a number of netted SFTs: we think it makes best sense for the approaches to be set out there, since they are closely related to the general collateral treatment in BPR132. The case in subsection E4.1(3) is not currently covered in BS2A or BS2B, and has been added for completeness.

This makes explicit the treatment that we think is implicit anyway when the collateral treatment is not applicable, and matches APRA's approach (see APS 112, Att C, paragraph 7(a)).

73. The references to the simple and comprehensive approaches for collateral (in subsection E4.1(1) and in the guidance boxes) reflect the way that the application of them has been clarified in BPR132.

Part F: CVA charge

74. Subpart F1, "Overview" comes from BS2A section 55A(1) and (2) and BS2B sections 4.82A and 4.82B, adapted and expanded a little as follows:

    - this material is now provided once only, to apply equally to standardised and IRB banks (to avoid doubt, subsection F1.1(5) states this explicitly).
    - we have added some guidance within section F1.1 to explain the nature of the CVA charge
    - we have spelt out that the CVA formula defines a capital charge, which means that the amount to be added to RWAs is 12.5 x the CVA capital charge (as specified in F1.1(6)).
    - consistent with Part E, we have removed the references to OTC derivatives. The CVA charge is calculated by drawing on all of the CEA amounts calculated under Part E arising from any derivative contracts that (i) give rise to contractual bilateral future cash-flows based on market variables; (ii) are not settled across a CCP (with a few exceptions), and (to avoid doubt) (iii) do not arise from SFTs. We think there should be a one-on-one link with Part E, ie the CVA formula should take in any CEA value calculated in Part E that is not from an SFT and is not for the purpose of TE required for Part G (CCP treatment).
    - with the aim of providing greater clarity, the new subsection F1.1(3) notes the few cases which a transaction settled on a QCCP may give rise to a CEA amount that does (exceptionally) have to be included in the CVA calculation. These cases, which are also spelt out in Part G, arise when a counterparty credit exposure arising from a trade settled on a QCCP has to be treated as a bilateral trade.

75. In Subpart F2, the general formula for the CVA charge has been tidied up somewhat compared to the versions in BS2A and BS2B as follows:

    - the term '$\sqrt{h}$' has been cut because h=1
    - the term EAD ("exposure at default") has been replaced with CEA "credit equivalent amount", because the latter has wider application. EAD is only used elsewhere as part of the IRB modelling approach, while CEA is used in the approach to counterparty credit risk for both standardised and IRB banks. For IRB banks, CEA arising from the market-related counterparty credit risk of a counterparty is one component of the total EAD for the counterparty.
    - "ind" has been switched to be used as a superscript to label any B or M that relates to an index CDS hedge (similar to the use of the superscript "hedge" as a label), so 'j' has been introduced as a counter across all index CDS hedges (in the event that there is more than one). This aims to remove confusion between the two meanings of "index".
    - the discount factors which are currently incorporated into the definitions of B_i, B_{ind} and CEA_i^{total} have been pulled out as separate defined terms (see subsection F2.1(2)), and hence included in the formula as well.
    - the definition of M_i has been refined, to explain what "notional weighted average maturity" must mean, that is, weighted according to notional amount of each transaction. (This is consistent

with APRA – see paragraph 9(a) of APS 112, Att C.) Also the statement in BS2A that “it is not capped at 5 years” makes no sense for a standardised bank: this has been moved to the guidance, to make it clear that the maturity of each transaction is an unadjusted amount.

- in the definition of M_j^{ind}, the reference to “weighted average” is not needed, since the summation is provided in the formula in any case.

76. Our current definition of the risk-weight w_j^{ind} for index hedge “j” says that it must be determined by the average spread for the index. This matches exactly the wording in the Basel source. On the other hand, APRA’s version of this says that the weight for a credit index must be determined by its credit rating grade.[2] We would welcome views on which of these is the most practical to implement.

77. We have split out the eligibility conditions for including the benefits of hedges in the CVA calculation to make them clearer: subsection F2.1(3) specifies the conditionality, while the conditions themselves are now in the separate section F2.5.

78. The order of the two simplified versions of the formula has been reversed, with explanatory titles added for greater clarity (see sections F2.2 and F2.3). This order seems more logical since F2.2 is a sub-case of F2.1, and F2.3 is a sub-case of F2.2. The title and scope of section F2.3 has been updated to clarify that this is the case with only one counterparty, where the bank has no hedge against the valuation risk on the exposure to that counterparty.

79. Note of course that these simplified versions of the formula are only provided for convenience: they follow automatically from the most general case by inserting the relevant assumptions, eg that all the B values are zero. Guidance has been added to clarify this point. This is the reason that sections F2.2 and F2.3 say the bank “may” calculate the CVA charge using these alternative versions of the formula, whereas section F2.1 says “must” calculate.

80. We have tried to make it clearer that hedges are subject to eligibility requirements as follows: in section F2.1, hedges are referred as “eligible hedges”, and subsection F2.1(3) has been added to cross-refer to the eligibility criteria. These eligibility criteria (sections 55A(6) to (9) in BS2A, and sections 4.82F to 4.82I in BS2B) have been grouped together in a single new section F2.5, with a new self-explanatory heading.

81. Subsection F2.5(5) in BPR131 corresponds to BS2A subsection 55A(9) and BS2B subsection 4.82I. This deals with the case where the bank has a counterparty that belongs to an index which is the reference index for an index CDS the bank has bought to hedge its CVA risk. The new version has been re-ordered to try and make its purpose clearer.

82. BS2A section 55A(10) (and BS2B equivalent section 4.82J) have been deleted: these do not really serve any purpose, since “total counterparty credit risk charge” does not feed in to anything, and also the statement is not accurate, as in neither the standardised nor the IRB case does it include the risk-weighting aspect of producing the counterparty credit risk capital charge.

Part G: Central Counterparties

83. We have grouped this material into its own separate Part, by contrast with the grouping in both BS2A and BS2B. This seems more helpful.

84. Note that there are more recent versions of these requirements that have been issued by the Basel Committee. This includes for example the treatment of tiered arrangements (clients of clients).

[2] See Basel II, Annex 4, paragraph 104, and APRA APS 112, Att C, paragraph 10.

However, consistent with the approach in the rest of the Handbook restructuring, we are sticking with the current material and trying to clarify its current intent where needed.

85. The criteria for a CCP to be "qualifying" say that the Reserve Bank determines whether a given CCP meets the principles (see section G1.2(2), which has equivalents in both BS2A and BS2B).

86. Section G2.1(1) has been slightly re-worded, to clarify that this covers specifically those trades where a clearing member is acting for its own purposes. (Not where it is acting on behalf of a client, see section G2.3). This also tries to clarify that TE in the formula is an aggregate figure, summed across a number of individual contracts the bank is clearing via the CCP, for each of which the exposure value is calculated using the CEA method in Part F.

87. We have added guidance to clarify that collateral that the bank is required to post in connection with its trades across the QCCP are not included in the RWA calculation here. That is treated separately in section G2.4.

88. BS2A section 55D(3) and BS2B section 4.82O refer to the case where a default fund is shared between "products and types of products that give rise to settlement risk only" and "products and types of products that give rise to counterparty credit risk". The Basel source and APRA both refer to sharing the fund between "products and types of business". The latter seems to make better sense, as it is not clear why there is a need to refer to both "products" and "types of products". In section G2.1(3), we have switched back to the Basel version.

89. On the other hand in the case dealt with in section G2.1(4), namely that default fund contributions are segregated by product type, the Basel source refers to calculating the RWA for the default fund contributions for each specific product (Basel II Annex 4 paragraph 120, also adopted by APRA, see APS112 Att C paragraph 27). It does not appear to us that there is intended to be a real difference between a "product" and a "product type", with the main distinction being between those and an individual contract. We have revised the text in G2.1(4) to refer throughout to "product type".

90. Our understanding of how this works is that if, for example, the default fund is segregated so that one portion is earmarked for all FX swaps and another portion is earmarked for all fixed/ floating interest rate swaps, then the formula in G2.1(2) must be calculated once across all FX swaps that the bank is clearing on the CCP, with DF = the portion of the default fund allocated to FX swaps, and TE summed across the CEAs of all those FX swaps; and once across all fixed/floating interest rate swaps likewise; and so on for all other types of product that the bank is clearing across the CCP that have their own segment of the default fund.

91. Section G2.2 tightens up the drafting somewhat compared to BS2A section 55E and BS2B sections 4.82P and 4.82Q, and hopefully the clearer layout also makes the sense clearer. The guidance added after subsection (5) clarifies how the RWA calculation works for a standardised or an IRB bank, in the case where the bank has to treat the exposure as a bilateral trade.

92. Section G2.3 deals with a clearing member bank's exposure to its clients, and comes from BS2A section 55F / BS2B section 4.82R:

    - Section G2.3 is considerably expanded from the source, to spell out more clearly the situations that this covers, and the RWA calculation.
    - It is not clear what the intention is (in BS2A and BS2B) of requiring multiplication by a scalar of "no less than 0.71". Referring to the Basel source and the way APRA have implemented it, it is clear that the scalar is intended to vary between 0.71 and 1, depending on the "margin period of risk" (the estimated time period from the last exchange of collateral covering a netting set of transactions with a defaulting counterparty until that counterpart is closed out and the resulting

market risk is re-hedged): 0.71 if that period is 5 days or less, increasing steadily to 1 if it is 10 days or more. For current purposes, so as not to increase RWAs without proper consultation, in BPR131 subsection G2.3(3) we have specified 71% precisely.

- The implications for the CVA calculation have also been spelt out more clearly (in section G2.3(4)). This includes clarifying that the 71% scalar must not be applied to the CEA figure that goes into the CVA formula. We think is the right answer, since the scalar reflects a possible shorter close-out period, whereas CVA is about future fluctuations in the exposure amount, not closing out the current exposure. However, the Basel and APRA versions do not make this clear one way or the other.

93. Section G2.4: Treatment of posted collateral. The revised version tries to clarify the original intent based on Basel, although the Basel text itself does not appear comprehensive (Basel II, Annex 4, paragraphs 117-119).

- The case where the bank is a clearing member and posts collateral with the QCCP (not bankruptcy-remote) is dealt with in Basel footnote 9 (and is in APRA's implementation), but is not in our current approach: we believe it makes sense to add this, and it represents a concession (2% risk-weight), assuming that the treatment would otherwise default to the standardised risk-weight. This now appears as subsection G2.4(5). For a clearing member of a QCCP, it seems to make sense that these are the only two possible cases, since the trade exposure itself can only have a risk-weighting of 2%.

- However, the Basel source for this (and APRA's version of it) refer to applying the 2% risk weight to "collateral included in the definition of trade exposures". This does not make clear sense, and indeed this phrase no longer appears in the equivalent in the draft APS180. As far as we can see, the main point is to make it clear that a trade cleared on a QCCP gives rise to two separate RWAs for counterparty credit risk: one for the trade exposure itself, using a CEA calculated in accordance with Part E of BPR131; and one for any collateral posted in relation to that trade. These are now provided in Part G by means of section G2.1 and subsection G2.4(3), along with guidance.

- In the case of a client bank, the BS2A and BS2B versions (sections 55G and 4.82S respectively) do not clearly specify what happens when none of the listed cases applies. The implication seems to be "standard risk-weighting applies", and this is what Basel appears to be saying as well. G2.4(4) and (5) now aim to make this clear: the full set of cases is 0%, 2% or 4% risk-weighting (provided by subsection G2.4(4), or the residual case of a standard risk-weighting treatment, provided by subsection G2.4(5). This is also consistent with the treatment of the trade exposure itself, which allows for 2%, 4% or standard risk-weighting.

- Note that the definition of TE for the purposes of sections G2.1 and G2.2 does not include any collateral posted by the bank in connection with the trade, and we have clarified this in the guidance after G2.1(2) and G2.2(2). (Note also that the methodology of Part E allows eligible assets that the bank holds as collateral against a trade exposure to offset the gross CEA of the exposure: the guidance mentions this as well.)

- Subsection (a) in BS2A section 55G and BS2B section 4.82S provides a list of what may be included in "collateral posted by a clearing member", but this is not referred to in subsection (b) of either section. In the APRA treatment, likewise this list is only provided in one of the five cases covered (see APS112 Att C, paragraph 26), and this seems to come from the Basel source. However, in the draft new APS180 (Aug 2017 version, Att B, paragraph 25), this list is now moved up to describe posted collateral in all cases. This seems to correct what is currently an error, so we have done the same in section G2.4(1)(b).

- Note that in BS2A section 55G, there is a floating subsection number (2) which is presumably a typo.

