



Reserve Bank
of New Zealand
Te Pūtea Matua

BS8

Connected Exposures Policy

Document Version

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Conditions of registration

The Banking Prudential Supervision Act 1989 (the Act) permits the Reserve Bank to impose conditions of registration (conditions) on registered banks¹.

This document BS8: Connected Exposures Policy forms part of the requirements for the following conditions:* A New Zealand-incorporated registered bank is normally subject to standard conditions of registration relating to exposure to connected persons. This document sets out these standard requirements.

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

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

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Part A: Introduction and definitions

A.1 Purpose of this document

1. The purpose of the connected exposures policy is to support the stability of the financial system by:
 - (a) addressing the risk of conflict of interest with connected persons, particularly in relation to unusually favourable contract terms with connected persons; and
 - (b) limiting the banking group's total exposure to connected persons; and
 - (c) providing a backstop measure to a locally incorporated registered bank in the event its prevention measures that seek to manage conflicts of interest with connected persons have failed.
2. This policy requires a locally incorporated registered bank to
 - (a) monitor transactions with connected persons; and
 - (b) have appropriate and effective systems and controls in place to ensure that
 - i. the risks of conflict of interest with connected persons are managed; and
 - ii. credit exposures to connected persons are not contrary to the interests of its banking group.
3. This document sets out the following:
 - (a) definition of a connected person; and
 - (b) requirements on conduct, systems and controls; and
 - (c) requirements on measuring a banking group's exposures to connected persons and limiting the size of the total connected exposures in relation to the banking group's capital.

A.2 Scope and level of application

1. Exposure limits are set out in Part B of this document. The limits are applicable to a locally incorporated registered bank and limit the banking group's exposures to the bank's connected persons. The banking group of a locally incorporated registered bank is defined in clause 4(1) of the Registered Bank Disclosure Statements (New Zealand Incorporated Registered Banks) Order 2014.
2. A locally incorporated registered bank (a '**registered bank**' unless otherwise specified) is generally subject to standard conditions of registration relating to exposure to connected persons.
3. The Reserve Bank reserves the right to impose non-standard conditions of registration or to vary the standard conditions of registration of a registered bank where special circumstances arise or the Reserve Bank considers it appropriate to do so.

A.3 Definition of connected person

1. A person (**A**) is a connected person of a registered bank if—
 - (a) A is a director or senior manager of the registered bank or of any person who has control of the registered bank; or

- (b) A is a close family member of a director or senior manager of the registered bank or of any person who has control of the registered bank; or
 - (c) A is a subsidiary of the registered bank; or
 - (d) A has control of the registered bank; or
 - (e) A has significant influence over the registered bank; or
 - (f) the registered bank has control of A; or
 - (g) the registered bank has significant influence over A; or
 - (h) a director of the registered bank has control of A; or
 - (i) any other person who has control of the registered bank has either control of or significant influence over A; or
 - (j) any other person who has significant influence over the registered bank has control of A.
2. The central government of any country with a long-term credit rating of A- or A3 or above, or its equivalent is not a connected person.
 3. However, despite A.3(1)(c), any member of the registered bank's banking group is not a connected person.
 4. Non-bank connected person means any connected person other than a registered bank or an entity which a registered bank has either control of or significant influence over.
 5. **Director** means —
 - (a) in relation to a company, any person occupying the position of a director of the company by whatever name called; or
 - (b) in relation to a partnership (other than a limited partnership), any partner; or
 - (c) in relation to a limited partnership, any general partner; or
 - (d) in relation to a body corporate or unincorporate, other than a company, partnership, or limited partnership, any person occupying a position in the body that is comparable with that of a director of a company.
 6. **Senior manager** means a person who occupies any of the following positions (by whatever name called):
 - (a) chief executive; or
 - (b) chief financial officer; or
 - (c) a manager who reports directly to the chief executive.
 7. **Subsidiary** means a subsidiary within the meaning of sections 5 to 8 of the Companies Act 1993.
 8. **Voting rights** and **voting securities** have the same meaning as in section 2 of the Banking (Prudential Supervision) Act 1989.
 9. A **close family member**, in relation to any person, means:
 - (a) the person's spouse, civil union partner, or de facto partner; or
 - (b) any child under the age of 20 years of the person or the person's spouse, civil union partner, or de facto partner.

