

Review of Connected Exposures Policy (BS8)

29 November 2021

Submission Contact Details

We invite submissions on this Consultation Paper by 31 March 2022. Please note the disclosure on the publication of submissions below.

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Subject line: BS8 Consultation November 2021

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The RBNZ may also publish an anonymised summary of the responses received in respect of this Consultation Paper.

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1 Executive Summary

- 1.1.1 Banks incorporated and registered in New Zealand (“a New Zealand bank”) must comply with a range of rules put in place by the Reserve Bank to support financial stability. Together, the rules reduce the risk of a bank failing, protecting New Zealanders from the economic and social costs associated with bank failure.
- 1.1.2 In recent years several parts of the rules have been changed, including higher capital requirements that banks must meet in the future.
- 1.1.3 We are now consulting on a set of changes to the rules that cover limits on the total size of a bank’s exposures to its connected persons. These rules are covered in the Reserve Bank’s document “Connected Exposures Policy”.

1.2 Connected Exposures: What Are They?

- 1.2.1 Connected exposures are a bank’s exposures to its connected persons – connected persons are natural or legal persons who are closely related to the bank. For example, a bank’s owners or other entities in which the bank’s owners may have a substantial interest.
- 1.2.2 Exposures to connected persons can take a variety of forms – for example, loans, leases, deposits, investments (which include investments in equities and bonds issued by connected persons), undrawn lines of credit, bank guarantees of a connected person’s obligations to third parties, and financial contracts (such as derivatives) with connected persons. In principle, any forms of transactions and arrangements that banks entered into with connected persons are considered as exposures to connected persons.
- 1.2.3 The connected exposures policy requires banks to measure their exposures to connected persons and limit the size of the total connected exposures in relation to their capital.
- 1.2.4 Exposures to connected persons are calculated using three components: credit exposures, credit risk mitigations and capital.
- 1.2.5 The credit exposure component works to increase a bank’s connected exposures calculation, while the components of credit risk mitigations and capital work to reduce it.
- 1.2.6 These components are used to calculate a bank’s connected exposures as follows:

$$\text{Connected exposures} = \frac{(\text{Credit exposure}) - (\text{Credit risk mitigations})}{\text{Tier 1 Capital}}$$

- 1.2.7 After the connected exposures are calculated for each of a bank’s connected persons, the bank aggregates the connected exposures across all connected persons. The resultant amounts are subject to aggregate gross and net exposure limits.
- 1.2.8 A New Zealand bank must not exceed the exposure limits set out in the connected exposures policy. The aggregate gross exposure limit is 125% of a bank’s Tier 1 capital.¹ The aggregate net exposure limit is contingent on a bank’s credit rating, ranging from 15% to 75% of Tier 1 capital.

¹ Tier 1 capital is defined in the Reserve Bank’s Banking Prudential Requires document, BPR110: *Capital Definitions*. It includes all capital except certain types of reserves and capital instruments that are classified as Tier 2 capital.

- 1.2.9 A New Zealand bank could be severely affected by a failure of a connected person. The connected exposure policy exists to put a limit on the maximum loss that a New Zealand bank could face in the event of a sudden failure of one or more connected persons. This ultimately helps support financial stability.
- 1.2.10 For similar reasons, the connected exposures policy also requires New Zealand banks to ensure that the terms of transactions with connected persons are not more favourable than the terms available for similar transactions with non-connected persons.

1.3 Review of the Connected Exposures Policy

- 1.3.1 The current version of the connected exposure policy has been in place without major policy updates for over ten years and needs to be updated.
- 1.3.2 We have become aware of some issues that banks have encountered when measuring an exposure amount under the connected exposures policy. These issues are mainly due to some ambiguity and inconsistency in the current connected exposures policy.
- 1.3.3 These issues appear to lead to a conservative calculation of connected exposures and appear to prevent banks from using what is common practice in financial markets (e.g., margin payments for derivatives contracts – see Box 1 for details). According to feedback from industry, this constrains banks' ability to manage credit and market risks appropriately and efficiently. We acknowledge that these ambiguities and inconsistencies exist and that they warrant a review of the policy.
- 1.3.4 However, a policy on connected exposures remains an important element of the suite of prudential policies the Reserve Bank has, as long as the inherent risks remain. Managing large exposures is also part of the Basel Core Principles (BCP 19) and is in line with international expectations. Moreover, the attestations made by bank directors in relation to managing conflicts of interest and managing the risk of abusive transactions will continue and are not part of this review. This will enable us to continue to hold a bank's board of directors accountable for addressing the risk of conflicts of interest with connected persons.

1.4 The Reserve Bank's Proposals

- 1.4.1 The Reserve Bank is proposing to clarify the methods used to calculate connected exposures. We are also suggesting changes to bring the connected exposures policy more in line with the existing standardised capital adequacy framework, while maintaining the effectiveness of the policy.
- 1.4.2 Our main proposals include:
1. *(in relation to credit risk mitigations)* – allowing banks to recognise eligible credit risk mitigations. This change will mean that banks can recognise eligible collateral received for their derivative contracts and securities financing transactions. The eligibility conditions will be the same as the existing standardised approach for calculating capital requirements. This change will also allow banks to recognise on-balance sheet netting;
 2. *(in relation to credit exposures)* – applying a flat 100% Credit Conversion Factor (CCF) to banks' off-balance sheet contingent credit exposures to connected persons. This is because the Reserve Bank considers that it is appropriate to assume that a connected person would draw on any funds available to it in order to prevent its failure if it was in financial difficulty;

3. (*in relation to credit exposures*) – exempting some specified interbank exposures. This is to avoid potential constraints that banks may face given banks' operational practice in relation to monetary policy implementation;
4. Expanding the definition of a connected person by adding: "an entity in which a director of the registered bank has a substantial interest (other than the registered bank and entities in which the registered bank itself has a substantial interest)" – this is to respond to one of the recommendations made in the International Monetary Fund (IMF)'s 2017 Financial Sector Assessment Programme (FSAP) review and to be consistent with Principle 20 of the Basel Core Principles for Effective Banking Supervision; and
5. Removing the current aggregate gross exposure limit, provided that the risk of credit risk mitigations not working as expected is limited, with clear requirements on eligible credit risk mitigations (note that the aggregate net exposure limits will be maintained with some possible adjustments).

1.4.3 Our detailed proposals, with technical descriptions, are covered in Section 4 and the Annex of this consultation paper. Section 4 and the Annex are most likely to be useful for those stakeholders regularly involved in assessing compliance with the connected exposures policy, including its relevant reporting requirements.