- The current wording in subsections (a) and (b) in BS2A section 55G and BS2B section 4.82S refers to collateral that is held by a custodian or the QCCP and is bankruptcy-remote from the QCCP. This is at odds with the Basel source and APRA, which refer only to posted collateral being held by a custodian. (See Basel II Annex 4, paragraphs 118-119, and APRA APS 112 Att C, paragraph 26, subparas (a)(ii) and (b)(i)). It does not seem a realistic case to us that the collateral is held by the QCCP and is bankruptcy-remote from it, and we have therefore revised the wording to match the source, to make it clear that to qualify for the 0% risk weight case, the posted collateral must be held by a custodian. (See subsection G2.4(3)(a).)

- Note that the Basel source also includes a definition of “custodian” that spells out the way that the assets it holds are bankruptcy-remote from the custodian itself: this is not in BS2A or BS2B, and we do not propose to add it now, as we take it as read in the concept of “custodian”.

94. Section G3.1: Treatment of exposures to non-qualifying CCPs. This treatment is relatively simple. One issue that seems to be not completely clear in the BS2B source (section 4.82T) is whether an IRB bank should use the IRB or standardised risk-weighting treatment. The Basel source and APRA equivalent are very clear that the standardised approach applies in all cases, so subsection G3.1(2) reflects this.

BPR132: Credit Risk Mitigation

95. One change made throughout BPR132 has been to replace references to “business day” with “working day”, since “working day” is the recognised term in New Zealand, being defined in the Interpretation Act 1999. We have aimed to make the corresponding change where needed throughout the Handbook replacement documents.

96. In Part A of BPR132, and also in the rest of the document, drafting has been changed to make the point clearer that this is all about the recognition of credit risk mitigation for RWA calculation purposes. The Reserve Bank does not generally “approve” or “recognise” a bank’s use of a particular CRM technique in any other context.

97. The following few policy issues in BS2A and BS2B remain unresolved, and will need to be considered further in future:

    - whether to provide formal definitions of “banking book” and “trading book”;
    - the definition of “recognised exchange”;
    - the meaning of an “overseas equivalent” to the NZX50;
    - whether to expand the list of “core participants” in the zero haircut conditions.

98. The following broadly goes through each Part of BPR132 in turn.

Part A: Introduction

Subpart A1: Applicability to standardised and AIRB banks (sections A1.1 and A1.2)

99. This whole subpart is new text. Section A1.1 is added to set out what BPR132 does. Section A1.2 aims to set out more clearly than in BS2A and BS2B which types of credit risk mitigation apply to which aspects of standardised and IRB RWA calculations, noting that the IRB methodology in many cases allows banks to model credit risk mitigation in their own way. Table A1.2 aims to summarise this all clearly, including the different circumstances in which the comprehensive and simple approaches to collateral apply.

100. One form of credit risk mitigation that is not covered in BPR132 is netting of derivative exposures, which is covered as part of the methodology for calculating the CEA of counterparty credit risk on derivatives (as in BS2A and BS2B at present). This is covered in subpart E3 of BPR131, which seems a more natural fit.

Subpart A2: General requirements

101. Subpart A2 sets out general eligibility conditions for credit risk mitigation to be recognised, which come from BS2A. Section A2.2 summarises all the ways in which credit risk mitigation can be recognised in IRB calculations: it is new text, but pull together what is currently implicit in the way that BS2A and BS2B interact on the topic. This also takes account of the removal of the FIRB approach, ie this only includes what still applies under our single IRB (AIRB) approach.

102. There is also some new text under specific forms of credit risk mitigation to distinguish the different ways that CRM feeds into the final RWA calculation under the standardised and IRB approaches: see sections B2.1(7) and (8), and C2.2(2) and (3).

103. Section A2.3(3) notes the general principle that CRM must not be double-counted. The following guidance now specifically clarifies how this applies to lender’s mortgage insurance (LMI), which can

already be used to apply a concessionary risk-weight to residential mortgage lending, subject to certain eligibility conditions (see sections C3.9 and C3.10 of BPR131).

Part B: Collateral

Simple v comprehensive approach

104. The current layout of BS2A makes it quite hard to understand what the distinction is between the simple and the comprehensive approaches to credit risk mitigation. BPR132 has been reorganised to make it clearer that this distinction only applies to the treatment of collateral, and to clarify which requirements apply under both treatments, and which apply under one or the other. This underlies the division of Part B into Subparts B1, B2 and B3.

105. None of this is intended to change the requirements in BS2A, but some additional explanatory text has been added particularly in B1.1 to clarify the intent. We have referred back to the Basel source when in doubt about the meaning.

106. The new text clarifies that the simple approach is not available for the cases where an IRB bank is using the standardised collateral treatment as part of an EAD calculation within an approved IRB model. This is implicit in BS2B and also supported by the Basel source. IRB banks have confirmed that this is their understanding.

107. Subsection B1.1(2) corresponds to BS2A section 63(3) and has been moved further up in the order of the material to confirm that it applies under both the comprehensive and simple approaches. This refers to capital requirements applying on both sides of SFTs and collateralised derivative transactions, and banks agreed that it should be included under both approaches.

Securities financing transactions ("SFTs")

108. BPR132 and the rest of the BPR documents reflect a rationalisation of the treatment of SFTs, repos and so on, as follows.

109. In the Basel II source, the term SFT refers to the following three categories of contract:

    (i) repos and reverse repos

    (ii) securities borrowing and lending transactions

    (iii) margin lending.

110. Instead, we have followed APRA's definition of SFT, which only covers categories (i) and (ii) above. This seems desirable both from the point of view of consistency with APRA, and because margin lending by New Zealand banks appears to be a retail-type product, rather than the wholesale-type business that the Basel II treatment is aimed at. References throughout BS2A and BS2B to the above terms and to SFTs are used inconsistency, but in the source material for BPR132, the term "repo-style transactions" is used, referring only to categories (i) and (ii) above.

111. We now use the term SFT consistently throughout the revised capital adequacy documents, wherever the current varying references appear, and have defined the term SFT in the Glossary to cover categories (i) and (ii) above.

"Lender" or "bank"? (B1.2 and B1.3)

112. The current BS2A text for the treatment of collateral appears to use "the lender" and "the bank" interchangeably. We have not found any clear distinction between the uses, so have reverted to the Basel II source which uses "bank" throughout.

Eligible collateral definitions (B1.2 and B1.3)

113. The definition of "cash" has been amended to refer to "cash collateral", and the term "balances on deposit" is now used to make it clear that this does not only mean physical notes and coin (subsection B1.2(1)(a)).

114. The eligibility criteria for debt securities have been set out more clearly in section B1.2(1)(b) and (c), and the links to the BPR131 rating treatment have been clarified and updated in line with the clarification between "short-term" and "long-term" provided in Part B of BPR131.

115. The eligibility of debt securities without an issue-specific rating relies on their being listed on a "recognised exchange" (see section B1.2(1)(c)). This term is not defined anywhere in BS2A or BS2B. There was no clear consensus among banks on this, with views split between providing specific lists, and providing general criteria (there are neither at present). We have not had time to develop any options for this, but aim to do so in due course.

116. Similarly, the eligibility of equity securities depends on their being included in the NZX 50 "or an overseas equivalent". The text (section B1.2(1)(d)) has been expanded to refer to "the NZX 50 or an overseas equivalent share market index", ie the main index on another national stock exchange.

117. BS2A Table 5.1 (collateral haircuts) currently includes a 25% haircut for "other equities" that are not in the NZX 50 (or overseas equivalent), although these are not included in the list of eligible equities. To confirm, these are not allowed as eligible collateral, and they have been cut from the equivalent Table B2.3 in BPR132. Related to this, BPR132 section B2.3(3) now states directly that the haircut to be applied to the exposure when the bank lends a non-eligible instrument is 25%, rather than referring to the "other equities" row in the table as section 65(2) in BS2A does. (Note that this applies only to instruments lent, since non-eligible instruments cannot be taken as collateral, by definition.)

Third party lodgement of collateral (B1.3)

118. BS2A section 61(1)(g) incorrectly refers to the treatment of collateral held by a third party, when it should refer to collateral lodged by a third party. (Compare APRA's APS112, Attachment H paragraph 14.) Subsection B1.3(3)(d) in the attached is the corrected version, and subsection B1.3(2)(a) has correspondingly been expanded to refer to the "agreement between the bank and the counterparty or third party lodging the collateral.

Calculation of adjusted exposure for collateral and adjustments to haircuts (B2.1 to B2.5)

119. In the methodology for adjusting exposure amounts for haircuts (sections B2.1 and B2.2, from BS2A section 64), subsection B2.2(2) has been substantially re-drafted. This is now generalised to apply to the case of collateral held against the net exposure on a group of netted derivatives, as well as the case of a single collateralised derivative. The wording has also been aligned better with the revised Part E of BPR131, simply referring to the value of CEA that comes out of the methodology provided there.

120. The following sections explaining the haircuts to be used and the adjustments to be made (sections B2.3 to B2.5) have also been clarified somewhat compared to the BS2A text, and a worked example

provided. We have added an explanation of what the term “holding period” refers to, to the guidance after section B2.3(1).

Zero haircut conditions (B2.6 & B2.7)

121. Among the conditions for zero haircut, the condition that is now at section B2.6(d) has been re-drafted compared to BS2A section 68(d), and explanatory guidance added to clarify the sense, by referring back to the Basel source. We have removed from the eligible instruments “PSEs with a 0% risk weight”, since there are none in our approach (and no plans for any). The wording has also been clarified to make it clearer that (i) the sovereign security must also be one qualifying for a 0% risk weight; and (ii) the exposure and collateral do not have to be both cash or both sovereign, ie the exposure can be cash and the collateral sovereign, and vice versa.

122. The definition of “core market participants” in BS2A includes “banks” without any further qualification. The term “bank” is now defined in the Glossary, so that definition will apply here. We note that the eligible list in BS2A is narrower than those specified by APRA or the Basel Committee, although banks have responded that this does not create any constraints for them at present, so we have left this unchanged in BPR132.

SFTs subject to master netting agreement (B2.8 & B2.9)

123. The calculation of net exposure for SFTs subject to a master netting agreement is covered in sections B2.8 and B2.9 in the attached, as part of the comprehensive approach to recognising collateral. This is a change from both BS2A (section 93) and BS2B (section 4.68(c)), where it is treated as a sub-topic of on-balance sheet netting. It seems to us to make better sense to include it within the collateral section, closer to where the necessary haircuts are defined, and also in the same section where the treatments for a single SFT and the zero haircut carve-out reside. This also matches the organisation in the Basel source document. Subsection B2.1(1) has been adapted, and subsection B2.2(3) added, to refer to the alternative formula for collateral in this case.

124. The guidance box after section B2.9(1) (taken broadly from Basel) has been added to try and explain the rationale for the formula. We have also updated the formula from BS2A and BS2B to provide a clearer, more precise version (see section B2.9(2)). Our thinking behind the way this is set out is that a group of n SFTs in a given netting set may include both securities lending and securities borrowing transactions (repos and reverse repos), so the positive exposure amounts can represent both cash and securities lent, and conversely the offsetting collateral received can be both cash and securities. The number of securities involved (m) may be less than the total number of SFTs in the netting set, if the same security is used in more than one transaction, and also there may be both long and short positions in a given security in the netting set.

Simple approach to collateral

125. Section B3.2 in the attached sets out the risk-weighting requirements under the simple approach to collateral. This comes from section 62 of BS2A, but the logic has been reorganised with the aim of making it clearer. The terms “exposure” and “bank” have been used in place of “claim” and “lender”, consistent with elsewhere. It does not seem strictly necessary to include any of the repeated references to “market value (at the most recent revaluation)” anywhere, but this has been moved to the separate subsection B3.2(4) to avoid doubt and remove the duplication. The guidance box after section B3.2 had been added in response to a request for a worked example.

Part C: On-balance sheet netting

126. In BS2A Section 92(4) (BS2B Section 4.68(b)), the formula for calculating the netted amount matches the standard collateral formula, with the exposure haircut H_E included, and BS2B further includes the

haircut for collateral H_C. Since on-balance netting is explicitly restricted to loans and deposits, we have concluded that the only haircut needed is H_{FX}, to apply when the loan and deposit are in different currencies. The methodology in BPR132 section C2.2(1) has been revised accordingly, and the definition of H_{FX}, has been spelt out more clearly by reference back to the general collateral definitions in subpart B2 (consistent with the Basel source). The text in subsection C2.1(2) has also been revised for consistency with those changes.

Subpart D1: Guarantees and credit derivatives – standardised approach

General

127. In BPR132, the BS2A material on recognition of guarantees and credit derivatives (sections 73 to 91) has been substantially reorganised in an attempt to make it clearer. This aims to reduce duplication by ordering the material as: (1) introduction and conditions applying to both guarantees and credit derivatives; (2) additional conditions applying only to guarantees; (3) additional conditions applying only to credit derivatives; and (4) mechanics of recognising guarantees and credit derivatives in the RWA calculation. Additionally, the adjustment for maturity mismatch is now covered in Part E, applying equally to all forms of credit risk mitigation, rather than being repeated in each case.

