RESERVE BANK OF NEW ZEALAND

Risk Management Programme Guidelines

Prudential Supervision Department
Non-bank deposit takers

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Part 1—Introduction

1. Purpose of this document

(1) This document provides guidance to non-bank deposit takers (“NBDTs”) in relation to the risk management programme requirements under the Non-bank Deposit Takers Act 2013 (the Act).

(2) Part 2 of this document notes some considerations in relation to risk management programmes and Part 3 provides some guidelines on how to interpret the main categories of risk set out in section 27 of the Act.

2. Meaning of risk

In this document, risk refers to the possibility of adverse effects on an NBDT including a loss of: earnings; capital; access to markets; reputation or the ability to continue in business.

Part 2—Risk management programmes

General matters

3. Requirement for risk management programmes

(1) Under section 27(1) of the Act, every NBDT must have a risk management programme and take all practicable steps to comply with that programme.

(2) Under section 27(2), a risk management programme must:

(a) be in writing; and

(b) set out the procedures that the deposit taker will use for the effective identification and management of the following risks:

(i) credit risk:

(ii) liquidity risk:

(iii) market risk:

(iv) operational risk; and

(c) set out appropriate and auditable documentation and record keeping requirements; and

(d) describe the steps that the NBDT will take to ensure that the programme remains current, which must include procedures for—

(i) regular review of the programme to systematically identify deficiencies in the effectiveness of the programme; and

(ii) obtaining the approval of trustees to amendments to the programme that are necessary to address such deficiencies; and

(e) be appropriate to the operations of the NBDT, having regard to the factors relevant to the risks referred to in paragraph (b) (for example, the size of the deposit taker, its funding structure, the market sector in which it operates, its business strategy, and its relationship with its borrowing group).

(3) Section 28 of the Act requires each NBDTs' trustee to be satisfied that the risk management programme meets the requirements of the Act.

4. Size and nature of deposit taker to be taken into account

The breadth and scope of an NBDT's processes and internal controls set out in its risk management programme for managing risks should depend on the nature and size of the NBDT's business.

5. Matters for inclusion in risk management programmes

(1) An NBDT's risk management programme should cover all activities affecting the NBDT's risk profile.

(2) An NBDT's risk management programme should:

- (a) identify the risks to be managed;
- (b) take into account the extent to which:
  - (i) a single transaction may give rise to multiple risks; and
  - (ii) one type of risk could trigger other types of risk;
- (c) describe processes, systems and procedures to measure (where possible), monitor and control the risks identified;
- (d) be comprehensive enough to capture all material risks to which the deposit taker is exposed;
- (e) describe the roles and responsibilities for positions in the NBDT's organisation that:
  - (i) manage risk for the NBDT; or
  - (ii) accept risk for the NBDT;
- (f) prescribe information flows between operational staff and senior management;
- (g) provide a system to address any exceptions, or instances of non-compliance observed;
- (h) describe the NBDT's contingency plans;
- (i) describe the processes for reviewing risk management systems, policies and procedures on an ongoing basis; and
- (j) be linked to the NBDT's capital adequacy policy (including its policy on the amount of capital required to provide a buffer against losses arising from unanticipated events).

Design considerations for programmes

6. Types of risk

(1) An NBDT's risk management programme should cover all risks that are material to the NBDT.

(2) At a minimum the programme should cover the four types of risks typically encountered by NBDTs: credit risk, liquidity risk, market risk and operational risk. These are discussed further in Part 3.

7. Assessment and measurement of risk

(1) Where possible, an NBDT should quantify its exposure to risk.

(2) If a risk is not quantifiable and cannot be avoided (for example, some types of operational risk), the NBDT should use qualitative measures to identify its exposure to such risks.

(3) An NBDT should make use of both quantitative measures of risk and qualitative assessments of risk to support its decision making processes.

8. Contingency planning

(1) An NBDT's risk management programme should include contingency plans for managing stress events.

(2) An NBDT's contingency plans should:

- (a) address stress events that could materially disrupt an NBDT's business and have a material probability of occurring;
- (b) include a process to identify possible future stress situations;
- (c) include plans to manage stress events in a timely and effective manner;
- (d) include plans for disaster recovery; and
- (e) be appropriate and workable.

9. Review process for risk management programmes

(1) An NBDT should review its risk management programme:

- (a) regularly; and
- (b) whenever there is a significant change in its business.