1.5 Impacts

- 1.5.1 If the proposed changes are implemented following the consultation process, we anticipate there will be a number of impacts on the level of aggregate net exposures.
- 1.5.2 To assess the impact of the proposed recognition of credit risk mitigations (CRMs), the Reserve Bank has carried out provisional analysis, based on information available to us. This suggests that a bank's exposures to its connected persons could move within a very large range. Our provisional estimate shows that aggregate net exposures could decrease by an amount between 0 percentage points and 78 percentage points of Tier 1 capital, depending on each bank's practice of recognising eligible CRMs.
- 1.5.3 This analysis does not include any impact from our other proposals (e.g., an expansion of the definition of connected persons, an application of a flat 100% CCF to off-balance sheet contingent exposures, and so on). These changes, if they proceed, are also likely to affect estimates of connected exposures.
- 1.5.4 For example, the expansion of the definition of connected persons may increase the number of connected persons for some banks more than others. If this is the case, it may create a situation where it would no longer be appropriate to apply the exposure limits to a bank's aggregated credit exposures to all connected persons. Instead, it would be more appropriate to impose a limit on the sum of all exposures to a single connected person.
- 1.5.5 To help us fully assess the possible impacts, we are requesting that banks provide some additional information as part of the consultation process. We will review this information to maintain the effectiveness of the connected exposures policy with appropriate net exposure limits. Based on the information provided by banks, we may make changes to the net exposure limits.
- 1.5.6 If needed, we will have another round of consultation on the net exposure limits.

- 1.5.7 The alignment with the capital adequacy rules will also likely expand the range of eligible bilateral netting agreements under the Connected Exposures Policy. Currently only the International Swaps and Derivatives Association (ISDA) Master Agreement is designated in BS8 as a robust industry standard netting agreement.
- 1.5.8 While we are open to the idea of allowing more netting agreements to be eligible under the Connected Exposure Policy, as long as they are as robust as the ISDA agreement, we are keen to understand the implications of such a decision and request more information from industry on the types of agreement that would become eligible.

1.6 Implementation Arrangement

- 1.6.1 The Reserve Bank is aware that banks would need time and resources to implement the proposed amendments outlined in this consultation document.
- 1.6.2 We believe that an appropriate implementation arrangement would help minimise any short-term costs (e.g., IT system changes, additional compliance capacity, etc.), while ensuring that the long-run benefits of these proposed changes are achieved.
- 1.6.3 Therefore, the Reserve Bank is proposing to implement these changes at the same time as, or after, the implementation of the upcoming Dual Reporting Requirements in Q3 of 2022. This arrangement should help minimise any additional resources required by banks.

1.7 Timeline for Implementation

- 1.7.1 The consultation period for this proposal will run until 31 March 2022. We expect to release our final decision in Q2/3 of 2022. This indicative timeline may change if further consultation on the exposure limits is required.
- 1.7.2 The proposed policy changes would be enacted by replacing section BS8 of the Banking Supervision Handbook ("Connected Exposures Policy") with a reformatted 'Banking Prudential Requirements' (BPR) document.

2 Introduction

- 2.1.1 The Reserve Bank is consulting on the proposed approach to amend the Reserve Bank document "Connected Exposures Policy" (BS8) issued in October 2021.
- 2.1.2 BS8 sets out a limit on a New Zealand incorporated bank's credit exposure to its connected persons.
- 2.1.3 Connected persons are, broadly speaking, entities linked or bound by ownership, financial linkages or inter-dependency (e.g., a bank's parent).
- 2.1.4 Connected persons can be either a source of strength or weakness for a bank. Sources of strength for banks being part of a conglomerate group may be access to (i) capital markets that would not otherwise be accessible on a stand-alone basis, and (ii) financial support during times of financial difficulty. However, there are some downside risks that require management.

2.2 Rationale of a Connected Exposures Policy

2.2.1 In the context of connected exposures, two sources of weakness have been recognised in the Basel Core Principles for Effective Banking Supervision. These are the risk of unduly large exposures and abuses arising in transactions with connected persons.

Downside Risk 1: Large Exposures

2.2.2 The first downside risk is a bank being exposed to a potential failure of its connected persons, which could lead to the bank itself becoming insolvent.

2.2.3 The Basel Core Principles (BCP19) – the set of standards of the Basel Committee on Banking Supervision – expects regulators to set prudential limits to restrict bank exposures to single counterparties or groups of linked counterparties. We do not currently have prudential limits in place for large exposures to non-connected general counterparties, but BS8 limits exposures to connected persons, which helps partially mitigate this first downside risk.

2.2.4 This risk is also currently monitored by the Reserve Bank through its Large Exposure Survey (LEX Survey) to supplement the capital adequacy framework outlined in the Reserve Bank document "*BPR100: Capital Adequacy*".

2.2.5 The LEX Survey contextualises a concept of maximum possible loss as a potential loss that a bank could face in the event of a sudden failure of one or more counterparties. Connected persons are a subset of a bank's general counterparties, and therefore exposures to connected persons are also reported through the LEX Survey.

Downside Risk 2: Abusive Transactions

2.2.6 The second downside risk is that a bank's connected persons might take advantage of their position and endanger the bank's capital (in an "abusive transaction"). This could be unwittingly or intentionally if, for example, a connected person faces financial difficulty themselves.

2.2.7 Related to this is the risk that a bank might be unduly influenced by a connected person (for example a parent), which could impede its ability to objectively and independently assess the costs and benefits of a transaction with a connected person. The Basel Core Principles (BCP20) recommend regulatory measures to address the risk of conflicts of interest to prevent abuses arising in transactions with connected persons.

2.2.8 Aside from the current BS8, this risk is also managed by the attestation framework set out in the Disclosure Order in Council (OiC). These regulatory tools work together in a complementary way. The attestations under the Disclosure OiC require a bank's directors to attest as to "whether or not [...] credit exposures to connected persons (if any) were not contrary to the interests of the registered bank's banking group".

2.2.9 BS8 limits a New Zealand-incorporated bank's credit exposure to its connected persons. The aggregate gross exposure limit is 125% of the bank's Tier 1 capital. The aggregate net exposure limit is contingent on a bank's credit rating with a maximum of 75% of Tier 1 capital. These limits function as a back-stop measure in case other controls have failed.

2.3 Problem Definition and Rationale of Amendments

Inconsistency Within BS8 and Among BS8, the LEX Survey and the Capital Adequacy Framework

2.3.1 The current drafting of BS8 has led to some ambiguity. The two key areas are to do with:

1. the recognition of collateral exchanged for derivatives and securities financing transactions (SFTs); and
2. the extent to which long positions (or assets) can be offset with corresponding short positions (or liabilities) – this approach is generally described as “netting”.

2.3.2 For example, Section 4(i)(i) of the current BS8 text suggests that, for a market-related contract, credit exposure is calculated in accordance with Part E of the Reserve Bank document “*BPR131: Standardised Credit Risk RWAs*”. However, the text immediately above (which reads: “credit exposure means the amount of the maximum loss [...] without taking into account the value of collateral [...]”) leaves an ambiguity as to whether margins exchanged as collaterals for derivative transactions can be recognised under the current BS8.