10. A person (B) has **control of** another person (C) if —
 - (a) B has the power (whether directly or indirectly) to —
 - (i) exercise, or control the exercise of, 50% or more of the voting rights in C; or
 - (ii) appoint 50% or more of the board of directors of C; or
 - (b) B has, together with one or more other connected persons, the power (whether directly or indirectly) to —
 - (i) exercise, or control the exercise of, 50% or more of the voting rights in C; or
 - (ii) appoint 50% or more of the board of directors of C.
11. A person (B) has **significant influence** over another person (C) if —
 - (a) B has the ability (whether directly or indirectly) to —
 - (i) exercise, or control the exercise of, 25% or more of voting rights in C; or
 - (ii) appoint 50% or more of the board of directors of C; or
 - (b) B has, together with one or more other connected persons, the ability (whether directly or indirectly) to —
 - (i) exercise, or control the exercise of, 25% or more of the voting rights in C; or
 - (ii) appoint 50% or more of the board of directors of C.
12. **Governing body** means —
 - (a) in relation to a body corporate, the board of directors (or other persons or body exercising powers of governance or management, however described) of the body corporate:
 - (b) in relation to a partnership or other unincorporated body of persons, either—
 - (i) the board of directors (or other persons or body exercising powers of governance or management, however described) of the partnership or other unincorporated body of persons; or
 - (ii) if there is no board or other persons or body as described in 12(b)(i) of this document, the partners of the partnership or members of the unincorporated body of persons

Part B: Requirements

B.1 Exposures limits

1. Aggregate credit exposures of the banking group to all connected persons must not exceed the rating-contingent limit outlined in the following matrix at the end of each working day at all times.

Credit rating ²	Connected exposure limit (% of the Banking Group's Tier 1 capital)
AA/Aa2 and above	75
AA-/Aa3	70
A+/A1	60
A/A2	40
A-/A3	30
BBB+/Baa1 and below	15

2. Within the rating-contingent limit, credit exposures to non-bank connected persons must not exceed 15 percent of the banking group's tier 1 capital at the end of each working day at all times.

Guidance: The exposure limits apply to the end-of-day exposures. Intra-day exposures are not subject to the exposure limits.

3. The exposures must be measured as specified in Part C of this document.
4. The aggregate credit exposures are the sum of exposures, across all connected persons, measured by each of connected persons.
5. 'Tier 1 capital' has the same meaning as in the Reserve Bank document '**BPR110: Capital Definitions (BPR110)**', in the version applying to the registered bank in its conditions of registration.
6. In relation to A2.2(2) and B1.6 in BPR110, an advance will be considered to be of a capital nature and defined as 'advances of a capital nature by a banking group to connected persons', if, in a connected person's financial statements, the advance
 - (a) is described as a capital or subordinated debt instrument; or
 - (b) it is counted as capital under the capital adequacy requirements imposed by a parent supervisor.
7. For the purpose of compliance with the rating-contingent limit:
 - (a) The credit rating will be the rating applicable to the registered bank's long-term senior unsecured New Zealand dollar obligations payable in New Zealand, in New Zealand dollars. Where a registered bank has more than one credit rating, the lowest rating will be used in determining the connected exposure limit.
 - (b) Only credit ratings produced by rating agencies approved by the Reserve Bank may be used. Those agencies are: Standard & Poor's, Moody's Investor Services and Fitch Ratings. (The Reserve Bank's 'Statement of Principles' (BS1), in particular Appendix Three of BS1, provides details on the approval of credit rating agencies.)
 - (c) A three-month grace period starting from the date of a credit rating downgrade will be allowed for the limit which applies before the downgrade to reduce to the new limit based on the above matrix. The Reserve Bank will consider allowing an extension of the limit adjustment period if a registered bank has structural reasons for not being

² The rating scales in this column are presented as "Standard & Poor's scale/Moody's Investor Services scale," noting that Fitch Ratings' scale is identical to Standard & Poor's.

able to comply within the three-month period. The limit extension would be for a specific time period (but no longer than an additional three months).