(2) For complex businesses a regular review should be conducted at least on an annual basis.

(3) A review of a risk management programme should include:

- (a) a review of the assumptions underlying the risk management programme to ensure that they remain appropriate; and
- (b) an assessment of the rigour and robustness of—
  - (i) the risk management programme's methodologies for measuring risk; and
  - (ii) the effectiveness of the risk management programme's internal controls.

(4) The results of a review should be reported, as appropriate, to: the operational areas of the NBDT's business, its senior management, and its governing body.

(5) Where problems are identified, necessary changes to the risk management programme should be implemented in a timely way.

Operational considerations

10. Responsibilities of governing bodies and senior management

(1) The responsibilities of an NBDT's governing body should include:

(a) the solvency, capital adequacy and liquidity of the NBDT;

(b) establishing risk tolerances for the NBDT;

(c) approving the reporting requirements, policies, procedures and controls for the NBDT;

(d) monitoring the risk exposures of the NBDT to check that they are consistent with established risk tolerances;

(e) monitoring the NBDT's compliance with legal requirements and the NBDT's policies and procedures;

(f) the NBDT's policy on managing conflicts of interest; and

(g) ensuring that any exposures to, and transactions with, related parties are on arm's length terms and conditions.

(2) The responsibilities of an NBDT's senior management should include:

(a) ensuring that risks taken are within limits set by the governing body;

(b) implementing the policies, procedures, controls and reporting mechanisms set out in the NBDT's risk management programme; and

(c) ensuring that the risk management programme includes:

(i) a requirement that an action that is contrary to the NBDT's policies is reported to senior management and, depending on materiality, to the governing body; and

(ii) a requirement that in such cases corrective measures are triggered.

11. Staff responsibilities and accountability

(1) Each area of an NBDT's business should be accountable and responsible for the risks it exposes the NBDT to through its operations.

(2) An NBDT should ensure that its staff are well trained and have experience appropriate to their roles.

(3) An NBDT's operational staff should understand the risks they encounter in conducting their part of the NBDT's business.

Part 3—Specific risks

Credit risk

12. How credit risk arises

(1) Credit risk is the risk of loss to an NBDT arising from a party to a contract or transaction with the NBDT that:

(a) is not able to meet its obligations; or

(b) defaults on its commitments.

(2) Credit risk can arise in relation to:

(a) on-balance sheet exposures (for example, lending activities); and

(b) off-balance sheet exposures (for example, guarantees and other commitments).

13. Credit risk – elements for risk management programmes

(1) Elements of credit risk that an NBDT could consider for inclusion in its risk management programme include:

(a) concentration risk – the risk arising from an overexposure to a borrower or a group of related borrowers, an industry sector or a country;

(b) business cycle risk – the risk arising from changes in the business cycle; and

(c) country risk – the risk arising from an exposure to a country.

(2) Elements for managing credit risk that an NBDT could consider for inclusion in its risk management programme include procedures for:

(a) establishing and modifying its lending policies and procedures;

(b) monitoring and reviewing its loan book with particular regard to:

(i) the continuing ability of borrowers to meet their obligations; and

(ii) any changes in the value of any security given for its loans;

(c) identifying potential defaulting loans or adverse trends in its loan book; and

(d) managing any of its loans that show signs of deteriorating credit quality.

Liquidity risk

14. How liquidity risk arises

(1) Liquidity risk is the risk that an NBDT is unable to meet its financial commitments as they fall due or that it suffers material loss in doing so.

(2) Liquidity risk can increase if there is:

(a) a high concentration of the NBDT's loans in a particular area of economic activity;

(b) a loss of confidence in the NBDT that adversely affects its ability to raise new funding;

(c) a substantial deterioration in the credit quality of its counterparties that affects their ability to pay principal or interest as it falls due; or

(d) a disruption in the market for normally liquid assets, making it difficult for the NBDT to sell them.

15. Liquidity risk – elements for risk management programmes

As part of its risk management programme for liquidity risk, an NBDT should:

(a) identify any funding gaps;

(b) manage its sources of regular funding; and

(c) maintain sources of emergency back-up liquidity.