128. Generally in Part D we have aimed to use more consistent terminology, such as “credit protection provider”, “protected” (not “covered”), “obligor”, and “underlying exposure”. As elsewhere in BPR132, we have also refined some of the wording to make it clearer that this is about allowing guarantees or credit derivatives to be reflected in the RWA calculation: banks are generally free to use whatever forms of credit risk mitigation they wish for their own risk management purposes.

129. Section D1.1(3) deals with the cases where an IRB bank needs to use the standardised approach in subpart D1, and in particular D1.1(3)(b) covers the case where a standardised underlying exposure is protected by an IRB-modelled credit protection provider (following the Capital Review change to change some IRB exposure classes to standardised).

“Legally enforceable” requirement

130. The requirement in D1.2(2)(c) for a guarantee or credit derivative to be “legally enforceable”, and the associated guidance for guarantees, are not in the equivalent sections of BS2A. However, legal enforceability for credit risk mitigants generally is covered in BS2A section 58, while the guidance matches a requirement in BS2A section 4.110(a) that applies to guarantees under the FIRB approach. We believe this requirement and guidance are worth spelling out here, and the banks consulted raised no concerns about this additions.

Eligible types of credit derivative

131. Eligible types of credit derivative under the standardised approach are defined in D1.4(1). This corresponds to BS2A section 81(1)(a) and comes originally from Basel paragraph 193 “only credit default swaps and total return swaps that provide credit protection equivalent to guarantees will be eligible …”.

132. Although the Basel text does not explicitly restrict credit default swaps (CDS) to single-name CDS only, this is spelt out in BS2A, and seems appropriate to us, so we have kept this in section D1.4. It also matches APRA’s treatment. This does not prevent a standardised bank from recognising an index CDS in its CVA calculation, as permitted in Part F of BPR131.

133. We have reorganised the eligibility criteria in D1.4(1) to make it clear that the qualifier “that provides credit protection equivalent to a guarantee” applies to a credit default swap as well as to a total rate of

return swap. The Basel source (paragraph 193) is ambiguous, but we believe this interpretation makes sense.

134. The treatment of cash-funded credit-linked notes in section D1.8 has been expanded somewhat compared to the sources (BS2A 81(1)(b), from Basel paragraph 194 footnote 56). This aims to clarify the mechanics of such transactions.

Required accounting treatment for total return swap

135. Section D1.4(2) has been revised from the text in BS2A section 81(1)(a), by reference back to the Basel II source (paragraph 193). This text serves the purpose of preventing double-counting of the benefit of a total return swap, and corrects the error in BS2A, which seems to omit a “not” and so permits double-counting.

Maturity mismatch

136. BS2A section 81(3) appears to rule out a maturity mismatch, but section 90 provides a treatment for it. Section 81(3) derives from Basel paragraph 191(c), but the Basel source makes better sense, in that it is stated to be conditional on the maturity mismatch adjustment. We have therefore not kept any equivalent to BS2A 81(3), but have dealt with the whole maturity mismatch treatment (including the current reference to grace periods) in Part E.

Credit events covered by credit derivatives

137. Section D1.5 has been re-organised compared to the source in BS2A section 81(2)(d), to try and spell out more clearly that there is full recognition if all three types of credit event listed in D1.5(1) are covered, partial recognition if credit events apart from restructuring are covered, and no recognition if coverage is limited to any other subset of the credit events listed.

Credit derivatives with asset mismatch

138. In BS2A, sections 82 and 83(2) set out the asset mismatch treatment, while section 83(1) is on the unrelated topic of cash-settled credit derivatives. This has been reorganised in BPR132 so that section D1.6 covers cash-settled credit derivatives, and section D1.7 set out the asset mismatch requirements.

139. The asset mismatch approach in section D1.7 has been substantially re-worked, as the BS2A text is hard to understand and in some respects appears wrong. The revised text has been prepared with reference to the Basel original, although we have re-ordered that as well, as it also quite dense (see Basel II sub-paragraphs 191(d), (g) and (h)). A particular error in BS2A section 82 is the placement of the requirement for legally enforceable cross-default or cross-acceleration clauses: this should apply in all cases, not only in case (ii) under 82(2)(b). This is clear from comparison with the Basel original, and we believe that it also fits the policy rationale.

140. It is worth noting that Basel does not allow the situation where the underlying exposure is an obligation <u>of an entity that is guaranteed by the reference entity</u>, rather than being an obligation <u>of the reference entity itself</u> (ie, the entity that is the obligor of the reference obligation). However, the current approach in BS2A does allow this, and APRA have also included this treatment in their standardised approach, so we see no reason not to keep it (see D1.7(2)(b)).

Currency mismatch adjustment

141. Compared to BS2A, the currency mismatch treatment in D1.9 now spells out the formula for adjusting the haircut H_{FX} (if necessary), rather than relying on a cross-reference back to the collateral approach. The formula in D1.9(3)(b) also incorporates the assumption that T_M is fixed at 10, which is not explicit in BS2A, but appears in the Basel source (paragraph 200). (The guidance following D1.9 explains the

link.) This adjustment is only presented once, to apply to both guarantees and credit derivatives, rather than twice as in BS2A.

“Tranched cover”

142. Sections 76 and 87 of BS2A rule out “tranched cover”, ie the case where the bank bears the first loss on an exposure under a guarantee or credit derivative. In the attached, this has been incorporated into the general approach to application: see D1.11(2). For consistency, we have replaced “covered” and “uncovered” with “protected” and “unprotected”. In addition, we have revised this subsection to clarify that, as well as the case where the bank and protection provider have equal ranking and so share losses on a pro rata basis (“proportional cover”), there is also the case where the protection provider ranks behind the bank, and covers the full loss up to the amount of protection provided. (See Basel II paragraphs 196 and 198.) (The risk-weighting approach is the same in both cases.)

Subpart D2: Guarantees and credit derivatives (“G & CDs”) – AIRB approach

143. In BS2B, sections 4.98 to 4.133., sections 4.297 to 4.300 and section 4.301 set out the method for recognising guarantees and credit derivatives for credit risk mitigation purposes under both the FIRB and AIRB approaches. There is a certain amount of repetition, and it is quite unclear which material applies under either or both of the IRB approaches. Subpart D2 aims to remove all FIRB-only material, fill in the details of the AIRB approach where BS2B does not make it clear, and also make it clear which parts of the approach are shared with the standardised approach in subpart D1.

Maturity mismatch adjustment (AIRB)

144. BS2B does not make it entirely clear how banks using the AIRB approach should adjust the amount of a guarantee or credit derivative when the credit protection expires before the underlying exposure. However, we have identified the Basel II paragraph (325) that applies the standardised maturity mismatch treatment to exposures in the corporate, sovereign and bank exposure class under AIRB as well as FIRB, and this is the approach also taken by APRA, and was confirmed by IRB banks as how they understand this. This is reflected in section D2.1(2) of BPR132, which cross-refers to the standard maturity mismatch approach set out in Part E.

145. We have also revised the existing wording of BS2B 4.130(b), which says that a guarantee or credit derivative must be “*in force until the debt is satisfied in full (to the extent of the amount and tenor of the guarantee or credit derivative*” (this is closely based on the Basel original). This could be read as ruling out any recognition for a guarantee or credit derivative that expires before the underlying exposure. However, we have concluded that the “debt” referred to must be that of the credit protection provider, not that of the underlying borrower. Subsection D2.2(4)(b) now includes the revised text to clarify this point. Note that with this interpretation, this is in fact putting a general condition on the nature of the credit protection contract, rather than referring to a maturity mismatch.

Enforceability

146. The current wording of BS2B section 4.130(c), which comes from Basel II paragraph 484, seems obscure to us. It appears that the intended sense is that: (a) the bank can obtain judgement against the credit protection provider; and (b) the credit protection provider has sufficient assets to meet its obligations in the jurisdiction in which the judgement was given; and (c) the bank has a legal ability to access those assets, should the provider fail to comply with the judgement. The corresponding section D2.2(4)(c) in BPR132 has been re-worked to convey this sense.

Recognition of Guarantees & Credit Derivatives under AIRB approach

147. Section D2.3 pulls together a number of strands from BS2B, where it is not at all clear, to spell out the mechanics of how an AIRB bank must reflect a guarantee or credit derivative in its RWA calculation. The main source is BS2B section 4.131. This states the main principle of the AIRB approach, as opposed to the FIRB approach, which is that a bank may adjust either the PD or the LGD estimate on the exposure.

148. BS2B section 4.131 has an error in referring back to section 4.111: it should refer to section 4.107, which sets out the PD adjustment approach (ie the only approach allowed under FIRB). Reflecting this, we have broadly incorporated the material from BS2B section 4.107 into BPR132 section D2.3(6) and (7). This deals at the same time with proportional cover (which section 4.111 also deals with, duplicating some of section 4.107). BS2B section 4.107 refers to a PD floor "detailed in section 2". That cross-reference only makes sense in the context of the corresponding APRA source text (see section 2 of Attachment B in APS 113), so the revised text refers to the corresponding PD floors in the RBNZ framework, which are in the separate IRB credit risk document (BPR133).

149. In brief, the PD adjustment approach divides the exposure into covered and uncovered portions, and uses the respective risk-weight formulae for each, with PD only being adjusted on the covered portion.

150. The LGD adjustment approach is not spelt out in detail anywhere either in Basel or in BS2B, so there is new text in sections D2.3(3) and (4) which is our assessment of what that approach should entail, as follows:

    - the bank takes into account the impact of the credit protection entirely by estimating how much it reduces the LGD percentage. This means that, regardless of how much of the exposure is covered by the credit protection, the risk-weight formula and PD to be used remain those of the underlying exposure.
    - for exposures where our AIRB approach specifies LGDs (residential mortgages and farm lending), the LGD estimate must not be reduced from the percentage specified. (So in practice, the LGD adjustment option is not available in these cases: but the PD adjustment approach still is.)

151. This is new policy text, but represents our best assessment of what we think is the logic of adjusting LGD. IRB banks consulted have agreed with this approach.

152. Subsection D2.3(8), based on BS2B section 4.103), clarifies how to determine M for the risk-weighting function to be used when recognising a guarantee or credit derivative, and has been included here as this seems to be the most logical place for it.

Tranched cover

153. Currently, BS2A and BS2B are clear that tranched cover is not allowed under the standardised or FIRB treatment, but it is not entirely clear whether this extends also to the AIRB approach. (This refers to the case where the credit protection provider does not cover the whole exposure, and the bank takes the first loss.) In light of feedback from IRB banks, BPR132 now clarifies that tranched cover is not recognised under the (A)IRB approach either (see section D2.3(2)). This has also been expanded to refer not just to equal seniority (ie pro-rata protection), but also to the case where the protection provider ranks junior to the bank, ie the protection provider covers the whole loss up to the amount of the coverage. This is now more closely aligned with the standardised version as well (see subsection D1.11(2)).

Minimum standards for guarantees applicable also to credit derivatives

154. We received feedback from banks that all relevant (A)IRB requirements for guarantees should apply to credit derivatives as well. This is reflected in sections D2.4 to D2.6, and is a change from the source text, where the applicability is ambiguous. Section D2.4 reflects a further minor amendment, to reflect the fact that "assigning" a credit rating is not a one-off event. (This aligns with the Basel II source, paragraph 481.)

Credit events covered by credit derivatives: IRB case

155. Following feedback from banks, the revised drafting clarifies that that the requirements on the credit events to be covered by a credit derivative under the standardised approach should apply equally in the IRB case. This is now achieved by subsection D2.8(d), which refers back to the standardised requirements in section D1.5.

Part E: Maturity mismatch treatment for CRM

156. As there is a standard maturity mismatch treatment that applies to all forms of CRM, this is now provided in one place in BPR132, namely BPR132 Part E. This matches the layout in the Basel source, and removes the duplication in BS2A and BS2B, which repeat the treatment in each section covering different forms of CRM. Some errors have been corrected in the process. For instance, in BS2A, sections 70(2) and 78(2) both refer to minimum residual maturity of the CRM being 12 months, whereas both the context and the Basel source make it clear that the restriction should be that the minimum original maturity is 12 months.

157. The adjustment formula in section E1.4 of BPR132 has been adapted to incorporate the (existing) requirement that CRM with a maturity mismatch is not recognised once its residual maturity is less than 3 months, by fixing the result at zero once (t-0.25) falls to zero.

Credit risk mitigation for IRB retail exposures and purchased receivables

158. The treatment of credit risk mitigation for IRB exposures is mainly spelt out in BS2B for exposures in the corporate, sovereign and bank exposure class. The regulator-defined CRM approaches set out in BPR132 apply to IRB retail exposures in mainly the same way as they do to corporate, sovereign and bank exposures. For completeness, we summarise here how the IRB retail exposure treatment in Part D of BPR133 refers to credit risk mitigation:

159. The application of this approach to the retail exposure class is addressed in the way that the IRB credit risk approach in BPR133 cross-refers to BPR 132, but we think this is mainly a straightforward adaptation of some current BS2B sections as follows:

    - BPR133 section D3.7 deals with the recognition of collateral in the retail case (this corresponds to BPR133 Section C3.3 for the corporate case). An IRB bank can generally recognise collateral in its own way in LGD estimation, but these sections spell out the exceptions.