B.2 Conduct

1. Exposures of a registered bank's banking group to connected persons must 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.
2. A registered bank must adequately monitor its banking group's transactions with connected persons to take appropriate steps to control the risks to prevent inappropriate transactions occurring and to address the risk of conflict of interest, as set out in B.3.

Guidance: Exposures to connected persons under standard staff banking packages are not considered to be on more favourable terms than corresponding exposures to non-connected persons for the purposes of B.2.

B.3 Governance and Compliance Management

1. The registered bank's board of directors retains the ultimate responsibility for the registered bank's compliance with the requirements set out in this Policy.
2. A registered bank must take reasonable care to establish and maintain effective systems to ensure the registered banks' compliance with the requirements in this Policy at all times.

Guidance: The purpose of B.3 is to encourage registered banks' directors to exercise due diligence to ensure the registered bank's compliance with the requirements in this Policy. B.3 should be read in conjunction with the required directors' statement in the Registered Bank Disclosure Statements (New Zealand Incorporated Registered Banks) Order 2014.

Guidance: Examples of the 'systems' in B.3(2) include (i) adequate policies and procedures approved by the registered bank's board to ensure that credit exposures to connected persons (e.g., writing off of exposures to connected persons) are not contrary to the interests of the registered bank's banking group; and (ii) adequate arrangements to monitor and control the banking group's exposures to connected persons to ensure the registered bank's compliance with the exposure limits at all times.

Part C: Exposure measurement

C.1 General measurement principles

1. The exposure values that a registered bank must consider in order to identify exposures to a connected person are all those exposures covered under the Capital Adequacy Framework defined in the Reserve Bank document '**BPR100: Capital adequacy**'.
2. It must consider both on- and off-balance sheet exposures included in either the banking or trading book and instruments with counterparty credit risk under the Capital Adequacy Framework (e.g., derivatives and securities financing transactions (SFTs)).

3. A registered bank must not recognise any kinds of credit risk mitigations or potential recoveries other than the eligible credit risk mitigations specified in C.3 and C.4 in this document.

Guidance: Some banks may take into account other relevant factors (e.g. credit quality) in their internal risk management framework to set internal exposure limits to their counterparties, including connected persons. However, such internal measures must not be recognised for the purpose of the connected exposures policy.

4. An asset deducted from capital must not be included in exposures to a connected person in accordance with A1.3(2) of the Reserve Bank document **BPR131: Standardised Credit Risk RWAs (BPR131)**.

Guidance: For example, assets which have been written off should not be included in the definition of exposure, as long as the registered 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.

C.2 Definition of exposure value

1. The exposure value for any on-balance sheet items must be defined as the value after deducting any impairment allowances attributable to the exposure in accordance with A1.3(2)(b) of BPR131. As a conservative alternative option, a registered bank may use the gross exposure value without deductions.
2. For the purpose of the connected exposures policy, off-balance sheet items will be converted into the credit equivalent amount (**CEA**) by using a credit conversion factor (**CCF**) of 100%.

Guidance: This flat 100% CCF is applicable only when registered banks calculate an exposure value for the purpose of the connected exposure policy. This is because 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, and therefore it is appropriate to assume that a connected person will take all possible actions to prevent its failure (e.g., drawing on any funds available to it in order to prolong its existence as a going concern).