16. Identify and manage funding gap

(1) An NBDT should forecast its future cash flows to identify the scale of the funding gaps that it will need to fill over a range of maturities and in doing so should:

(a) base its forecast on realistic assumptions about:

(i) the amounts of cash due to be received that will be received; and

(ii) the rates of withdrawal of cash that can contractually be withdrawn; and

(b) cover all material cash flows including, for example, those arising from off-balance sheet instruments.

(2) An NBDT should consider whether it can reduce the size of its expected funding gaps at various time horizons by altering the relative contractual maturities of its funding and its lending.

17. Manage sources of regular funding

(1) An NBDT should understand its funding markets and regularly monitor each market for any signs of specific resistance to its own name or more general declining confidence in that market.

(2) An NBDT should manage the risk of concentrated funding, that is, the risk arising from a substantial proportion of its funding originating from one depositor or from a number of depositors who might be likely to act together.

(3) An NBDT should manage the risk that its funding sources will be adversely affected by a credit rating downgrade.

18. Emergency sources of liquidity

(1) An NBDT should have alternative emergency sources of liquidity sufficient to enable it to survive for a planned period when it is temporarily unable to raise money in its usual funding markets.

(2) As its principal source of emergency liquidity, an NBDT should hold a portfolio of reliably marketable liquid assets that is diversified as far as possible across a range of instruments and issuers.

(3) If an NBDT relies on one or more standby lines of credit as part of its emergency liquidity, for each such line of credit the NBDT should:

(a) negotiate terms as far as possible to minimise the likelihood that the provider can refuse to provide funds when called upon; and

(b) regularly assess whether it is likely to breach any covenants or trigger any material adverse change clauses.

Market risk

19. How market risk arises

(1) Market risk is the risk of loss arising from adverse movements in market prices or rates.

(2) Market risk can arise in relation to an NBDT's:

(a) on-balance sheet positions; and

(b) off-balance sheet positions.

20. Market risk – elements for risk management programmes

Elements of market risk that NBDTs should consider for inclusion in their risk management programmes include:

(a) interest rate risk;

(b) foreign currency risk; and

(c) equity risk.

21. Interest rate risk

(1) Interest rate risk is the risk that the value of assets or liabilities will change because of changes in interest rates.

(2) Elements of interest rate risk that an NBDT could consider for inclusion in its risk management programme include:

(a) repricing risk – the risk arising from a change in the price of a financial instrument;

(b) basis risk – the risk arising from changes in the relationships between different yield curves;

(c) yield curve risk – the risk arising from a change in the shape of the yield curve; and

(d) option risk – the risk arising from options embedded in an NBDT's balance sheet exposures.[1]

(3) An NBDT could consider including procedures in its risk management programme to:

(a) measure the effect of changes in interest rates on net interest income; and

(b) estimate the effect of changes in interest rates on the value of the NBDT based on the present value of future cash flows of its on-balance sheet and off-balance sheet exposures.

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[1] In this context an embedded option is an option attached to another instrument that affects its redemption date. The presence of an embedded option provides uncertainty about whether or not the NBDT will pay or receive a specified rate of interest on or from a specified date. Examples include put and call features of bonds and early termination options of securities.

22. Foreign currency risk

(1) Foreign currency risk is the risk arising from a change in an exchange rate.

(2) The circumstances in which currency risk can arise include:

(a) open foreign currency positions;

(b) interest rate mismatch positions;

(c) credit exposures that do not settle; and

(d) time zone differences, where settlement in one currency occurs before settlement in another time zone.

23. Equity risk

(1) Equity risk is the risk arising from changes in the prices of equity instruments.

(2) The price risk associated with equities may include elements of:

(a) systematic risk; and

(b) firm specific risk.

(3) Equity risk may be embedded in credit exposures.[2]

Operational risk

24. How operational risk arises

(1) Operational risk is the risk arising from human error, system failures, and inadequate procedures and controls.

(2) For example, operational risk can arise from:

(a) deficiencies in information systems;

(b) technological or physical failures;

(c) breaches in internal controls; or

(d) fraud or other criminal activities.

(3) Operational risk includes, among other things, legal risk (including, for example, an NBDT's exposure to fines, penalties or damages), risks arising from money laundering and regulatory risk.

25. Operational risk – elements for risk management programmes

An NBDT should consider including processes in its risk management programme to:

(a) identify its operational vulnerabilities; and

(b) mitigate its operational risk exposure.

[2] For example, a lending covenant linked to the share price or market capitalisation of the deposit taker.