2.3.3 These ambiguities have introduced uncertainty and confusion among banks about how to comply with BS8, as well as repeated queries from industry as to their correct interpretation.

2.3.4 In addition to these ambiguities within BS8, there is also some inconsistency with other policies and obligations on banks. For example, under both the capital adequacy framework and the LEX Survey, both the recognition of credit risk mitigations and netting are allowed subject to meeting certain conditions. However, under BS8, collateral exchanged for derivative transactions cannot be recognised, even if the derivative transactions are carried out under an agreement that has been designated in BS8 by the Reserve Bank as a robust netting agreement (i.e., an International Securities and Derivatives Association (ISDA) Master Agreement).

2.3.5 Additionally, the measurement methodologies of BS8 and the LEX survey are not aligned, although both use the same concept of maximum possible loss.

Outcome of Inconsistencies

2.3.6 Uncertainty about the rules in BS8 has been causing recurring queries by industry, including during the recent capital review process.

2.3.7 Stakeholders have argued for a different interpretation of BS8, which would allow banks to recognise credit risk mitigation and enable netting in the same manner as in the capital adequacy framework. Stakeholders have told us that the BS8 wording leads to an overstatement of the actual level of banks’ credit exposures to their connected persons. This, they argue, affects banks’ ability to manage risk efficiently and effectively.

BOX 1: What are margin payments for derivative contracts? What are the practical implications of the Reserve Bank’s proposal for them?

Derivatives are contracts whose value is based on an agreed underlying financial asset (like an equity issued by a company), rate (like an interest rate or exchange rate), index (like an equity index), or commodity (like crude oil). Derivatives are used either for speculative trading or for market risk management (e.g., to hedge currency risk on overseas transactions). Common types of derivatives include futures, forwards, options and swaps.

Margins are similar to collaterals pledged to a lender in case a borrower fails to fulfil an obligation. The exchange of margins is a prudent risk management tool that limits the build-up of risk throughout the time of a derivative contract until the contract is expired. Margining of derivatives is a common and established practice among significant market participants.

Some New Zealand banks transact derivatives with their parent bank – the parent bank is a connected person under the connected exposure policy – and they exchange margins.

To calculate the connected exposures associated with derivative transactions, the New Zealand banks must add up a large number of exposures to work out the maximum possible loss that they would face if their connected person did not fulfil the contract at some future date. Some contracts could be an obligation to buy the underlying financial assets in the future (“long positions”); while some could be obligation to sell the underlying financial assets (“short positions”). New Zealand banks often have an agreement in place with their connected person that allows for them to cancel out their long positions against their short positions as well as the contracts’ associated margins. This cancelling out is generally called netting. An effect of this netting is that if the contracts are terminated in the future, each party would only owe the other party the net amount of all of the contracts, rather than paying each contract individually.

Under the connected exposures policy, netting is allowed so long as banks follow a netting agreement that the Reserve Bank has designated as a robust netting agreement for purposes of the connected exposures policy. In such cases the bank may use the net amount when calculating its connected exposures.

However, under the connected exposure policy, credit exposure is defined as “the amount of the maximum loss that a party to a contract could incur [...] without taking into account the value of collateral”. Based on this, the Reserve Bank has not been allowing banks to net margins exchanged for derivative transactions even if margins are exchanged in accordance with a designated netting agreement in the policy.

The Reserve Bank’s proposal outlined in this consultation paper will enable banks to recognise margins exchanged for their derivative contracts in the same manner as that allowed under the existing standardised capital adequacy framework.

Rationale underlying the current BS8

2.3.8 The current drafting of BS8 leads to a conservative outcome for several reasons. The current inability to include netting is an attempt, in part, to address the risk that a netting agreement is not enforceable. This risk could be higher in respect of connected persons due to the lower incentive to perform appropriate due diligence. Moreover, given the nature of the relationship, there is a risk that a bank might not fully explore opportunities to enforce a netting agreement.

- 2.3.9 The conservative outcome regarding the recognition of collateral reduces the impact of situations where credit risks have not been mitigated properly and exposed the bank to higher risk than shown by its position with mitigation taken into account.
- 2.3.10 The intention of BS8 was to limit the amount of exposure a bank might have when exposures to connected persons (including conflicts of interest) have been mismanaged or when risk cascades form connected persons.
- 2.3.11 However, these concerns have led to a conservative calibration and have introduced inconsistencies and ambiguities. These could introduce unintended consequences if banks are unclear about what they have to comply with and if risk management becomes inefficient and costly.

Review of BS8

- 2.3.12 We acknowledge that the current level of ambiguity and inconsistency in BS8 is less than ideal. This warrants a review of BS8. However, the risks associated with exposures to connected persons have not diminished and will continue to require appropriate regulatory management in the form of exposure limits and through our attestation framework.
- 2.3.13 Bank directors will continue to attest to their banks managing these risks as part of the attestation framework under the Disclosure Order in Council (OIC). This will enable us to continue to hold a bank's board of directors accountable for addressing the risk of conflicts of interest with connected persons.

Financial Sector Assessment Program: Financial System Stability Assessment

- 2.3.14 The International Monetary Fund (IMF)'s 2017 assessment of the stability of the financial system in New Zealand recommended that the Reserve Bank:
- Require prior board approval for a bank to provide its connected persons with loans and to write them off;
 - Expand the information collected to include terms, names, and repayment status; and
 - Expand the definition of a connected person to include related parties of a bank's directors and other parties and transactions, as defined in the footnotes of BCP20.
- 2.3.15 The review also provides us with an opportunity to assess the extent to which these recommendations ought to be incorporated into our policy settings.

3 Overall Approach to Amend the Connected Exposures Policy

- 3.1.1 This section sets out the Reserve Bank's proposed overall approach to amend the Connected Exposures Policy.
- 3.1.2 Our overall approach to amend the connected exposures policy is based on the following principles:
1. An amended connected exposures policy, as far as possible, should be consistent with the existing relevant frameworks, i.e., the capital adequacy framework as defined in *BPR100: Capital Adequacy*. Adoption of such a principle minimises complexity while

ensuring that the connected exposures policy is an effective back-stop if other controls have failed.

2. Within the relevant frameworks, the simpler approach that already exists should be adopted if there is a case for it.
3. Exceptions to these principles need to be justified in terms of the objectives of the connected exposures policy.

3.1.3 It is also useful to refer to other international regulators. For example:

- Australia: The Australian Prudential Regulation Authority (APRA) has its own versions of a connected exposures policy and a large exposures policy in place. The two policies share the same concept of “maximum possible loss”. The measurement methodology of credit exposures in these two policies closely follows the methodology in the standardised approach of APRA’s capital adequacy framework, except for some caveats.
- The Basel Committee on Banking Supervision (BCBS): The Basel Framework does not have a connected exposures policy in place, but it does have a Large Exposures Policy. Like APRA’s policies, the measurement methodology of credit exposures in Basel’s Large Exposures Policy is closely aligned with the standardised approach of Basel’s capital adequacy framework.