    - BPR133 section D5.6 clarifies that for AIRB retail (as for corporate) exposures, EAD for counterparty credit risk is calculated using the standardised approach in Part E of BPR131, which relies in turn on the standardised collateral approach in BPR 132 Part B. (This is based on BS2B section 4.159, although that contains some errors.)

    - BPR133 section D5.4 straightforwardly applies the standardised on-balance sheet netting approach to retail EAD estimation. (This derives from the second part of section 4.154 in BS2B, but again that contains some errors).

- For retail exposures protected by guarantees or credit derivatives, BPR133 section D4.1 refers to Subpart D2 (and D1 as applicable) of BPR132 for the methodology to use. (This comes from BS2B sections 4.160 to 4.162, although 4.161 and 4.162 are superfluous as they refer to specific parts of the general approach that 4.160 cross-refers to.)

160. For purchased receivables, Subpart E5 of BPR133 sets out the risk mitigation considerations (for both credit risk and dilution risk). This allows only guarantees to be recognised, in line with the BS2B source (sections 4.195 to 4.198) and also Basel.

BPR133: IRB Credit Risk RWAs

Introduction and general points

161. BPR 133 is a re-worked version of BS2B Subparts 4A and 4B.

162. One main change has been to provide a proper hierarchy of headings and sub-headings, to make it easier to follow how the various topics covered are grouped together. The correct grouping is far from obvious in BS2B, and we have gone back to the Basel source material to clarify how the material should be grouped.

163. Other key changes include the removal of material relating to the FIRB approach wherever it appears, and also the QRRE treatment (as consulted on and agreed in 2015). Also, in line with the revised high-level structure of the capital adequacy documents, all material setting out supervisor-specified treatment of credit risk mitigation is now in BPR132 ('Credit risk mitigation'), and the methodology for counterparty credit risk on derivatives and SFTs that is common with the standardised approach is now in BPR131 ('Standardised credit risk RWAs'). The material has been replaced in BPR133 by suitable cross-references.

164. A certain amount of entirely new text has been provided in BPR133 to help clarify structure and links between different sections. All sections are marked to show which sections of BS2B they come from, or otherwise that they are new text.

Part A: Introduction and Overview

165. Section A1.1 is new text. There are two main purposes for this new text:

- First, it aims to make clearer up-front the distinction between the calculation of RWAs for credit risk unexpected loss (UL) that goes into the denominator of the capital ratio, and the calculation of EL on credit risk that goes into the numerator. At the moment this is implicit from BS2B sections 4.1, 4.10 and 4.207 among others, but in a non-transparent way.

- Second, it aims to make it clearer that these approaches are to be used only by a bank that has been accredited to use IRB models for credit risk, and only for credit risk exposures within a portfolio for which the bank has an accredited IRB model.

166. Subpart A2 comes from section 4.2 of BS2B and provides a general overview of the exposure categories, and has been inserted here so that the following Subpart A3 can include the summary description of the RWA calculation for IRB credit risk. The detail of the exposure class definitions has been put into a separate Part B, as it seems a substantial enough subject to merit its own part. Section A2.1(1) cross-refers to the overarching scope of the credit risk RWA calculation from BPR130, and A2.1(7) makes it clear that BPR133 is only for calculating RWAs on modelled exposure classes.

167. Subpart A3 is all new text, providing an overview of the RWA calculation, in line with a similar Subpart in BPR131 for the standardised approach. As there, the intention of summarising all the components of the RWA calculation in section A3.2 is both to help provide certainty about what needs to be included in total IRB credit risk RWAs, and also to make BPR133 as a whole easier to navigate.

Part B: Exposure categories

168. In the definitions of the corporate specialised lending sub-categories, a certain amount of the existing text has been presented in guidance boxes, as this material is in the form of discussion or examples (see sections B1.4 to B1.7). We have done the same to a limited extent with subsequent category definitions as well.

169. In BS2B, the discussion of corporate purchased receivables in subsection 4.4(b) largely duplicates the later sections 4.176-4.181. These set out eligibility conditions for the top-down approach to corporate purchased receivables, rather than simply defining the category. Hence section B1.8 now only includes a brief definition of corporate purchased receivable, with the rest deleted. (The detailed eligibility criteria now appear only in Subpart E3.)

170. In the definition of the sovereign exposures class, the list of supranationals etc has been replaced by the reference to "lowest-risk multilateral development banks and supranationals", a term which is now defined in one place in BPR131, and also included in the Glossary by reference to BPR131. The list has been revised compared to the current BS2B version, in line with the latest Basel Committee version.

171. We have simplified the current categorisation of residential mortgage loans in BS2B by removing all time-expired definitions, and the definitions of the key terms have been cut from here, and rely on BPR131 as the principal source (see section B4.2). This removes duplication, and also means that in the LVR policy (BS19), the definitions can rely on a single source, regardless of whether the bank is IRB, standardised, or an overseas-incorporated bank.

172. The definition of equity exposure has been greatly simplified and shortened in section B5.1, so that equity exposures are defined in the same way and are subject to the same standardised RWA calculation under both the IRB and standardised approach (see BPR131 sections C2.13 and C2.14).

173. Section B6.1 refers to all exposures not covered elsewhere, unchanged from section 4.9 of BS2B. No such exposures fall within any of the IRB exposure classes, so RWAs on these are now calculated by reference to BPR131.

Part C: RWAs for corporate, sovereign and bank

174. BS2B Sections 4.10 to 4.14 have been substantially re-worked into the new Subpart C1 of BPR133. This reflects a number of structural changes –

    - There is no longer a single Part corresponding to Subpart 4B of BS2B, but instead Part C deals with the RWA calculation for the corporate, sovereign and bank exposure class, Part D deals with the retail RWA calculation, Part E RWAs for purchased receivables, and Part F the Expected Loss calculations. We think this allows clearer navigation.
    - Discussion of the differences between the AIRB and FIRB approach has been cut.
    - We have provided clearer signposting of later sections dealing with the various components of the RWA calculation (PD, LGD etc), but this now only needs to do so for the corporate, sovereign and bank exposure class.
    - We have also provided clearer flagging up-front of the distinction between capital requirement (K) and RWA (= 12.5 x K x EAD), which is also made clearer where the respective formulae are set out.

175. Section C1.2 is new here, and deals with exposures arising from leases which will fall under the corporate IRB exposure treatment because they create and exposure to a corporate counterparty. This replaces the lease methodology in the "other exposures" sections 4.204 and 4.205 in BS2B, and also incorporates material from BS2B Subpart 4C: the definition of "residual value risk" in section 4.323. The risk-weighting for residual value risk is 100%, so strictly speaking that is provided in BPR131.

176. Section C2.3 is a shorter version of BS2B section 4.19, as it only needs to provide a cross-reference to the full description of how a guarantee or credit derivative is taken into account, provided in Subpart C4 (with reference to BPR132 Credit Risk Mitigation).

177. All of the BS2B material setting out the specified LGD treatments of collateral under the FIRB approach has been deleted (BS2B sections 4.20 to 4.60). However, of these sections, the recognition of eligible financial collateral for credit risk mitigation (BS2B sections 4.30 to 4.48) does correspond to the standardised treatment, and appears in BPR132. This material applies to AIRB banks only in relation to EAD arising from counterparty credit risk.

178. Subpart C3 covers LGD estimates, and starts from BS2B section 4.61 (which is section C3.1 of BPR133).

179. Section C3.3 replaces section 4.62 of BS2B, but is largely new text, aiming to clarify how an AIRB bank may take account of credit risk mitigation in the calculation of LGD. (The intended sense of BS2B section 4.62 still appears within section C3.3(2), in relation to SFTs.) The recognition of collateral in the IRB approach should be part of the bank's modelling of LGD under an approved IRB model (but subject to the minimum LGDs specified for housing and farm lending). However, the exception to this is in the recognition of collateral in the calculation of the exposure amount (CEA) for counterparty credit risk, given that IRB banks are subject to the standardised approach in this case. In this case, a bank can adjust the CEA to recognise collateral using the standardised method set out in BPR132 (see BPR132, section B2.2(2)) – the adjusted figure is reflected in the EAD rather than LGD for the counterparty. The bank can still use its own estimate of LGD for the residual adjusted exposure E*.

180. Part C4 dealing with the recognition of guarantees and credit derivatives is now very short, mainly providing cross-references to BPR132. The material from BS2B sections 4.98 to 4.133 has now been incorporated into BPR132, substantially re-worked and with duplication with the standardised approach removed: none of these sections of BS2B have been kept in BPR133. The thinking behind moving this Subpart earlier in the document (compared to BS2B) is that guarantees and credit derivatives may be used to adjust either PD or LGD, so this follows immediately after Subpart C2 (covering PD) and Subpart C3 (covering LGD).

181. Guidance has been added after section C4.1, to refer to the case where the credit protection provider is within a standardised exposure class. (This will be more common once the IRB bank and sovereign exposure classes switch to standardised.)

182. Part C5 deals with EAD estimates for corporate exposures. This comes from BS2B sections 4.64 to 4.84, but with substantial re-organisation to remove the FIRB approach, to make it clearer which parts of the FIRB approach are relevant for AIRB banks, and to cross-refer to the standardised approaches in BPR 131 and BPR 132 where those are applicable to AIRB banks. This gives the following:

    - Section C5.2 gives over-arching requirements, gathered from different parts of BS2B. The cross-reference to the minimum system requirements for using the AIRB approach to EAD are given incorrectly in BS2B section 4.84. The reference should be to sections 4.291 to 4.296 (rather than to 4.153 to 4.162). These minimum requirements are now in BPR 134, so subsection C5.2(1)(c) now cross-refers to the right part of BPR134.

    - Section C5.3 sets out the EAD methodology for AIRB on-balance sheet exposures, based on BS2B sections 4.66 and 4.67, which applies to AIRB banks because of BS2B section 4.84. The guidance provides a worked example. There is a proposed minor correction –

        - The reference to the "amount by which Tier 1 capital would be reduced" has been changed to refer to CET1 capital. Basel made this change when CET1 capital was

introduced as part of Basel III, which seems logical to us, as CET1 is where credit impairment losses are absorbed. APRA also refer to CET1 capital.

- Section C5.4 cross-refers to BPR132 for the methodology for on-balance sheet netting. The material in BS2B section 4.68 (a) and (b) (with corrections, as previously discussed) appears in BPR132, and applies also to standardised banks.

- Section C5.5 provides the measurement approach for commitments, guarantees given etc. This conflates the FIRB approach in BS2B sections 4.69 to 4.72 with section 4.84. BS2B section 4.84 says that under the AIRB approach, the bank can estimate its own CCF, except that a CCF of 100% applies when the instrument would have had a 100% CCF in the FIRB approach. C5.5 subsections (6) and (7) list the categories with the 100% CCF and those available for internal modelling, respectively.

    - As part of this, we have corrected an error in BS2B section 4.71: the exposure amount that the bank must multiply by the CCF is the gross amount (before provisions). This is a key distinction between the standardised and IRB approaches. (See BPR 133 subsection C5.5(5).). This correction aligns our text with the Basel source (paragraph 308), and is also consistent with the approach for on-balance sheet exposures (see BPR133 section C5.2(2)). The logic is that, for IRB banks, provisions in excess of expected losses (which are based on EAD) can be added back to Tier 2 capital.

- The measurement of exposure for counterparty credit risk (section C5.6) now relies on brief cross-references to the standardised approach which is covered in BPR131, to remove duplication. This cuts all of BS2B sections 4.73 to 4.82U, and also the treatment given in section 4.68(c) of "repo-style transactions" (now "SFTs") covered by a master netting agreement. The layout generally tries to bring out more clearly the major difference between off-balance sheet contingent items (guarantees, NIFs etc) and counterparty credit risk on SFTs and derivatives.

183. In subpart C6, the methodology for calculating maturity (M) for corporate exposures in BS2B sections 4.86 to 4.96 has been substantially re-worked, by reference back to the Basel source and to APRA's approach. The new layout aims to remove confusion and unnecessary duplication. A few points to note:

    - References to repo-style transactions, securities lending transactions and margin lending have been replaced with references to SFTs, in line with the treatment adopted throughout the capital framework.

    - The exemptions from the one-year floor (sections C6.6 and C6.7) have been moved to come after the general methodology (sections C6.2 to C6.5).

    - The exemption for SFTs and short-dated OTC derivatives (section 4.95) has been put before the more general exemptions (sections 4.91, 4.92 and 4.96), and rationalised. (See section C6.6.)

