Reserve Bank of New Zealand
Te Pūtea Matua

28 July 2023

[Generic version for website publication]

Dear Chief Executive

Regulatory treatment of loans in North Island Weather Events Loan Guarantee Scheme

On 29 June 2023 the Government announced a package of financial support for businesses, orchards, and farms affected by the North Island weather events in early 2023. The package includes the North Island Weather Events Loan Guarantee Scheme that will enable commercial lenders to provide loans to highly affected businesses across all sectors with more favourable terms, such as reduced interest rates.

The scheme is intended to support businesses that are highly impacted by the North Island Weather Events but can still receive commercial lending. The Crown will cover the risk by taking up to 80% of the loan's default risk for scheme loans provided by lenders to eligible businesses. This letter sets out the regulatory treatment that banks may apply to lending covered by the Scheme.

Information about the Scheme is available on Treasury's website:

https://www.treasury.govt.nz/information-and-services/other-services/north-island-weather-events-loan-guarantee-scheme

We intend to publish a generic version of this letter on our website.

Implementation of the North Island Weather Events Loan Guarantee Scheme by standardised banks

As noted above, the Government will carry 80% of the credit risk, with the other 20% to be carried by the banks. The approach to credit risk calculations for Standardised banks consists of the following:

- Subpart D1 of BPR132, Section D1.11(2), covers guarantees and credit derivatives.
- The full value of NIWELGS exposures can be reported as claims on corporates.
- Claims on unrated corporates are risk weighted at 100%, as provided for BPR131 C2.7.
- 80% of the loan is covered by the indemnity from the Crown. Exposures to the Crown are risk weighted at 0%, as provided for in BPR131 C2.2.

2 The Terrace, Wellington 6011. PO Box 2498, Wellington 6140, New Zealand. +64 4 472 2029
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- Banks can therefore treat NIWELGS exposures as claims on corporates, risk-weighted at 20%.

No change in Conditions of Registration is necessary for banks to apply this treatment.

IRB banks should also take the approach described here into account for the purposes of calculating the output floor for credit risk.

The details of the scheme on Treasury's website indicate that loans should only be made to "viable" businesses. For the purposes of the change in Conditions discussed in this letter, this means the loans should be "performing" and therefore movement of these exposures to Stage 2 under IFRS9 should not be needed at this time.

If loans experience a significant increase in credit risk in the future, banks should follow their usual processes, incorporating the effect of the 80% Crown indemnity.

Implementation of the North Island Weather Events Loan Guarantee Scheme by IRB banks

While your bank is not accredited to use IRB models to calculate credit risk, we have included the details of the approach we will be permitted for IRB bank below. The intention of this is to provide you clarity about the regulatory framework.

As part of the Scheme, The Crown will carry 80% of the credit risk, with the other 20% to be carried by the banks. As such, in the event of default, the loss imposed on a bank would be 20% of what it would otherwise be.

Eligible exposures could likely fall into the following categories, where banks can model a range of the different components that serve as inputs into risk weights, subject to Reserve Bank approval of the models:

- Retail SME
- Corporate

D2.3 of BPR132: Credit Risk Mitigation allows a bank to reflect the risk-mitigating effect of a guarantee or credit derivative in an RWA calculation by adjusting either Probability of Default (PD) or Loss Given Default (LGD) estimates. However, D2.3(3) prevents a bank from adjusting an LGD for farm lending (and residential mortgage loans).

In the case of farm lending, IRB banks must currently use the minimum Loss Given Default (LGD) for exposures covered by the estimates that correspond to particular Loan-to-Value ratios set out in Table C3.2 in BPR133: IRB Credit Risk RWAs.

The treatment set out in this letter will permit IRB banks to apply a different LGD, depending on the type of lending.

Approach to farm lending (within Retail SME or Corporate categories)

For farm lending, BPR132 prevents IRB banks from adjusting the LGDs – they must use the minimums described above. However, if a loss was realised on a NIWELGS loan, there would be a 0% loss rate for the bank on the 80% of the exposure covered by the Crown indemnity.

To reflect the impact of the Scheme, IRB banks will be permitted to overwrite the minimum LGDs specified in BPR133 and apply an 8.5% LGD for this lending, regardless of the LVR. This is based on using the highest LGD for farm lending exposure, as specified in BPR133, of 42.5% and multiplying that by 20% - to factor in that for a NIWELGS loan there would be a 0% loss rate for the bank on the 80% of the exposure covered by the indemnity from the Crown.

The details of the scheme on Treasury's website indicate that loans should only be made to "viable" businesses. For the purposes of the change in Conditions discussed in this letter, this means the loans should be "performing" and therefore movement of these exposures to Stage 2 under IFRS9 should not be needed at this time.

If loans experience a significant increase in credit risk in the future, banks should follow their usual processes, incorporating the effect of the 80% indemnity from the Crown.

Approach to other lending within Retail SME or Corporate categories

For NIWELGS exposures, banks may apply their existing internal LGD estimates (where greater than 12%), or a fixed LGD of 12% - this reflects the following factors:

- If a loss was realised on a NIWELGS loan, there would be a 0% loss rate for the bank on the 80% of the exposure covered by the indemnity.
- For simplicity, the residual 20% will be treated as unsecured (as any security must be exhausted before a claim is made).
- Most IRB banks' unsecured LGD estimates for corporates are approximately 60%.
- The NIWELGS LGD is therefore ((80% * 0%) + (20% * 60%)) = 12%.

Incorporating changes in IRB models

If an IRB makes the above changes to their LGD models – and only the changes outlined above – each IRB bank should update its compendium of approved models and provide a copy, including any supporting documentation, to the Reserve Bank.

That is, if these changes (and only these changes) are made then we propose that the Reserve Bank will treat them as approved models. As such, banks need not apply for model change approval, but it is important that the compendium is updated for tracking and monitoring purposes.

If you have any questions or require any additional information about any aspect of this letter, please contact the supervisor for your bank in the first instance.

Yours sincerely

Christian Hawkesby

Deputy Governor / General Manager Financial Stability

CC: Regulatory Affairs