3.1.4 We propose to follow this practice and use the standardised approach defined by the Reserve Bank’s document “BPR131: Standardised Credit Risk RWAs” for measuring connected exposures.

Q1. The Reserve Bank welcomes views on our proposed overall approach.

4 Our Proposed Changes

4.1.1 The connected exposures policy requires banks to measure their exposures to connected persons and limit the size of the total connected exposures as a proportion of their capital.

4.1.2 The exposures to connected persons are calculated with these three components: credit exposures, credit risk mitigations and capital, as outlined in the following equation:

$$\text{Connected exposures} = \frac{(\text{Credit exposure}) - (\text{Credit risk mitigations})}{\text{Tier 1 Capital}}$$

4.2 An Outline of Annex 8.1 to 8.4

4.2.1 The Reserve Bank’s proposed amendments and specific questions to each of the components are summarised in the Annex. An outline of the Annex is as follows.

Annex 8.1 Exposure Measure

This section provides clarification on a measurement methodology of the credit exposure component. As part of that, we are proposing to apply a flat 100% Credit Conversion Factor (CCF) to off-balance sheet contingent credit exposures to connected persons. This is because the Reserve Bank considers that it is appropriate to assume that a connected person would draw on any funds available to it in order to prevent its failure if it was in

financial difficulty. This proposal is aligned with the approach taken by APRA. An alternative option is applying a floor to the CCFs, which is the approach taken in the Basel Framework.

This section also covers the scope of the connected exposures policy, the meaning of the terms such as “potential recoveries” and “market-related contracts”, and the measurement methodology of on-balance sheet exposure values. Further details are in section 8.1 in the Annex.

Annex 8.2 Calculation of Exposure Value for Financial Instruments Held for Trading

In this section we are proposing to clarify the measurement methodology applicable to financial instruments issued by connected persons and held with the intent to trade or to hedge such positions held for trading. Further details are in section 8.2 in the Annex.

Annex 8.3 Recognition of Eligible Credit Risk Mitigations

In this section, we are proposing to allow banks to recognise credit risk mitigations eligible under the Reserve Bank’s document “*BPR131: Standardised Credit Risk RWAs*”. This change will enable banks, subject to meeting the conditions, to recognise eligible collaterals received for their derivative contracts and securities financing transactions in the same manner as specified for banks that follow the standardised approach. This change will also enable banks to recognise on-balance sheet netting. Further details are in section 8.3 in the Annex.

Annex 8.4 Capital Measure

This section provides clarification on a measurement methodology of the capital component (e.g., deduction). Further details are in section 8.4 in the Annex.

4.3 The Scope of the Policy and Exposure Limits

Interbank Exposures

- 4.3.1 Under the current BS8 it is not clear whether interbank exposures are included in the exposures that are subject to the connected exposures limit.
- 4.3.2 The Reserve Bank considers in principle that any exposure captured under the capital adequacy framework should also be captured under the connected exposures policy. This would mean that all exposures, including intra-day and inter-day exposures would be captured.
- 4.3.3 However, we are aware of potential constraints that banks may face given, in relation to monetary policy implementation, their operational practice with connected persons. Hence, we are seeking information to determine if exemptions for intraday interbank exposures would be needed beyond simple alignment with the capital adequacy framework.

Q2. The Reserve Bank welcomes views regarding interbank exposures. Please quantify your feedback if you think the exemptions would be required.

Definition of Connected Person

- 4.3.4 The IMF's 2017 assessment of the stability of the financial system in New Zealand recommended that the Reserve Bank expand the definition of a connected person to include related parties of a bank's directors. This recommendation was made based on Principle 20 of the Basel Core Principles for effective banking supervision (BCP).
- 4.3.5 The BCP states that connected persons "*can include, among other things, the bank's subsidiaries, affiliates, and any party (including their subsidiaries, affiliates and special purpose entities) that the bank exerts control over or that exerts control over the bank, the bank's major shareholders, Board members, senior management and key staff, their direct and related interests, and their close family members as well as corresponding persons in affiliated companies.*"
- 4.3.6 Related parties of a bank's directors are not currently in the scope of a connected person under BS8. To respond to the IMF's recommendation and align the definition of a connected person with Principle 20 of the BCP, the Reserve Bank is proposing to expand the definition of a connected person by adding: "an entity in which a director of the registered bank has a substantial interest (other than the registered bank and entities in which the registered bank itself has a substantial interest)".
- 4.3.7 If this proposed change is implemented, we anticipate that both the number of connected persons that a bank has and the level of aggregate exposure will change (see Section 6 for an impact assessment). The Reserve Bank does not intend to change the existing definition of "substantial interest" set out in the section 4(f) of the current BS8.
- 4.3.8 For example, the expansion of the definition of connected persons may increase some banks' connected persons more than other banks, which may create a situation where it is no longer fair to apply the exposure limits to a bank's aggregated credit exposures to all connected persons. If this is the case, it may be more appropriate to impose a limit on the sum of all the exposures to a single connected person.
- 4.3.9 In order to maintain the effectiveness of the exposure limits, the Reserve Bank is requesting that banks send us a list of their connected persons after taking into account the expanded definition.
- 4.3.10 Based on this information, we may make changes to the net exposure limits. The aim of this would not be to tighten the limit, but rather to accommodate any impacts that might emerge from an expanded definition. We are interested in any feedback from stakeholders about practical ways to do this.

Q3. The Reserve Bank welcomes views on our proposed expansion of the definition of a connected person. The Reserve Bank is requesting that banks send us a list of their connected persons after taking into account the expanded definition. Please send us any supporting information if you disagree with our proposal.