    - Subsections C6.6(3) and (4) aim to remove ambiguity around the calculation of weighted average M for derivatives and SFTs subject to master netting agreements: this now spells out that the 5 day/ 10 day floors apply to the weighted average, not to the individual transactions in calculating the average. (The Basel II source (paragraph 323) makes this quite clear, but the BS2B version does not.)

    - In the more general exemptions (section C6.7), the current BS2B subsections 4.91(a) and (b) have been cut: on the one hand, they duplicate the exemptions for SFTs and short-dated OTC

derivatives, which are now more clearly specified in section C6.6; on the other hand, the reference to “short-dated loans and deposits” in 4.91(a) is either too vague to be helpful, or would appear to exempt far more exposures than is the intent of the policy. Also, the option for additional exemptions with Reserve Bank approval has been moved to this section (see subsection C6.7(3)).

184. Note that we have kept the exemptions for exposures from securities settlement, cash settlement by wire transfer, and failed FX settlement (see subsection C6.7(1)(b) to (d)), as we heard from that they apply the under 1 year exemption in the case of short-term cash settlement accounts and unsettled FX transactions. We note that as follow-up work, we might need to clarify what the credit risk treatment should be for such exposures, as it is not spelt out at present.

185. We have deleted BS2B section 4.97, as it does not add anything. “Explicit adjustment” refers to the value of M that is calculated, which is fully specified above. It is true that when M=2.5, the adjustment to the capital function to reflect M is nil, but there is no need to say that.

186. We have put the methodology for “R” (correlation) for corporates, sovereigns and bank into a separate part (Subpart C7), as there are now several legs to it. This includes the standard R specified in the formula for K in BS2B section 4.136, the AVCM adjustment in section 4.136A, and the firm-size adjustment in sections 4.139 and 4.139A.

    - In the AVCM adjustment (section C7.3), the discursive descriptions of “regulated financial institution” and. “unregulated financial institution” have been presented as guidance, as this seems appropriate. We have replaced the reference to “thrifts” with “non-bank deposit takers”, as that seems the closest New Zealand equivalent, and have deleted “futures commissions merchants” as that does not seem relevant in the New Zealand context.
    - The formula for the firm size adjustment (section C7.4(3)) has been tidied up (for example, S in the formula as written must refer to the multiple of $1mn, rather than being the actual $ sales amount). Also, if total sales is “not meaningful”, then the alternative measure, total assets, must be used not only in the calculation formula (as in BS2B), but also for applying the size test: the requirement has been reorganised accordingly.

187. Section C8.1 has been re-drafted somewhat compared to the BS2B source, to bring out more clearly that K is different from RWA (which is also brought out by the following headings).

188. Section C8.3 (providing the capital requirement for defaulted corporate exposures) corrects a problem in the equivalent BS2B section 4.137. In BS2B, the units are wrong, in that the method produces a value of K that is a $ amount, which is then multiplied in section 4.138 by the $ amount for EAD, to derive the RWA figure. The corrected version gives a percentage value for K. A guidance box has been added to present the description as a formula.

189. Subpart C9 provides the supervisory slotting approach for corporate specialised lending exposures. For the slotting approach only, we have combined the calculation of UL (to be added to total RWAs) and EL (for adjusting capital) in one place: as there is a lot of overlap between the UL and EL calculations for the slotting approach, this removes some duplication and seems clearer overall. The general treatment of EL for all exposure classes is set out later on in BPR133, in Part G: the supervisory slotting case is covered there by a short cross-reference back to Subpart C9 for the detailed methodology.

190. The calculation of the exposure amount under the supervisory slotting approach is set out twice in BS2B, in footnote 45 (to section 4.143) and footnote 54 (to section 4.210). The on-balance sheet component is the book value of the exposure, gross (without deducting any provisions). The calculation of the off-balance sheet component is not entirely clear or consistent between the two footnotes: as

currently worded, the intention seems to be broadly to use the FIRB approach. As the FIRB approach has been removed, it is no longer available to cross-refer to.

191. The solution we have adopted here (see section C9.2) is to cross-refer to the standardised methodology for off-balance sheet exposures in section D2.2 of BPR131, but add an override in this section to deal with the two differences between the standardised and FIRB calculation in this area: namely (1) the CCF for NIFs and RUFs is 75%, as opposed to the 50% CCF under the standardised approach, and (2) the CCFs are applied to the gross principal amount, ie before deducting provisions.

192. Table C9.3 comes from the table after BS2B section 4.143, but with the external ratings row removed. Banks are required to map exposures to one of the slotting categories using the criteria set out in the Appendix, and apply risk weights based on that mapping, so the external credit ratings essentially provide guidance, which is now provided after C9.1(3). We think that showing the ratings alongside the risk-weights was confusing.

Part D: retail RWAs

193. Subparts D1, D2 and D3 largely follow the source material in BS2B sections 4.144 to 4.151, except:

- Subsection D3.2(3) includes within the LGD treatment material that currently is only mentioned later under EAD (BS2B section 4.157).
- The definition of LVR in section 4.150A has been unpicked into the definition in section D3.3, and the separate eligibility conditions for the residential property valuation policy, property valuer and the nature of the valuation (sections D3.4 to D3.6). Section D3.3 sets the LVR at a fall-back value of 101% if the eligibility conditions are not met. This corresponds to the new LVR definition in BPR131 (sections C3.5 to C3.8). However, the IRB approach still needs its own definition of LVR, since it uses a loan value including EAD.
- Section D3.7 is new, spelling out how a bank can take account of credit risk mitigation in its LGD estimates. We believe this is all implicit in the current approach, noting that the specified minimum LGDs for residential mortgage lending already take account of the collateral provided.

194. Subpart D4 on the recognition of guarantees and credit derivatives corresponds to subpart C4 for the corporate (etc) exposure class, and likewise has been moved earlier to come immediately after the PD and LGD subparts. Sections 4.161 and 4.162 in BS2B have not been kept here, as the material is already reflected in BPR132.

195. Section D5.3 simplifies the calculation method for EAD for on-balance exposures by simply referring back to the corporate method in section C5.3. The current BS2B approach in sections 4.153 and 4.154 (first paragraph) contain the following errors which are thereby fixed:

- The reference to “the amount by which the minimum capital requirement would be reduced” is wrong: this should refer to the reduction in capital itself. The Basel source here refers to “regulatory capital” which is not precise: APRA refers to CET1 capital, which makes the best sense and is what we have used in the corporate approach in section C5.3. Cross-referring back to that ensures a consistent approach.
- The cross-reference from section 4.154 back to subsection 4.53(a) is an error and should refer to 4.153(a).

196. The rest of BS2B section 4.154 after the first paragraph is on the quite separate issue of on-balance sheet netting, and hence needs to be presented separately: this is now done by section D5.4, by reference to the treatment set out in BPR132.

197. Section D5.5 comes mainly from BS2B sections 4.155 to 4.158, but material has been added (i) to clarify that the notional exposure amount must be gross of provisions, (ii) to cross-refer to the minimum system requirements in BPR134 and (iii) to clarify that drawn amounts get on-balance sheet treatment.

198. Section 4.159 of BS2B provides the EAD method for the counterparty credit risk on any FX and interest rate derivatives in the retail category (if there are any). It is currently quite confusing: the cross-reference to sections 4.72 to 4.80 is wrong (it should refer to sections 4.73 to 4.83); the statement that own CCF estimates are not permitted for retail exposures is confusing, as own CCF estimates are not allowed for market-related exposures to corporates either; and in any case the term “CCF” is generally only used for commitments and contingents etc, not market-related contracts. The reference to foreign exchange and interest rate commitments also appears wrong (although it is in the Basel source): to make sense in this context, the word “commitments” needs to be replaced by “derivatives”. This is all borne out by comparing APRA’s version: see APS113, Attachment C, paragraph 13. In BPR133, we have fixed all of this by the short section D5.6 which refers back to the standardised counterparty credit risk methodology (the same as used for IRB corporate exposures).

199. In Subpart D6 (retail RWA formulae), the QRRE (Qualifying revolving retail exposure) subclass has been removed.

200. Section D6.1 corresponds to section 4.163, but reflecting the changes noted below, it now notes that this subpart excludes reverse residential mortgages, as they are subject to a standardised treatment provided in BPR131 (this categorisation is also set up in BPR130). Section D6.1 also refers to the separate approach for defaulted retail exposures.

201. The current RWA definition for reverse residential mortgage loans in BS2B is unclear on what happens in case of default. Implicitly the RWA calculation for defaulted retail exposures in sections 4.167 and 4.168 is also meant to apply to reverse mortgage loans, but it is not a good fit, given that it is an IRB treatment: for example, it refers to LGD and EAD, which are not estimated for reverse mortgage loans. This issue has been resolved by acknowledging that the reverse mortgage treatment in BS2B is standardised, and simply having the RWA treatment in one place in BPR131 (section C3.10), for both IRB and standardised banks.

202. Also in D6.4 (RWA for defaulted retail exposures), the same problem as in the corporate, sovereign and bank case has been fixed. (See section C8.3 and the commentary on it above.)

Part E: purchased receivables

203. Section E1.2 corrects the errors in BS2B section 4.170 where placeholders for cross-references were never filled in.

204. Section E1.3 “Minimum requirements for risk quantification” has been moved here from the Subpart 4C material in BS2B, rather than being put into BPR134 (IRB minimum system requirements). This comes from BS2B section 4.302 (and the footnote, which has been incorporated into the main text). This material seems to us rather different from the rest of the operational requirements in Subpart 4C, as it sets specific requirements about grouping receivables into homogeneous pools, which underlies the RWA calculation methods set out in subparts E2, E3 and E4. It therefore seems to fit more logically here.

205. Subpart E3 (credit risk for purchased corporate receivables) has been tidied up considerably compared to the BS2B source (sections 4.176 to 4.188) with better use of sub-headings and some duplicate material removed. Material that is only applicable for the FIRB approach has been deleted.

206. The conditions in sections E3.2(2) and (3) suggest that the top-down approach for corporate purchased receivables has never been used: we are not aware of any IRB bank having requested approval for this, nor of any bank having established an asset-backed securitisation structure to hold purchased receivables.

207. In the criteria for the top-down approach, BS2B section 4.180(c) just requires that “there is a claim”, but we think this needs to make it clear that it is the bank that has the claim: see section E3.3(1)(d).

208. The methodology for the top-down approach set out in sections E3.4 to E3.7 has been generally restructured for greater clarity (compare with APRA’s APS113 Attachment D paragraphs 12-17).

209. The calculation of the appropriate R (correlation) provided in subsections E3.4(3) and (4) has been inferred from footnote 49 to section 4.184 in BS2B, along with the various R treatments in the corporate, sovereign and bank risk-weighting approach (see subpart C7).

210. Section E3.6 tries to explain better how the dilution risk capital charge is deducted from the credit risk EAD amount. This is drawn from the description of EAD in the middle of BS2B section 4.188. The basic idea is to avoid double-counting: dilution risk RWAs for a pool of receivables is a measure of how much the pool is likely to be smaller than expected because of asset dilution, so this amount needs to be subtracted from EAD before applying the risk-weighting for credit risk (ie, a bank does not face credit risk on assets it no longer has). The Basel source says that to derive EAD, a bank deducts “capital charge for dilution risk” from “amount outstanding”. These must both be dollar amounts: section E3.6 (and explanatory guidance) aim to ensure that the gross EAD figure and the amount to deduct are in the same units. (We have introduced the term $K_{dilution}$ in Subpart E4 to help clarify the calculations.)

211. The definition of M (maturity) for the RWA calculation for top-down corporate receivables is not very precise in BS2B (see last part of section 4.188). The revised text in section E3.7 follows the Basel source and APRA more closely in cross-referring to the corporate M calculation in Part C6: we take this to be what “effective maturity” means. We assume this means that effective maturity for each exposure in the pool must be calculated using the method in Part C, including the 1 year / 5 year floor and ceiling, and then calculating a weighted average using exposure amounts as weights.

212. The RWA calculation for dilution risk uses the corporate risk-weight function. This is stated in BS2B section 4.192, and is in the Basel source. However, it is quite unclear what some of the necessary components of the risk-weight function are. This is a problem in the Basel source material, reflected in BS2B (sections 4.189 to 4.193):

   - Section E4.2 retains the proviso that the bank must calculate a capital requirement for dilution risk “unless immaterial”.
   - Basel does not specify which formula to use for R (correlation). This suggests by default it is the standard corporate formula for R, so this is what we have stated in subsection E4.3(2)(c).
   - For M, the Basel instruction is to use an “appropriate maturity treatment”. Without anything else to go on, we have kept this wording (subsection E4.3(2)(d)). This suggests banks should model their own estimate for M. However, a bank can also apply to the regulator to use a fixed one year value (see subsection E4.3(3)), so implicitly there must be a one-year floor on any own estimate.