3. A registered bank may enter into an unfunded contingent credit protection arrangement (e.g. guarantee, credit derivative and indemnity) with a connected person to reduce the value of its exposure to a counterparty that is not a connected person, to the extent of the portion protected under the unfunded contingent credit protection arrangement. Such arrangements give rise to a contingent credit exposure to connected persons. For the purpose of the connected exposures policy, the definition of exposure value excludes any such contingent exposures to connected persons.
4. The exposure value for derivatives and SFTs that give rise to counterparty credit risk must be measured in accordance with Part E of BPR131 in the version applying to the registered bank in its conditions of registration, which sets out the measurement methodology to calculate the CEA of the counterparty credit risk arising from these contracts.

C.3 Recognition of CRMs in reduction of exposures to its connected person

1. When a registered bank has recognised eligible credit risk mitigation (CRM) for the purpose of risk-weighted asset (RWA) calculation for credit exposure, the registered bank may reduce the value of the exposure to its connected person, by the amount of the eligible CRM calculated in accordance with Part B, Part C and Sub-part D1 of the Reserve Bank document **BPR132: Credit Risk Mitigation (BPR132)** and recognised for the purpose of RWA calculation.
2. Types of CRMs that are allowed to be recognised for the purpose of the Connected Exposures Policy are only those available for adjusting standardised RWA calculations.

Guidance:

- As a conservative alternative option, a registered bank may choose to use gross exposure value without recognising eligible CRMs to measure exposures applicable to the connected exposure limits.
- Registered banks are not allowed to recognise eligible CRMs that are not recognised for the purpose of RWA calculation for credit exposure.
- Any other types of CRMs that are eligible only for internal-ratings based modelled exposures (e.g. real estate and collateral for lease financing) must not be used to reduce exposure values for the purpose of connected exposures policy.

C.4 Eligible credit risk mitigation

1. Eligible CRMs are those that meet both the general requirements set out in A2 of BPR132 and all the relevant parts of requirements, conditions and eligibility criteria for the recognition of collaterals, guarantees, credit derivatives and on-balance sheet netting that are set out for adjusting standardised RWA calculation in BPR132 and Part E of BPR131.

Guidance: To be an eligible CRM, all elements of the eligibility conditions including details of requirements and Guidance must be met.

For example, E3.1(2)(d)(i) of BPR131 clarifies the application of the phrase “laws of all relevant jurisdictions” by stating that “if a foreign branch of the counterparty is involved, the law of the jurisdiction in which the branch is located”. This means that a bilateral netting agreement involving a foreign branch of the counterparty can be eligible, but that involving a subsidiary of the counterparty cannot be eligible.

Another example is that Guidance for E3.1(2) clarifies that “a payment netting contract intended only to reduce the operational costs of daily settlements typically does not meet the conditions in subsection (2)”. All the Guidance should be taken into account as part of the eligibility conditions.

2. Registered banks must not recognise any form of unfunded contingent credit protection provided by its connected person.

Guidance: C.4(2) is a recap of D1.2 and D2.2 of BPR132. Examples of unfunded contingent credit protection are a guarantee, credit derivative, indemnity. For clarity, 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.

3. A registered bank must use the standardised supervisory haircuts specified in B2 of BPR132 and must not use its internally modelled haircuts.
4. In accordance with provisions set out in E1.3(1) of BPR132, a registered bank must not recognise a CRM that has
 - (a) an effective original maturity of less than 12 months; and
 - (b) a maturity mismatch with the underlying exposure.
5. 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, the adjustment of the credit protection for the purpose of calculating connected exposures is determined using the same approach as in Part E of BPR 132.

C.5 Calculation of exposure value for trading book positions

1. Where a banking group holds positions in financial instruments (such as equities and bonds) issued by a connected person in its trading book, the registered bank must add those exposures to its exposures to the connected person that lie in the banking book.

Guidance: C.5 is relevant only for a registered bank whose banking group holds positions in financial instruments issued by a connected person for a trading purpose.

2. The exposure value must be measured in accordance with BPR140.
3. A registered bank may offset long and short positions in financial instruments issued by its connected person within a trading book. A registered bank may not offset long and short positions across the banking and trading books.