Conduct Requirements

- 4.3.11 Under the current BS8, banks must follow the conduct requirement that: “exposures to connected persons shall not be on more favourable terms (e.g., as relates to such matters as credit assessment, tenor, interest rates, amortisation schedules, requirement for collateral) than corresponding exposures to non-connected persons.”
- 4.3.12 The IMF’s 2017 assessment recommended that the Reserve Bank additionally require banks to obtain their Board’s approval prior to providing loans to connected persons and the writing-off of such loans.
- 4.3.13 This recommendation was made based on Principle 20 of the BCP, which reads: *“In order to prevent abuses arising in transactions with related parties and to address the risk of conflict of interest, the supervisor requires banks to [...] monitor these transactions; to take appropriate steps to control or mitigate the risks; and to write off exposures to related parties in accordance with standard policies and processes.”*
- 4.3.14 The Reserve Bank could consider these two options to respond to this recommendation:
- Option 1: Continue to rely on the attestation framework and not explicitly require board approval in the connected exposures policy; and
 - Option 2: Explicitly require board approval in the connected exposures policy.
- 4.3.15 Banks are already expected, under the attestation framework set out in the Disclosure Order in Council (OIC), to ensure that credit exposures to connected persons are not contrary to the interests of the bank’s banking group. Based on the attestation provided by banks, the Reserve Bank believes that directors have been ensuring the effective management of conflicts of interest through their systems of internal controls and governance arrangements. We further believe that board approval is effectively implemented as part of banks’ standard policies and processes.
- 4.3.16 If banks’ practice continues to support the effectiveness of the attestation framework on loan provisions to connected persons and the writing-off of such loans, the Reserve Bank will be comfortable to continue relying on the attestation framework under the current arrangement (i.e., Option 1).
- 4.3.17 However, if the Reserve Bank for whatever reason ceases to be satisfied with banks’ policies, procedures and practices to manage conflicts of interest when providing loans to connected persons and writing-off such loans, we will add this specific board approval requirement in the connected exposures policy (i.e., Option 2).

Q4. The Reserve Bank welcomes views on our proposed options to respond to the IMF’s recommendation. The Reserve Bank requests that banks provide us with supporting materials if they believe that the attestation framework has been effective in managing conflicts of interests, including the provision of loans to connected persons and the writing-off of such loans. The Reserve Bank also welcomes your feedback as to what the compliance costs impacts would be under Option 2.

Gross Exposure Limit

- 4.3.18 Under the current BS8, the aggregate gross exposure of the banking group to all connected persons must not exceed 125% of the banking group's Tier 1 capital.
- 4.3.19 Gross exposure is the exposure value without applying netting. Under an amended connected exposures policy, gross exposure would be the exposures without recognising any eligible credit risk mitigations (CRMs) for the purpose of the policy.
- 4.3.20 If the Reserve Bank's proposed amendments are implemented, the requirements, conditions and eligibility criteria for CRMs will be clearly set out in the amended connected exposures policy. This means that the risk of CRMs not working as expected will be limited under the amended connected exposures policy. This raises the question as to whether a gross exposure limit is still required.
- 4.3.21 An alternative option could be to replace the current gross exposure limit with the following requirement that "the extent to which banks can recognise eligible credit risk mitigations for exposures shall not be greater than 125 percent of the banking group's Tier 1 capital".

Q5. The Reserve Bank welcomes views regarding the gross exposure limit. Do you consider a gross exposure limit is still required? What would be the consequences of abolishing it? Please provide evidence and send us any supporting information.

Net Exposure Limits

- 4.3.22 Under the current BS8, the aggregate net credit exposure limit is contingent on a bank's credit rating, ranging from 15% to 75% of Tier 1 capital.
- 4.3.23 The Reserve Bank anticipates that the proposed amendments described above will impact the aggregate net exposure amount to which the exposure limit is applied (see Section 6 for a provisional impact assessment).
- 4.3.24 To ensure that the limit remains appropriate to address the risks arising from exposures to connected persons, the Reserve Bank will assess if the current net exposure limits are appropriate based off estimate data provided from banks.
- 4.3.25 Hence, the Reserve Bank requests that banks estimate aggregate net credit exposures reflecting all the changes proposed in this consultation paper and submit the estimate data to the Reserve Bank.
- 4.3.26 If needed, we will have another round of consultation regarding net exposure limits.

Q6. To the extent possible, please submit an estimate of your aggregate net credit exposures reflecting the changes proposed in this consultation paper.

4.4 Surveys and Information Collection

- 4.4.1 When enacting our proposed changes outlined in this consultation document, the Reserve Bank plans to make corresponding changes to the connected exposures survey. We also intend to make corresponding changes in the large exposures survey to provide consistency and reduce undue regulatory burdens on banks.

- 4.4.2 Along with these changes, we are proposing to begin collecting information on the terms, names and repayment status of a bank's transactions with its connected persons through the connected exposures survey.
- 4.4.3 During the IMF's assessment in 2017, the IMF found that *"Compliance is monitored off-site but information collected does not provide sufficient detail to monitor related party transactions"*. Based on this finding, the IMF recommended the Reserve Bank expand the information collected to include terms, names, and repayment status of a bank's transaction with its connected persons.
- 4.4.4 These proposed changes to the surveys are envisaged to take place at the same time as the changes outlined in this consultation document is enacted. An exact timing will be decided based on feedback that we receive on our proposed implementation arrangement, which is described in the following section (Question 8).

Q7. The Reserve Bank welcomes views on changes to the surveys. Please indicate if there are any practical concerns or challenges in relation to the additional information collection.

5 Implementation Arrangements

- 5.1.1 The Reserve Bank recognises that banks would require time and resources to implement the amendments to the connected exposures policy outlined in this consultation document.
- 5.1.2 Under the proposed amendments, banks that have been accredited by the Reserve Bank to use the internal-ratings based (IRB) approach for calculating risk weighted assets ("IRB banks") will be required to calculate both a standardised equivalent Tier 1 capital and an exposure amount in accordance with the standardised approach in BPR131.
- 5.1.3 However, IRB banks are scheduled to start calculating their exposures to other banks in accordance with the standardised approach in BPR131 from 1 January 2022. IRB banks will also be calculating both standardised equivalent capital components and exposure amounts according to BPR131 under the upcoming dual reporting requirements.
- 5.1.4 The Reserve Bank considers that, if the implementation of the amended connected exposures policy is at the same time as or after introduction of dual reporting requirements, our proposed amendments will not require IRB banks to carry out additional calculations or IT system changes.
- 5.1.5 The Reserve Bank believes that an appropriate implementation arrangement would help minimise any short-term costs (e.g., IT system changes, additional compliance capacity, etc.), while ensuring the long-run benefits of these proposed changes is achieved.
- 5.1.6 Therefore, we are seeking views on the timing of implementing the amended BS8.

Q8. The Reserve Bank welcomes views on implementing the amended BS8 at the same time as or after the upcoming implementation of the Dual Reporting Requirements.