- While the capital requirement formula $K_{dilution}$ is specified, the source material, and hence BS2B, do not spell out how then to calculate RWAs for dilution risk. Section E4.4 sets out what we believe logically must be the right approach. First, as in every other case, RWAs = $K_{dilution}$ x 12.5 x EAD. Second, we have to define EAD. For retail pools and corporate pools using the bottom-up approach, this must simply be the standard retail or corporate EAD from Part C or Part D. For corporate pools under the top-down approach, EAD must be consistent with the EAD defined for the credit risk calculation in section E3.6. This means that dilution risk EAD is the gross exposure amount defined in section E3.6(2), for consistency with the credit risk EAD, which is that gross amount less the dilution risk RWAs. This is reflected in section E4.4, with guidance added to try and explain this.

213. Note that sections 4.194 and 4.199 in BS2B both repeat earlier material, so are not kept in BPR133.

214. Subpart E5: Credit risk mitigation on purchased receivables. Although the introductory text in the Basel source (paragraph 373) starts with “Credit risk mitigants will be recognised generally…”, a guarantee is the only type of CRM for which Basel specifies how it should be applied to purchased receivables. The existing BS2B text broadly follows Basel here. In Subpart E5 therefore we have changed the heading to make it clearer that this material is here specifically about the treatment of guarantees. (This is in line with APRA.)

BS2B: Other exposures and claims

215. As noted elsewhere, sections 4.200 to 4.206 set out mostly standardised treatments, which have not been retained in BPR133: these are now covered in sections C2.13 to C2.18 of BPR131.

216. The treatment of an exposure to a lessee under a lease granted by the bank is now dealt with in section C1.2 (in the introduction to the corporate risk-weighting approach). BS2B section 4.205(a) specifies the calculation of the exposure amount in this case, but the PD, LGD and risk-weight function to use can be covered under the corporate risk-weighting approach.

Part F: Expected losses and eligible allowances

217. The organisation and section headings of this Part have been generally tidied up with the aim of making it easier to follow. As noted above, the details of the EL calculation for the supervisory slotting approach have been moved to Subpart C8, but the approach is referred to in the introduction to Part F, and there is a cross-reference to the detailed methodology from subsection F1.2(2).

218. In light of the narrowing of the scope of BPR133 to only provide the methodology for modelled exposure classes, introductory text has been added to that effect in section F1.1(1), along with a reference to BPR130 for the classification of modelled exposure classes.

219. The methodology for calculating CET1 deductions or Tier 2 additions requires a bank to allocate collectively assessed credit impairment allowances (as part of total eligible allowances) between defaulted and non-defaulted exposures. We plan, as soon as resources permit, to review what the implications of NZ IFRS 9 are for the capital adequacy framework generally, which may lead to some change of approach here. As an interim solution, we have added the guidance box after section F1.5 to say that if a bank has any part of its total collective impairment allowance amount that it cannot identify as relating either to defaulted or non-defaulted exposures, it should allocate that part across defaulted and non-defaulted exposures pro rata.

Appendix: Supervisory Slotting criteria

220. The Appendix comes largely unchanged from BS2B Annex 1, which is also very close to the Basel source (Annex 6 of the 2006 Basel II document).

221. We have corrected two errors in BS2B: first, we have moved the row “market conditions” from being the last row of Table 1 to being the first row of Table 2, since it relates to income-producing real estate (this matches the Basel source); and secondly, we have inserted the sub-heading “Financial strength” above the first few rows of Table 2.

BPR134: IRB Minimum System Requirements

Introduction and general points

222. BPR 134 is a re-worked version of BS2B Subpart 4C. The main change has been to provide a proper hierarchy of headings and sub-headings, to make it easier to follow how the various topics covered are grouped together. The correct grouping is far from obvious in BS2B, and we have gone back to the Basel source material to clarify how the material should be grouped.

223. Throughout, we have deleted material that is relevant only for the FIRB approach, and references to the AIRB /FIRB distinction. We note in this document which sections of BS2B have gone.

224. We note that when the Reserve Bank drafted BS2B Subpart 4C, some of the Basel source material was cut or shortened in the interest of brevity. Generally when preparing BPR134 we have not added back material that was cut, except where it seems desirable to do so to improve the logic and flow of the material.

225. BS2B Subpart 4C also makes extensive use of footnotes, which was possibly done to try and reduce the volume of the main text. A number of these footnotes contain specific requirements that a bank must meet, so we believe they should be given suitable prominence. In any case, the proposed new Handbook layout does not generally favour footnotes. Where material is illustrative or provides examples, we have instead put it in a guidance box.

226. The rest of this note goes through the sections of BPR134 in order, noting cases where lack of clarity or problems with the BS2B text have required drafting changes.

Parts A and B

227. BS2B sections 4.260 and 4.261 have been moved up in the order to become section A1.3. This is the "use test", and seems to fit more naturally as part of the introductory general requirements.

228. BS2B section 4.225 appears to have an error in saying that the rating process must provide meaningful differentiation of risk etc. This makes better sense if it refers to the process of allocating exposures to pools, since it applies to retail exposures (this is also consistent with the Basel source). BPR134 section B2.6(2) corrects this accordingly.

229. We have moved BS2B section 4.227 later to go under the heading B4 "Rating Criteria", as it is about rating criteria, not rating structure. The Basel source material for the current sections 4.227 and 4.232 is Basel II paragraphs 410 and 411. We have re-grouped this material in the new sections B4.1 to B4.3 in a way which we believe make better sense.

230. Also in BS2B section 4.227 the last sentence requires assignment of exposures to be on a "conservative basis". In our view, this does not have any testable meaning. So in line with the Basel source and APRA's approach, in the new section B4.3(2) we have made this a relative concept, ie the less information, the more conservative the approach must be.

231. The first part of BS2B section 4.228 defines "obligor grade". As the concept is first introduced in 4.222 and then discussed in some detail in 4.223, we have moved this material earlier in BPR134. The material from this part of 4.228 and from 4.223 have been merged into the new section B2.3. (Note, this departs from the Basel ordering, as it moves what is in Basel para 405 earlier to combine with Basel para 397. The distinction between "rating dimensions" and "rating structure" is a bit hard to pin down.)

232. B2.5 has been separated out from the last paragraph of BS2B section 4.224. It sets out the special case for the supervisory slotting approach, ie that the two-dimensional approach does not apply, so it

does not go with the rest of BS2B 4.224 (which is about facility ratings, ie one of the two dimensions in the normal case). Similarly, the second part of BS2B section 4.229 deals with the rating structure in the supervisory slotting case, and is not related to the first part of 4.229, so we have moved it to become B3.6 (to restore the Basel ordering). The result is that sections B3.3 to B3.5 cover obligor grades and facility grades in the general corporate case, while section B3.6 deals with grades (which are combined obligor/ facility grades) in the supervisory slotting case.

233. The meaning of BS2B section 4.234 is obscure. Section B5.1 should be clearer, based on the Basel source (paragraph 414). The point is that PD estimation must be based on one-year default rates (as specified in section E1.2, which is now cross-referred to from here), but obligor ratings must be based on a longer time horizon.

234. The reference in BS2B section 4.235A to “PD estimates of hedge funds” etc comes from the Basel source, but sits oddly in this subpart which is specifically about rating grades. (This was inserted as a Basel III addition (new paragraph 415(i) inserted into the Basel II 2006 document, by paragraph 112 of Basel III (Dec 2010)), and the Basel source clearly intended it to go here.) We think that changing it to “obligor ratings for hedge funds” etc makes the logic clearer without really changing the purpose: the discussion in Subpart B5 is about the time horizons and range of economic circumstances for determining obligor ratings, not PD. Subpart E5 deals with the estimation of PD for each rating grade.

235. It is not clear where the definitions of highly leveraged financial institutions (HLFIs) or hedge fund come from (we have not found them in the Basel sources), but the list of characteristics seems to pin down the concept reasonably well. However, since “hedge fund” is not itself a clearly defined concept, section B5.2(4) now instead refers to “HLFIs (for example, hedge funds)”, with guidance following on “typical characteristics of HLFI”, using the current list from (a) to (e).

Part C

236. In BS2B section 4.241, the reference to “specific wrong-way risk” is somewhat obscure. It was added to BS2B to reflect a Basel III update (paragraph 101 of the Basel III document expanded the Basel II source paragraph (423)). However, this omitted the definition of specific wrong-way risk given in Basel III. This has now been added as guidance after section C1.2. We note further that the Basel III addition relates specifically to the risk-weighting treatment of specific wrong-way risk in the Basel internal models-based approach for estimating counterparty credit risk (CCR), which we have not implemented in our capital framework. However, there seems no harm in retaining this requirement for banks to identify this risk.

237. Section C4.5 replaces BS2B section 4.250: note that 4.250 appears to be relevant only for FIRB banks, but the footnote to 4.250 makes it clear that this covers the supervisory slotting approach as well. (This is ambiguous in the Basel II source (paragraph 432), but APRA’s version is clearer (APS113 Attachment A, para 55.) So section C4.5 removes the reference to FIRB, but incorporates the material from the footnote.)

238. Section C5.1, dealing with stress tests, combines BS2B sections 4.252 to 4.254. The material now presented as guidance after subclause (2) seems suitable for guidance, as it gives examples. We have added the word “adverse” to “liquidity conditions”, as “liquidity conditions” does not really describe a useful scenario.

239. Footnote 68 to section 4.254 in BS2B is not very clear. We have re-drafted this to reflect what the intention appears to be. We have also changed this from a footnote to guidance (see guidance after section C5.1(5)(b)), as it seems to be explaining the implications, rather than really giving an instruction.

Part D

240. BS2B section 4.258 has become BPR134 section D2.1. Basel here says “banks must have independent credit risk control units”, which leaves it ambiguous whether an individual bank must have a single such unit. BS2B section 4.258 makes general remarks about such units without actually specifying that a bank must have one. In section D2.1, we have said “the bank must have an independent credit risk control unit” (ie singular), which we believe is the desirable outcome, and also matches how APRA have implemented this (see APS 113 Attachment A, para 65).

241. In D2.1(2)(b), “areas including” has been removed, as it seems unnecessary to say that this list is not necessarily comprehensive. In D2.1(3), the passive has been changed to active, but this raises the question whether it is the credit risk control unit or (eg) the bank generally that must document changes. In line with parts of section D2.1(2) above, we have said the unit itself must also be responsible for these matters.

242. In section D3.1 (from BS2B 4.259) we have simplified “annually or more frequently” to “at least annually”, and removed “and, where relevant”, as LGD and EAD are always relevant under the AIRB approach.

Part E

243. E1.2(3) corresponds to the first paragraph of BS2B 4.263, and comes from the first sentence of Basel para 447 “PD estimates must be a long-run average of one-year default rates for borrowers in the grade, with the exception of retail exposures (see below).” The Basel source does not make it clear where “below” this is dealt with, and hence is not clear about the nature of the exception. In BS2B and in the revised new text we have followed the line that APRA take here, namely that –

    - the principle of long-run average of one-year default rates applies also to the retail case; but
    - the nature of the exception is that for retail exposure, default can be defined at the level of individual facilities rather than obligors. This comes later in the Basel II source, at paragraph 455, hence is consistent with “see below”.

244. Basel paragraph 455 appears as 4.270 in BS2B, reproduced as section E2.4 within Subpart E, “definition of default”. So we have added a cross-reference from section E1.2 to section E2.4.

245. Also on this material, we have deleted the footnote to BS2B section 4.263, as it is repeated in BS2B section 4.270 (and is now section E2.4(2)).

246. The new section E1.3 has been reorganised from some sub-paragraphs of BS2B section 4.263 with references to AIRB and FIRB removed.

247. Sections E1.4 to E1.6 aim to be more clearly presented versions of the material from BS2B sections 4.264 to 4.267. In particular, the second paragraph and subparagraphs (a) and (b) within BS2B 4.266 are hard to make sense of, and section E1.5(2) is our interpretation of what the intention is here, by reference back to Basel para 450 (which is itself not very clear).

248. Subpart E2 “Definition of default” comes from BS2B sections 4.268 – 4.272. The BS2B version does not make it clear what the purpose of this material is, and the phrase “reference definition of default” appears for the first time in section 4.271 without explanation. In subpart E2 we have re-ordered this section to make the purpose clearer, i.e., this is the definition of default that must be used for IRB purposes.

249. Subsection E2.1(4)(a) cross-refers to section E5.4 “Mapping to external data”. This corrects an error in the BS2B source section 4.271, which cross-refers to 4.275 and 4.276, but should instead cross-refer

to 4.278. (Note that in the Basel source material the cross-reference goes to the whole of the very long paragraph 462, which corresponds to all of BS2B sections 4.276 to 4.279.)

250. Section E2.2 “reference definition of default” comes from BS2B section 4.268. We have moved the footnote up to become subsection E2.2(2), as it seems an integral part of the definition. The reason that BS2B gives the two optional alternatives for measuring “90 days past due” appears to relate to APRA’s definition of this in APS 220 “Credit Quality”, which is used for the purpose of APS113: the Basel source does not mention “90 days’ worth of contractual payments”. We have left the definition unchanged, in the interests of avoiding unintended consequences.