6 Impacts of the Proposed Policy Changes

- 6.1.1 This section presents an initial assessment of the expected impacts of amending the connected exposures policy. We will present further analysis in a regulatory impact assessment (RIA), which will be released when we announce our decisions on the amendments of the connected exposures policy.
- 6.1.2 The Reserve Bank considers that our proposed changes outlined in this consultation paper would broadly address banks' issues with the current connected exposures policy.
- 6.1.3 If our proposed changes are implemented, we anticipate an impact on the level of aggregate net exposures.
- 6.1.4 To assess the impact of allowing credit risk mitigations (CRMs), the Reserve Bank carried out a provisional analysis using data collected through the Connected Exposures Survey and the Large Exposures Survey. Historical data suggests that a bank's net exposure to connected persons could reduce by an amount between 0% and 78% depending on each bank's practice of recognising eligible CRMs. This provisional analysis does not include the impact from our other proposals (e.g., expansion of the definition of "connected persons", application of a flat 100% credit conversion factor (CCF) to off balance sheet contingent exposures).
- 6.1.5 For example, the expansion of the definition of connected persons may increase the number of connected persons for some banks more than others. If this is the case, it may create a situation where it would no longer be fair to apply the exposure limits to a bank's aggregated credit exposures to all connected persons. Instead, it would be more appropriate to impose a limit on the sum of all exposures to a single connected person.
- 6.1.6 In order to maintain the effectiveness and fairness of the connected exposures policy with appropriate net exposure limits, the Reserve Bank is requesting that banks send us both their estimated aggregated net connected exposures and the number of their connected persons before and after the definition expansion.
- 6.1.7 Based on this information, we may make changes to the net exposure limits.
- 6.1.8 The Reserve Bank welcomes views on our proposed changes, the potential changes to the current net exposure limits and any impacts that banks and the financial system may encounter with these changes.
- 6.1.9 If needed, we will have another round of consultation regarding net exposure limits.
- 6.1.10 The alignment with the capital adequacy rules may also expand the range of eligible bilateral netting agreements under the Connected Exposures Policy. Currently only the International Swaps and Derivatives Association (ISDA) Master Agreement is designated in BS8 as a robust industry standard netting agreement.
- 6.1.11 While we are open to the idea of allowing more bilateral netting agreements to be eligible under the Connected Exposures Policy, as long as they are as robust as the ISDA agreement, we are keen to understand the implications of such a decision and request more information from industry on the types of agreement that would become eligible.

Q9. The Reserve Bank welcomes views on our proposed changes and any impacts that banks and the financial system may encounter with the proposed changes. We also seek any feedback about possible risks that might result from allowing more bilateral netting agreements to be eligible under the Connected Exposures Policy.

7 Timeline for Implementation

- 7.1.1 The consultation period for this proposal will run until 31 March 2022. We expect to release our final decision in Q2/3 2022, along with a summary of the submissions received and a regulatory impact assessment (RIA). This indicative timeline may change if further consultation on the exposure limits is required.
- 7.1.2 The proposed policy change would be enacted by replacing section BS8 of the Banking Supervision Handbook ("Connected Exposures Policy") with a reformatted 'Banking Prudential Requirements' (BPR) document. This will require a change to banks' Conditions of Registration (CoR). If the decision to amend the connected exposures policy is confirmed, we will run a short consultation (minimum seven days) on the required changes to CoR prior to implementing the amended connected exposures policy.

8 Annex

This Annex covers the Reserve Bank's proposed amendments and specific questions in relation to exposure measure, recognition of eligible credit risk mitigations and capital measure.

8.1 Exposure Measure

8.1.1 The connected exposures policy requires a definition of exposure values for assets and off-balance sheet items.

General Principles

- 8.1.2 As a general principle, the scope of the connected exposures policy is expected to include any exposures defined under the Capital Adequacy Framework set out in A1.3 of the Reserve Bank document "*BPR100: Capital adequacy*". This covers both on- and off-balance sheet exposures and instruments with counterparty credit risk under the capital adequacy framework (i.e., derivatives and securities financing transactions (SFTs)) regardless of where these exposures are recorded (e.g., banking book or trading book in general terms).
- 8.1.3 To clarify the meaning of "*maximum loss [...] without taking into account [...] the potential recoveries*" in section 4(i)(i) of the current BS8, the credit quality and the amount expected to be recovered in the connected persons' bankruptcy process should not be considered in the connected exposures policy and hence, not reflected in measures of exposure values. Some banks may take into account these factors in their internal management of credit exposures to set internal exposure limits to their counterparties, including connected persons, but such internal measures should not be taken into account for the purpose of the connected exposures policy. This is because BS8 is meant to serve as a simple back-stop measure to limit the maximum possible loss that a bank could incur if connected persons were to fail. When banks use eligible credit risk mitigation (discussed below), the effects of these mitigations on the maximum possible loss should be reflected as a reduction in the exposure value.
- 8.1.4 With regard to items deducted from capital, the deducted amount should not be added to the exposures to a connected person and should not be subject to the connected exposures limit. For example, assets which have been written off should not be included in the definition of exposure, as long as the bank has reduced their capital commensurately. This is because, if an exposure has Tier 1 capital held against the value of the exposure, there is no prudential benefit from an added limit to the size of the exposure relative to capital.

Q10. The Reserve Bank welcomes views on these general principles.

Market-Related Contracts

8.1.5 Under the current BS8, exposure values of a "market-related contract" are defined as the credit equivalent amount (CEA) calculated in accordance with Part E of the Reserve Bank document "*BPR131: Standardised Credit Risk RWAs*".

- 8.1.6 The Reserve Bank is proposing to replace the terminology of “market-related contracts” with “derivatives and securities financing transactions (SFTs)²”.
- 8.1.7 The Reserve Bank is not proposing to make any changes to the current measurement methodology.

Q11. The Reserve Bank welcomes views on the replacement of the terminology of “market-related contracts” with “derivatives and securities financing transactions (SFTs)”.

On-Balance Sheet Items (except “market related contracts”)

- 8.1.8 Under the current BS8, exposure values are net of any impairment allowances.
- 8.1.9 Under the Capital Adequacy Framework, for banks using the standardised approach for credit risk, exposure values are net of any impairment allowances, while for banks accredited to use the internal ratings-based (IRB) approach, exposure values are gross of eligible impairment allowances, which are offset against the expected loss (EL) deduction as set out in Part F of the Reserve Bank document “*BPR133: IRB Credit Risk RWAs*”.
- 8.1.10 To ensure consistency, the Reserve Bank intends to clarify that, for all banks (including IRB banks), the exposure value of on-balance sheet item must be measured in accordance with the standardised approach set out in A1.3(2)(b) of the Reserve Bank document “*BPR131: Standardised Credit Risk RWAs*” (i.e., net impairment allowances from their exposures) for connected exposures purposes.
- 8.1.11 The Reserve Bank believes that IRB banks have already been netting any impairment allowances when calculating on-balance sheet exposure values for BS8 purposes. Therefore, the Reserve Bank does not anticipate that banks will need to make any changes with this clarification. However, should the netting be operationally burdensome for IRB banks, they would have the option of using gross exposure values, which are a more conservative measure.
- 8.1.12 For the avoidance of doubt, the “full value” in section 4(i)(ii) of the current BS8 means that exposure values, for the purpose of the connected exposures policy, should be those before being multiplied by risk weights. This will continue to apply after this amendment.

Q12. The Reserve Bank welcomes views on the proposal to allow IRB banks to use gross exposure values, if netting of any impairment allowances is operationally burdensome.