251. In subsection E2.4(1), an “obligor borrower” has become just an “obligor”.

252. Section E2.5 comes from BS2B section 4.272, but split into two sub-sections. E2.5(2) qualifies/overrides E2.5(1), so we have changed E2.5(1) from “should” to “may”, and made it subject to subsection (2). Note that the proviso in E2.5(2) is not in the Basel original, but it is in APRA’s equivalent (see APS112 Attachment A, para 80), so we have retained this. We have replaced the term “restructured item” with “renegotiated or otherwise modified item”, as the former term is no longer defined in NZ IFRSs. The replacement ties in to the NZ IFRS 9 concept of “modified financial asset”.

253. Subpart E3 (Re-ageing) comes from BS2B section 4.273. We did raise with IRB banks questions about how they see the purpose of this section and whether it is relevant, but did not receive any clear steer in response. So we have left the wording broadly unchanged from BS2B to BPR134.

254. Sections E5.2 to F5.6 (PD risk quantification requirements for the corporate, sovereign and bank exposure class) broadly corresponds to BS2B sections 4.275 to 4.279, but has been re-ordered somewhat with the aim of making the material clearer.

255. In section E5.2(3), the wording from BS2B 4.276 “Banks must recognise the importance of judgemental considerations” has been revised “The bank must use judgement where appropriate …”.

256. Section E5.7(3) comes from BS2B section 4.280 (last sentence), but with “may” changed to “must”. The Basel source material for this (paragraph 464) and APRA’s implementation of it (APS113 Attachment A, paragraph 85) both use the word “must”, and it seems to us that with the word “may” the requirement becomes largely pointless.

257. In section E5.8(1), we have changed the text from “to drive estimates” (as used in BS2B section 4.281) to “to derive estimates” as this is what the Basel source has, and also seems to make better sense.

258. In section E5.9(1), which comes from BS2B section 4.282, we have changed “quantification procedure” to “estimation of loss characteristics” (as in Basel and APRA), which seems a more specific and relevant description.

259. Section E6.3 has been re-ordered somewhat from BS2B 4.285, for the logic to flow better. Some material has been put into a guidance box as it only provides examples.

260. Section E6.6 has been expanded somewhat compared to the BS2B source section 4.288. Looking at the Basel source paragraph 471, it is clear that this more or less repeats what is in the capital treatment for UL and EL for defaulted exposures, so we think it is worth making this clearer by adding cross-references to that treatment (which BS2B does not currently have). The footnote in BS2B has been promoted to the main text as it is a requirement.

261. E6.8 has been slightly re-drafted from BS2B section 4.290: the second sentence of 4.290 suggests that estimation can be based on fewer than 5 years’ data, despite the first sentence. Referring back to the Basel source (para 473) confirms this should say only that the less data a bank has, the more

conservative it should be. (This is also consistent with APRA's approach, see APS113 Attachment A paragraph 100).

262. New sections E7.2 to E7.5 have been re-worked from BS2B sections 4.291 and 4.292.

- Section E7.3 comes from the second paragraph of 4.191, but with references to the FIRB approach removed, and cross-references provided to the on-balance-sheet netting requirements in BPR132.
- Section E7.4 is new material, which notes that the approach to EAD for counterparty credit risk exposures on market-related contracts is given by the standardised approach in BPR131 (E7.4 corresponds to Basel paragraph 477(i), which is not currently reflected in BS2B). At the same time, including section E7.4 should make it clearer that the rest of this subpart E7 is mainly about EAD for non-market related off-balance sheet items (commitments, guarantees given, etc). The added guidance box spells this out explicitly.
- Section E7.5 groups together the third paragraph of BS2B 4.291 and all of 4.292, as these seem to fit naturally together. E7.5(5) has been slightly re-drafted from BS2B, to clarify that a given exposure has a single EAD.

263. Section E7.6(2) has been re-drafted from the second paragraph of BS2B section 4.293, in an attempt to draw sense from the BS2B text, by reference to the Basel source (see third sentence of Basel II paragraph 476).

264. Section E7.7(1) aims to make sense of the first paragraph of 4.294, again by reference to Basel and APRA. We think that the point is not that a bank must have policies and strategies in place on account monitoring and payment processing, but that the bank's EAD estimation must give due consideration to those policies and strategies (which we reasonably assume that it has in place).

265. The whole of BS2B sections 4.297 to 4.300 have been deleted. These provide minimum requirements for how an AIRB bank should take account of the credit risk mitigation provided by credit derivatives and guarantees in its RWA calculations. These were mostly duplicated in sections 4.98 to 4.133 of BS2B (where the calculation methodology is also set out), and all of this material is now covered in Part D of BPR132, with duplication and references to the FIRB approach removed. BS2B section 4.301 is also deleted, as it relates to the FIRB approach only. (This was all covered in the earlier correspondence on BPR132.)

266. We have not kept BS2B section 4.300A ('Orderly operation of margin agreements') in BPR134. This text was added to BS2B as part of the Basel III amendments, and was added at the same time as section 56(7) in BS2A Part 5, Credit Risk Mitigation. (It comes from Basel paragraph 115(i), which was a Basel III insertion into the standardised credit risk mitigation treatment in the Basel II source.) We view it as providing a general statement of good risk management, rather than being a condition a bank must meet to be allowed to use the IRB approach. Since our banking regulations do not currently provide stand-alone rules or guidelines on the management of most risks, we have no natural place to locate it. (We have also not kept it in the standardised credit risk mitigation material in BPR132.)

267. BS2B section 4.302 (minimum requirements for risk quantification for purchased receivables) has been moved to the calculation section on purchased receivables in BPR133. (See BPR133 section E1.3, and the discussion of it in the section on BPR133 above.)

268. Section E8.1(3) is adapted from the last sentence of BS2B section 4.303: rather than listing the main requirements by name, it makes it clearer that each of them is spelt out in detail in the following sections.

269. In Section E8.2(1), compared to the BS2B source (section 4.304), we have clarified that “facility” means the facility under which the receivables are purchased, and also moved the phrase “including incidences of seller or servicer distress and insolvency” to the right place. (This is consistent with APRA’s wording, see APS113 Attachment D, paragraph 33.)

270. BS2B section 4.305(b) states “There must be in place internal policies and procedures adequately safeguarding against contingencies”, which gives no indication what sort of “contingencies” are contemplated. Referring back to the Basel original (paragraph 495) and the APRA version (APS 113 Attachment D paragraph 33(b)(i)) makes it clear that “contingencies” refers to outcomes in which there is correlation between any of the things referred to in the previous subsection. New sections E8.3(2)(a) and (b) have been re-worked to make sense of this.

Part F

271. Section F1.3(1) has been slightly re-worded compared to BS2B section 4.311, to make it clear that a bank must not only make comparisons with external data sources, but must also use those comparisons for validation (which is implicit from the context in any case, and is clear in the Basel II source (paragraph 502)).

272. BS2B section 4.314 has been deleted, as it refers to supervisory LGD and EAD estimates. These only arise in the FIRB case.

273. BS2B sections 4.315 to 4.322 (‘Supervisory LGD and EAD estimates’) have been deleted, as they provide requirements that a bank only needs to satisfy if it is following the FIRB methodology for recognising collateral in the form of commercial or residential real estate, or eligible financial receivables. This is in line with the deletion of sections 4.49 to 4.60 of BS2B, where the corresponding FIRB calculation methodology is set out, in creating BPR133.

274. BS2B sections 4.323 and 4.324 (‘Requirements for recognition of leasing’) are not reflected in BPR134, as they only provide the RWA calculation methodology for leases, not any minimum system requirements. Section 4.323 is now partly reflected in both the standardised treatment of leases (see section C2.17 of BPR131) and the IRB treatment (see section C1.2 of BPR133).

BPR150: Standardised Operational Risk

275. BPR150 has been closely adapted from Part 9 of BS2A, with some reorganisation as noted below, and one particular point of clarification. Some material has been presented as guidance where that seems appropriate.

276. We note that as part of the Capital Review decisions announced in 2019, and as outlined in the main Consultation Paper "Changes to the Banking Supervision Handbook: Exposure Draft for Capital Review Changes" that the Reserve Bank intends to consult on a new standardised approach for calculating operational risk in 2021. This would replace both the current standardised approach in BPR150 and the AMA approach in BPR151.

277. In a few cases in the discussion below, we have referred back to the Basel source material and/ or APRA's implementation of the same Basel source to help clarify the original intention. The main Basel source remains Part V of the June 2006 Basel II document, https://www.bis.org/publ/bcbs128.htm. The main APRA source document is APS114 (see link_to_APS114).

Part A: Introduction

278. The definitions in section A1.2 are mainly new compared to those in BS2A section 119. In the definition of "corporate finance activities", BS2A 119(1)(a)(ii) has become guidance after BPR150 A1.2(1)(b), as it provide examples of corporate finance rather than being definitive. The definition of "operational risk" itself is now in the Glossary, as it serves not only as a common definition for BPR150 and BPR151, but also for the related disclosure requirements set in the OiCs. The definition of "legal risk" from BS2A 119(1)(c) is now included within that definition of operational risk as guidance, as it illustrates the meaning by example, rather than being definitive.

279. The definition of generally accepted accounting practice is also now in the Glossary. Section A1.2(2) comes from BS2A section 119(2) and specifies that in the following sections, accounting terms have the same meaning as under GAAP.

280. The definition of "retail and commercial" banking has been moved into section A1.2, from section 120(2) in BS2A. This definition refers to "banking book activities". The terms "banking book" and "trading book" have long complex definitions in the Basel framework, but in BS2A and BS2B the terms are very rarely used, and are not defined. We have not provided a definition at this point in the BPR documents.

281. An issue with the current BS2A definition of "retail and commercial banking" is the categories of borrower it covers. These categories include sovereigns and financial institutions, but not public sector entities (PSEs) or multilateral development banks and other international organisations (MDBs). In BS2A (consistent with the Basel standardised approach for credit risk), PSEs and MDBs each have their own separate risk-weighting category, separate from sovereigns or banks, so the presumption would be that these are excluded from "commercial loans and advances". The term "financial institution" is only defined in BS2A for the purpose of Part 2 (definition of capital), so is not defined explicitly in Part 9, but it is by no means clear that it would include MDBs in any case.

282. BS2A does follow the Basel II source material here (footnote 104 to paragraph 652), except for referring to "bank" rather than "financial institution". However, we do not think it makes sense that this definition should include lending to sovereigns but exclude lending to PSEs and MDBs. It would make better sense to read the Basel source as referring to the IRB categories, since the IRB "sovereign" category includes MDBs with a 0% standardised risk weighting, and the IRB "bank" category includes all other MDBs and all PSEs. Also, under the BS2A standardised credit risk approach, financial institutions other than banks (ie insurers and securities firms) fall within the corporate category by default.

283. Accordingly, in the defined term in BPR150 section A1.2, we have added MDBs and PSEs, and replaced “financial institution” with “bank”. The same issue arises with the definition of “gross retail and commercial loans and advances” (section B1.1(2)(a) in BPR150).

Part B: Calculation of capital requirement

284. The material from sections 120-123 of BS2A has been slightly reorganised in BPR150. Section B1.1 provides an overview, from BS2A 120(1). Sections B1.2 and B1.3 provide, in turn, the methodologies for each of the two main components of the standardised operational risk capital requirement (section B1.2 comes from BS2A sections 121 and 123(1), section B1.3 from sections 122 and 123(2)). Section B1.4 then defines the total, including providing it as a formula.

285. In that formula, BS2A subsection 123(6) states that “t” is a quarterly observation, which is not a useful definition. In the corresponding BPR150 section B1.4(2) we have provided what should be a more accurate and precise definition for “t”.

BPR151: AMA Operational Risk

286. BPR151 has been adapted from Part 8 of BS2B. The material mostly follows the order of the source material closely, with some minor clarifications. The main area that has been clarified is the recognition of insurance as a mitigant for operation risk.

287. As noted under BPR150 above, BPR151 and BPR150 are likely to both be replaced by a single standardised approach to operational risk, following consultation in 2021.

288. In a few cases in the discussion below, we have referred back to the Basel source material and/ or APRA's implementation of the same Basel source to help clarify the original intention. The main Basel source remains Part V of the June 2006 Basel II document, https://www.bis.org/publ/bcbs128.htm. The main APRA source documents is APS115 (AMA). (See link_to_APS115.)

Part A: Introduction

289. As elsewhere, we refer to "the bank" rather than "the registered bank", since the context makes clear the bank that is referred to. BPR151 now relies on the Glossary for the definition of operational risk (so BS2B section 8.2 is cut).