Off-Balance Sheet Contingent Credit Exposures

- 8.1.13 In the current BS8, it is not sufficiently clear how banks measure off-balance sheet contingent credit exposures to connected persons.
- 8.1.14 Since the connected exposures policy is focused on the maximum possible loss that could arise in the event of the sudden failure of a connected person, it is appropriate to assume that a connected person will take all possible actions to prevent its failure. One can assume

² A securities financing transaction (SFT) is defined in BPR001: Glossary as a repurchase transaction, a reverse repurchase transaction, a securities lending transaction, or a securities borrowing transaction. Broadly speaking, these are transactions where securities – or collateral – are used to borrow cash, or vice-versa.

the connected person would draw on any funds available to it in order to prolong its existence as a going concern.

- 8.1.15 This indicates that Credit Conversion Factors (CCFs), for the purpose of calculating off-balance sheet credit exposures to connected persons, should be set at 100%. Therefore, we are proposing that the exposure value of off-balance sheet contingent liabilities to connected persons should be measured in accordance with Part D of *"BPR131: Standardised Credit Risk RWAs"*, but with the application of a flat 100% CCF. Alternatively, the Reserve Bank could consider applying the standardised CCFs as set out in Part D of BPR131, with a CCF floor.

Q13. The Reserve Bank welcomes views on our proposed application of a flat 100% CCF for off-balance sheet commitments to connected persons. Please quantify your feedback, particularly if you disagree with our proposed flat 100% CCF.

8.2 Calculation of Exposure Value for Financial Instruments Held for Trading

- 8.2.1 If a bank holds positions in financial instruments (such as equity instruments or debt securities) issued by connected persons or derivatives with underlying financial instruments issued by connected persons, and are held with the intent to trade or to hedge such positions held for trading, then an exposure to a connected person can arise from those positions.
- 8.2.2 The Reserve Bank believes that these exposures have already been included in a bank's credit exposure amount when banks apply the connected exposure limit. However, under the current BS8, it is not sufficiently clear how the exposure value is calculated for such financial instruments.
- 8.2.3 To clarify measurement methodologies, the exposure value of straight debt securities and equity instruments would be the accounting value of the exposure (i.e., the market value of the respective instruments) as defined in the Reserve Bank document *"BPR140: Market Risk"* (BPR140). This is because the market value equals the maximum loss a bank could incur if the issuer of a debt security or an equity instrument defaulted (i.e., the value of debt and equity claims could fall to zero in the case of default).
- 8.2.4 Instruments such as swaps, futures, and forwards would be decomposed into their individual legs following Section B1.4 of BPR140. Only transaction legs representing exposures to a connected person would need to be considered.
- 8.2.5 The measurement methodology of the exposure value of options under the connected exposures policy would differ from that set out in the current BPR140 and would be based on the change in the option price resulting from a default of the underlying instrument issued by a connected person (the gross jump-to-default risk positions measurement in general terms).
- 8.2.6 This measurement methodology in the current BPR140 is formed on an assumption that the underlying price change is relatively small. However, the scenario considered in the connected exposures policy is a connected person's default. Under such a scenario, it is appropriate to consider a very large price movement in the underlying instruments.

Therefore, we are proposing to use the gross jump-to-default risk positions measurement methodology for options.

- 8.2.7 Banks would be allowed to offset long and short positions in financial instruments issued by its connected persons if these instruments are the same issue (two issues are defined as the same if the issuer, coupon, currency and maturity are identical).
- 8.2.8 Offsetting long and short positions across a book for financial instruments held either for trading or hedging purpose (trading book in general terms) and a book for financial instruments held for any other purposes (banking book in general terms) would not be permitted.

Q14. The Reserve Bank welcomes views on our proposed clarification of the measurement methodologies for financial instruments issued by a bank's connected persons or derivatives with underlying financial instruments issued by a bank's connected persons. Please quantify your feedback, particularly if you disagree with our proposed clarification.

8.3 Recognition of Eligible Credit Risk Mitigations

- 8.3.1 Under the current BS8, exposure values are described as *"the amount of the maximum loss [...] without taking into account the value of collateral, guarantees, indemnities, other support arrangements [...]."*

Requirements, Conditions and Eligibility Criteria

- 8.3.2 The Reserve Bank is proposing to apply the same general requirements set out in A2 of the Reserve Bank document *"BPR132: Credit Risk Mitigation"* (BPR132) and the same requirements, conditions and eligibility criteria for the recognition of collateral, guarantees, and credit derivatives as under the standardised approach in BPR132 and Part E of BPR131.
- 8.3.3 This includes the condition in section D1.2(1)(b) of BPR132, which does not allow a bank to recognise credit protection if it is issued by connected persons.
- 8.3.4 To clarify a boundary of eligible credit risk mitigations (eligible CRMs) for the purpose of the connected exposures policy, the Reserve Bank proposal is that banks must not recognise unfunded contingent credit protection (e.g., a guarantee, credit derivative and indemnity) provided by connected persons. For example, unfunded contingent credit protection provided by Connected Person A against a failure of Connected Person B is not allowed to be recognised. Unfunded contingent credit protection provided by an entity other than a connected person against the failure of a connected person can be recognised.
- 8.3.5 Banks would need to recognise an eligible CRM if it meets the requirements, conditions and eligibility criteria for recognition set out in BPR132 and BPR131, whenever it has used the eligible CRM to calculate risk weighted assets under the Capital Adequacy Framework.
- 8.3.6 The value an exposure to connected persons can be reduced by the same amount as the eligible CRM recognised for capital adequacy purposes. This will be:
- The value of the protected portion in the case of a guarantee or credit derivative provided by an entity other than the connected person.

- The value of the portion of claim collateralised by the market value of the recognised financial collateral when the bank uses the simple approach set out in B3 of BPR132.
- The value of collateral adjusted after applying the required haircuts, in the case of financial collateral when a bank applies the comprehensive approach set out in B2 of BPR132 to derivatives and SFTs. The haircuts used to reduce the collateral amount are the standard supervisory haircuts described in B2.3 to B2.5 of BPR132. Internally modelled haircuts must not be used.

8.3.7 For example, for SFTs, this means that banks would be able to recognise eligible collateral by defining the exposure value as the credit equivalent amount (CEA) for SFTs as set out in Part E of BPR131. This would require banks to calculate the CEA of the counterparty credit risk arising from a single SFT using either the comprehensive approach to recognition of collateral, or the simple approach, as set out in BPR132. Additionally, BPR131 allows a bank to calculate a net exposure amount – after netting all the exposures and collateral – when a number of SFTs are covered by a master netting agreement with a given counterparty.