290. In section A1.2, we have tried to make the formula for the solo calculation approach easier to read by providing abbreviations, and also provided cross-references to BPR100 to define the terms in the definition of "NonOp" (capital requirements for risks other than operational risk).

291. System requirements for operational risk have since January 2019 been imposed explicitly on IRB banks by a new condition of registration, replacing the previous condition to meet all the requirements of BS2B. This is reflected in section A1.3, which replace BS2B section 8.4. The list of contents in BS2B section 8.4 has also been cut, as this is now dealt with in the table of contents.

Part B: Qualitative and Quantitative Requirements

292. The reference in BS2B section 8.15 to the soundness standard for IRB credit risk has been put in a guidance box (within BPR151 section B2.2), and a cross-reference to BPR133 has been added. Note that the 99.9% confidence level is not discussed anywhere explicitly in BPR133, but rather is implicit in the risk weighting formulae, so a more specific cross-reference is not feasible.

293. The text in the guidance box after B2.4(2)(b) is given as guidance because it is explanatory of the subsection, rather than providing a precise calculation requirement. (This comes from the paragraph in BS2B following section 8.19(b).)

294. Section B2.6(2)(a) comes from BS2B section 8.23(a). This BS2B text refers to Level 1 loss event types and business lines, but only provides a cross-reference to Annex 3 (loss event types), not to Annex 2 (business lines). The Basel source (paragraph 673 first bullet) and APRA equivalent (APS115 Attachment B paragraph 24) make it clear that internal loss data must be mapped to the Level 1 category for both business lines and event types. The wording of BPR150 section B2.6(2)(a)(i) is intended to make this clearer compared to BS2B. At the same time, the Annex of loss event types has been put first (as Appendix 1), since it is referred to first (from section B2.4). (We have also standardised the use of Appendix rather than Annex across the BPRs.)

Section B2.10: recognition of insurance used to mitigate operational risk

295. The treatment of insurance to mitigate operational risk in sections 8.32 to 8.34 of BS2B has been restructured and re-drafted somewhat to help clarify its intent in BPR151 section B2.10, as explained in the following.

296. The text on the required initial maturity and the treatment of residual maturity has been split into separate parts. This is currently in BS2B sections 8.33(b) and 8.34(a). So BPR151 subsection B2.10(4)(b)(i) deals with the 1 year minimum initial maturity, while the treatment of an insurance policy with residual maturity less than one year is now covered in section B2.10(6). The current wording in BS2B is not very precise on the details of the residual maturity adjustment, so we have stipulated a linear adjustment declining from 100% at 1 year to nil at 3 months.

297. The new section B2.10(4)(a), comes from BS2B section 8.33(a) and the footnote. This deals with the required rating ("claims-paying ability") for the insurance provider, and the eligible rating agency for providing that rating. BS2B currently lists Moody's and S&P, and refers in a footnote to our criteria for approving other rating agencies that are set out in BS1. However, this is wrong in this context, as the criteria in Appendix 3 of BS1 are specifically for the purpose of approving credit rating agencies that a bank may use to maintain its own credit rating, to comply with a notice issued under s80 of the Reserve Bank Act.

298. Accordingly, section B2.10(4)(a) refers to the three rating agencies that we have currently approved under our insurance supervision regime, and the guidance notes that additional rating agencies may be added to this list, and refers to the process for doing that so within the insurance regime.

299. BS2B section 8.33(d) follows very closely the Basel wording (paragraph 678, 4th bullet), and appears very dense, and hard to follow. We have tried to break it out in a more meaningful way in section B2.10(4)(c) in BPR151 –

- Our understanding of the intent of this material in Basel is that, among other things, a serious operational risk loss event could lead to supervisory action (such as a restriction on the bank's business, required plan to restore capital, etc), or in the extreme could lead to the bank's failure.

- The prohibition on policy limitations and exclusions that is stipulated here is meant to ensure that in either of these cases (among others), the insurance policy would still pay out on an insurance claim made in relation to the loss event.

- In the case of the bank failing, the insurance policy can exclude loss events that occur after the point of failure: but the liquidator, statutory manager, etc (or the bank itself, if relevant) must be able to pursue a claim for a loss event occurring before and up to the point of failure.

- The policy can have an exclusion for fines and penalties imposed by the supervisor, and we have grouped this proviso with the ban on exclusions for regulatory / supervisory triggers, as it seems to relate more closely to that than to the case of the bank failing.

300. BS2B section 8.33(f) says that insurance provided by a captive or affiliate insurer is not eligible, and that the insurance must be fully laid off to a third-party entity. The Basel source for this says that insurance must be provided by a third-party entity, and that if the bank uses a captive insurer, the insurance must be laid off with a third party. Our intention in BS2B was to be more restrictive than the Basel approach, ie to ban any involvement of a captive or affiliated insurer, and this is in line with APRA's general approach. Given this, we believe that "fully laid off" needs to be replaced by "provided by". Section B2.10(4)(e) in BPR151 is the revised version.

Section B2.11: mapping to specified business lines

301. The new section B2.11 comes from "Principle for business line mapping" which are currently part of Annex 2 in BS2B. The reason for moving this material out of the Annex is that it sets out a number of things that a bank must do, as distinct from the table "Mapping of business lines" which simply lays out information. It seems to us more transparent to have this material within the body of the Part B text,

where it will be part of the set of process requirements a bank must meet. The wording of section B2.11 has also been revised somewhat to attribute responsibility more clearly to the bank.

302. The current Principle 3 in BS2B Annex 2 has become subsections (d) and (e) of section B2.11, revised to fix the drafting problem in Principle 3, which says that the mapping must be consistent with other definitions, but then allows deviations from that rule.

BPR160: Insurance, securitisation, and loan transfers

303. The new document BPR160 comes from Parts 6, 7 and 8 of BSA, and Parts 5 and 6 of BS2B (which are identical to Parts 6 and 7 of BS2A, except for internal cross-references). Part 8 of BS2A (loan transfers) should also have been in BS2B, but was inadvertently omitted.

304. We have combined these Parts of BS2A and BS2B in one document, first because they feed in to the main capital ratio calculations in similar ways, and second because there is an interaction between the treatments for funds management and securitisation on the one hand, and insurance affiliates on the other.

305. In BPR100 (Capital Adequacy), the sections that set out the scope of the calculations (group and solo etc) now include references to BPR160, to spell out where these treatments may lead to an SPV being added to the consolidation, or transferred assets being excluded [REF]. This is not currently provided in BS2A or BS2B. This is also reflected in the new credit risk overview document (BPR130 REF).

306. Any CET1 deductions arising from these treatments are already spelt out in the capital definitions sections of BS2A and BS2B, and these are reflected correspondingly in BPR110 (Definition of Capital) (section B1.5).

Part A: Funds Management and securitisation

307. This corresponds to Part 6 BS2A, Part 5 BS2B.

308. Section A1.1(1) explain the purpose of this Part. The rest of sections A1.1 and A1.2 follow BS2A sections 94-97 (BS2B sections 5.0 to 5.3) quite closely, but the text is broken up into hopefully a more logical layout. Lists which are given as non-comprehensive examples are presented as guidance. The plural “banks” is replaced with the singular.

309. Subpart A2 pulls out, in what should be a clearer and more explicit way, what the actual capital ratio calculation implications are for a bank. So section A2.1 puts in one place all the cases in which an SPV must be consolidated with the bank for that purpose. Section A2.2 defines separately what the “minimum separation requirements” are. And Section A2.3 specifies other calculation requirements in the case where consolidation is not required (these include the case where consolidation is one option available, see section A2.3(3)(c)).

310. In BS2A section 98 / BS2B section 5.4, there are references to the scope of consolidation to be used for calculating solo capital ratios. (This scope is now set out in BPR100 section B2.4, and broadly requires consolidation of entities that are 100% owned and wholly funded by the bank.) In section A2.1 of BPR160, we have removed the references to the solo capital case, as they appear to be redundant. First, the solo approach already takes out all directly-owned subsidiaries with external funding, so it seems inconsistent to require SPVs to be added back in. Also, the reference to consolidation required under GAAP is irrelevant in the solo case, because GAAP only requires group financial statements.

311. In section A2.1(1)(a), we have changed the text to refer to a requirement to consolidate “the SPV” rather than “an SPV” under GAAP. We think this is meant to be based not on whether this is a general requirement in GAAP, but whether consolidation is required for this particular SPV. It will always depends on the facts of the case, applying the tests in NZ IFRS 10, “Consolidated Financial Statements”. (The source text is in BS2A section 98(a), BS2B section 5.4(a)).

312. The definition of “covered bond SPV” is now in the Glossary, and has been updated to refer to the Act, rather than to the covered bonds amendment Bill.

313. The guidance on meeting obligations under the Securities Act and Regulations has been updated to refer to the FMC Act. This is in BS2A section 102(a) and BS2B section 5.8(a), and the new guidance is after Section A2.2(a)).

314. The text from BS2A section 102(b) / BS2B section 5.8(b) has been cut because it refers to disclosure requirements that are already specifically covered in the disclosure Order in Council. It would be odd to require consolidation of the SPV's assets because a bank has failed to meet this particular disclosure requirement.

315. BS2A section 103 / BS2B section 5.9 refers to a requirement that depends on a bank's combined amount of securitisation and insurance business, so applies across the two treatments. This has been moved to a new Part C to clarify this treatment and make sure the mechanics work.

Part B: Affiliated insurance business

316. This corresponds to Part 7 in BS2A, Part 6 in BS2B.

317. The structure of Part B now aims to make clearer the three broad topics: Subpart B1 – introduction and definitions; Subpart B2 – treatment of credit enhancements; Subpart B3 – treatment of funding exposures when minimum separation requirements are not met.

318. As with Part A, section B1.1 adds an opening sentence explaining the point of this part.

319. In the definitions (section B1.2), references to "New Zealand banking group" have been changed to just "banking group", since that term is defined in a registered bank's conditions of registration, and adding "New Zealand" is unnecessary (indeed, it could be misleading if the registered bank itself owns overseas subsidiaries, since there is no intention that they should excluded just for this purpose).

320. Other changes in the definition section arise from the terms "insurance entity", "ultimate holding company", "subsidiary", "GAAP", and "joint venture" now being provided in the Glossary BPR001. The term "parent" has been generally replaced by "holding company". The terms "affiliated insurance entity" and "affiliated insurance group" have been kept here, as they have meanings very specific to this context, and the concept of "affiliate" is not generally used in New Zealand legislation or in GAAP. The term "associate" has also been kept here and remains defined by reference to GAAP, since we do not want to change the scope of this policy. "Associate" has different meanings elsewhere (eg in the Act), so we have not attempted to provide a single definition in the Glossary.

321. Section B2.1 slightly re-words BS2A section 108 / BS2B section 6.2 and has a new title to spell out the requirement. The wording now reflects the fact that a banking group is not a legal entity that can provide a credit enhancement, only specific entities within the banking group can do that (including the registered bank). The non-exhaustive list of examples has been shown as guidance.

322. References to the Securities Act 1978 in BS2A section 109 / BS2B section 6.3 have been kept in section B3.1, given the possible long duration of insurance products, but references to the Financial Markets Conduct Act 2013 have been added.

323. The text from BS2A section 109(e) / BS2B section 6.3(e) has been cut because it refers to disclosure requirements that are already specifically covered in the disclosure Order in Council. It would be odd to require a deduction from CET1 capital because a bank has failed to meet this particular disclosure requirement. (See similar issue in the securitisation case above – BS2A section 102(b) and BS2B section 5.8(b).)

324. The text of BS2A section 109(g) / BS2B section 6.3(g) has been cut, because the mechanics don't work: the 10% threshold is not a hard limit, but a trigger for deduction (as covered in the securitisation

treatment). This is now reflected in the new Part C instead. The guidance provided after section B3.1(g) refers to the combined requirement in Part C, and adds a new piece of guidance to clarify that if funding provided to an affiliated insurance group contributes to a CET1 deduction under Part C, then it does not also have to be deducted if it meets the test in section B3.1(g).

325. In section B3.2(b) (from BS2A section 6.4(b) / BS2B section 110(b)), the order has been switched for greater clarity, to start with “any claims which represent …”.

326. BS2A sections 111-114 / BS2B sections 6.5-6.8 have been reflected as guidance in BPR160, after section B3.2. This appears to provide only examples of what section B3.2 covers, and explanation of what the requirements mean, so is better suited to guidance. In the guidance, the first paragraph has been re-ordered from the source. It seems better to start with what “funding” does include, rather than what it does not.

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

327. As noted above, this short new Part serves to clarify the way that the total funding to all securitisation and funds management vehicles and affiliated insurance groups is deducted from CET1 capital.

Part D: Loan transfers

328. In the BS2A source, the status of section 115(2) is not clear, since all the qualifications are set out in 116 and 117. We propose not to treat them as additional objective tests, but rather as descriptive material to explain the ex post outcomes that the qualifying conditions are meant to achieve. This is now provided in the guidance after section D1.1.