8.3.8 For the avoidance of doubt, a bank may recognise an eligible CRM on an exposure only if the CRM is of one of the types covered in Part B, Part C and sub-Part D1 of BPR132. Other forms of collateral that are only eligible under the internal-ratings based approach (e.g., real estate and collateral for lease financing) cannot be used to reduce exposure values for connected exposures purposes.

Q15. The Reserve Bank welcomes views on (i) the proposal to apply in the connected exposure policy the same conditions and same treatment of CRMs as those in the standard approach in BPR132, and (ii) the proposal that banks would not be able to recognise unfunded contingent credit protection provided by a connected person (e.g., a guarantee, credit derivative and indemnity).

To assess an impact of this proposed change, the Reserve Bank also request that banks send us a list of bilateral netting agreements that they are using (or intending to use) for derivatives and SFTs under BPR131 and BPR132 as well as, in the future if our proposed changes are implemented, under the connected exposure policy. We also seek any feedback about possible risks that might result from this proposed change.

BOX 2: A practical example of recognising margins for derivative contracts

Suppose that a New Zealand bank is transacting a group of interest rate derivative contracts with its Connected Person X.

All the interest rate derivative contracts are subject to a bilateral netting agreement and their maturities fall within one year.

The New Zealand bank holds NZD 10 million cash lodged by Connected Person X as initial margin. Also, Connected Person X holds NZD 10 million cash of initial margin received from the New Zealand bank in a non-segregated manner.

The net current market value of the derivative contracts (i.e., the “NCCE” in E3.2(1) of BPR131) is NZD 80 million.

The New Zealand bank holds NZD 79.5 million in variation margin in total for the derivative contracts in the form of cash collateral.

In this example, the adjusted exposure amount after risk mitigation (B2.2(2) of BPR132) is:

$$\begin{aligned}
 E^* &= \max\{0, CEA - C \times (100\% - H_c - H_{FX})\} \\
 &= \max\{0, \$80m - (\$79.5m + \$10m - \$10m) \times (100\% - 0\% - 0\%)\} \\
 &= \$0.5m
 \end{aligned}$$

Currently, BS8 does not allow banks to recognise any collaterals, and therefore the New Zealand bank’s exposure to Connected Person X in relation to the group of interest rate derivatives is NZD 80 million under the current BS8.

If the Reserve Bank’s proposed changes are implemented, the New Zealand bank will be allowed to recognise both margins. This practically means that the New Zealand bank’s exposures to Connected Person X in relation to the group of interest rate derivatives will be the adjusted exposure amount after risk mitigation, which is NZD 0.5 million.

On-Balance Sheet Netting

- 8.3.9 Under the current BS8, it is not sufficiently clear whether on-balance sheet netting is allowed or under what conditions it is allowed.
- 8.3.10 To clarify these points, the Reserve Bank is proposing that a bank may calculate exposure values for connected exposure purposes according to the calculation specified in C2.2 of BPR132, only where the requirements for on-balance sheet netting set out in C1.2 of BPR132 are met.

Q16. The Reserve Bank welcomes views on the proposal to allow on-balance sheet netting subject to meeting the requirements set out in C1.2 of BPR132.

To assess an impact of this proposed change, the Reserve Bank also request that banks send us a list of bilateral netting agreements that they are using (or intending to use) for on-balance sheet netting under BPR132 as well as, in the future if our proposed changes are implemented, under the connected exposures policy. We also seek any feedback about possible risks that might result from this proposed change.

Treatment of Maturity Mismatches in CRM

- 8.3.11 The Reserve Bank proposes to follow the approach set out in Part E of BPR132 to treat mismatches between the maturity of an exposure and the maturity of a hedge against the exposure.
- 8.3.12 Under our proposal, a bank will not be allowed to recognise a CRM that has (i) an effective original maturity of less than 12 months; and (ii) a maturity mismatch with the underlying exposure.
- 8.3.13 If there is a maturity mismatch in respect of CRMs (collateral, on-balance sheet netting, guarantees and credit derivatives), recognised in accordance with Part E of BPR132, then the adjustment of the credit protection for the purpose of calculating connected exposures will be determined using the same approach as in Part E of BPR 132.

Q17. The Reserve Bank welcomes views on the proposed treatment of maturity mismatches under the Connected Exposures Policy.

8.4 Capital Measure

- 8.4.1 The aim of the connected exposures policy is to ensure that a bank can absorb losses resulting from the sudden failure of its connected persons without failing itself.
- 8.4.2 Currently, BS8 sets out that *"advances of a capital nature by a banking group to connected persons must be deducted from the banking group's tier 1 capital"*. It does not explicitly state whether other assets specified in B1.3 to B1.13 of the Reserve Bank document *"BPR110: Capital Definitions"* (BPR110) must also be deducted.
- 8.4.3 The Reserve Bank clarifies that banks using the standardised approach for credit risk ("standardised banks") are expected to use Tier 1 capital, defined in A2.2 of BPR110, including deductions specified in B1.3 to B1.12 of BPR110.

- 8.4.4 Under the capital adequacy framework, for standardised banks, exposure values are net of any impairment allowances, while for banks accredited to use the internal ratings-based (IRB) approach (“IRB banks”), exposure values are gross of eligible impairment allowances. There is a corresponding difference in the definition of capital between the IRB approach and the standardised approach – the deduction of expected losses from Common Equity Tier 1 (CET1) capital as specified in B1.13 of BPR110 for IRB banks.
- 8.4.5 Under the current BS8, exposure values are net of any impairment allowances, which implicitly expects IRB banks to use the corresponding standardised version of Tier 1 capital (“standardised equivalent Tier 1 capital”) for the purpose of BS8.
- 8.4.6 Therefore, the Reserve Bank is proposing to clarify that IRB banks must use Tier 1 capital as defined in A2.2 of BPR110, except for the deduction of expected losses as required under B1.13 of BPR110.
- 8.4.7 This means that IRB banks would be required to add the deduction made from CET1 capital in accordance with Part F of BPR133 (i.e., B1.13 of BPR110) back to CET1 capital to calculate the standardised equivalent Tier 1 capital for the purpose of the connected exposures policy.
- 8.4.8 The Reserve Bank believes that IRB banks have already been using the standardised equivalent Tier 1 capital for the purpose of BS8. Therefore, this clarification should not require any changes.
- 8.4.9 Even if IRB banks have been deducting expected losses in accordance with B1.13 of BPR110, the Reserve Bank does not anticipate that this clarification will significantly change the level of their capital bases. Particularly given that credit exposures to banks (along with those to sovereigns) will no longer be categorised in the modelled exposure class and, therefore, will no longer be relevant to the B1.13 deduction on and after 1 January 2022.
- 8.4.10 IRB banks will also likely need to calculate standardised equivalent capital components – including standardised equivalent Tier 1 capital – once dual reporting requirements have been implemented in the near future.

Q18. The Reserve Bank welcomes views on the clarification of the capital measure for the purposes of calculating the connected exposures limit.