Submission

to the

Reserve Bank of New Zealand

on the

calibration of effective maturity for non-farm corporate exposures

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Submission by the New Zealand Bankers' Association to the Reserve Bank of New Zealand on the calibration of effective maturity for non-farm corporate exposures

1. New Zealand Bankers' Association (NZBA) appreciates the opportunity to submit on the calibration of effective maturity (M) for non-farm corporate exposures.

2. NZBA member banks consider that the calibration of M for non-farm corporate exposures does not need to change. See the rationale for this position set out below.

About NZBA

3. NZBA works on behalf of the New Zealand banking industry in conjunction with its 12 member banks. NZBA develops and promotes policy outcomes which contribute to a safe and successful banking system that benefits New Zealanders and the New Zealand economy.

4. The following twelve registered banks in New Zealand are members of NZBA:
   - ANZ National Bank Limited
   - ASB Bank Limited
   - Bank of New Zealand
   - Bank of Tokyo-Mitsubishi, UFJ
   - Citibank, N.A.
   - The Hongkong and Shanghai Banking Corporation Limited
   - JPMorgan Chase Bank, N.A.
   - Kiwibank Limited
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited.

5. This submission is made on behalf of the following NZBA member banks that are internal model banks:
   - ANZ National Bank Limited
   - ASB Bank Limited
   - Bank of New Zealand
   - Westpac New Zealand Limited.

Issues

6. NZBA submits that the current approach for the calibration of M in internal model banks for non-farm corporate exposures is appropriate as it stands. There are no policy, economic or commercial reasons to impose a minimum fixed term maturity of 2.5 years.

7. Internal ratings based banks are accredited to use internal models to assess risk and ensure the modelling is sensitive to the actual economic risk of exposures. A fixed term calibration of M removes that sensitivity. It limits those banks' ability to shift smoothly with changes in New Zealand market conditions and business activity.

8. To assist the Reserve Bank in reviewing the calibration of M approach, we set out the rationale for our position advocating no change.

Difference in economic risk

9. There is a genuine difference in economic risk between agricultural and corporate exposures that warrants more flexibility in the level of regulatory capital imposed through the calibration of M for non-farm corporate exposures, including four main reasons:

   - **Diversity of products and security:** Banks hold a greater diversification of products and security within the corporate book than the agricultural book (where there is a strong focus on dairy farming and reliance on security over farm land and dairy company shares). This diversity dilutes exposure risk.

   - **Diversity of cashflow cycles:** A single event of severe economic downturn, at a time when assets are likely to be relatively illiquid, will have less economic impact across the corporate book as industry categories within the book often have different cashflow cycles.

   - **Lower correlation:** Exposure risk is reduced by the lower levels of correlation among exposures in the corporate book due to the range of industries involved that are not interrelated, ie that are not networked. This limits the transmission of shocks throughout the corporate sector.

   - **Level of asset equity:** Corporate lending requires higher levels of asset equity (ie loan-to-value ratios are lower) due to higher levels of deposit required than other bank lending. This reduces the loss on default risk.

Economic reasons for short term loans

10. Facilities are generally a mix of short and term debt in recognition of the different assets being funded or timing of the business need for the funds. For instance:

   - Many corporate (i.e. business) customers have short-dated facilities (usually overdraft or similar at call facilities subject to annual review). Typically these are required to meet seasonal and/or regular trading cash flow requirements where accounts fluctuate from credit funds to overdrawn. Generally customers would provide the bank with detailed cash flows which are monitored to ensure expected cash flows occur or any deviations are explained.[1]

- Longer term debt is usually granted for capital expenditure or other items that will generate income and depreciate over a longer term rather than a single trading cycle.

11. There are genuine economic reasons why term loans to corporates can be short. A term loan can be for one year because the customer can repay it in that time period. This is where the size of the corporate's cash-flow and the depreciation rate of assets provided as security are the two main components in determining the term of the loan.

12. For instance, the term of the loan often matches the level of monthly repayment amount so that repayments are spread to match the cash-flow of the corporate and the depreciation rate of the asset funded. For example, a loan for $1.2 million to purchase four logging trucks might be for one year because the repayments must be ahead of the depreciation rate of the trucks – so all trucks are paid off in one year and before they fully depreciate to near zero in book value.

13. Also note working capital facilities above. The nature of working capital facilities is that they are "on demand" and do not contain events of default like a term loan. These on demand facilities are reviewed at least annually by banks to evaluate whether they should be continued or reduced to meet bank concerns, or increased to meet customer needs where the business is expanding. The customer cannot be in default in the same way as a term loan because there are no regular instalments required as there is no "term of the loan" as there is with term loans. There are no contractual "events of default" as there are under a term loan. Therefore, product only works by being "on demand", with the bank being able to "call up" the facility at any time.

14. While asset values may fall in periods of financial stress, a market for the sale of these assets will still exist. This is unlike the recent lack of liquidity in the farmland market. Even in a downturn the value of the assets provided as security for corporate exposures will be sufficient to repay debt on forced sale of the assets.

[1] Other types of short term debt products requiring a term of less than 2.5 years includes repo-style transactions, exposures arising from securities lending transactions, short-term self-liquidating trade transactions (eg import and export letters of credit can be accounted for at their actual remaining maturity), exposures arising from settling securities purchases and sales (eg overdrafts arising from failed securities settlements provided that such overdrafts do not continue for more than five consecutive business days), exposures arising from cash settlement by wire transfer (eg overdrafts arising from failed transfers provided that such overdrafts do not continue for more than three consecutive business days), and exposures to banks arising from failed foreign exchange settlements.

15. To account for the potential degradation of the value and liquidity of securities in an event of severe economic downturn, it is more relevant to recognise risk via the loan-to-value or loss given default attributes rather than the term for corporate book exposures.

16. The recent global financial crisis demonstrated this position where debt calibrated at one year, like revolving funding facilities, were the first to be repaid. Longer term debt remained or, in the extreme, were recovered through the forced sale of secured assets.

17. Artificially raising the average tenor for short term debt only discourages prudent lending practices based on proper business risk assessment. It encourages a default position geared towards longer term facilities as it does not differentiate risk based on tenor. It also adds cost to “on demand” facilities which is not warranted. This in turn distorts pricing models which affects the cost of funds to New Zealand business.

Commercial reasons for continuing contracted maturity

18. We note that Basel II focuses on the contractual maturity of loans rather than the economic maturity of loans. In the corporate book these things are normally the same.

19. Applying a fixed calibration of M reduces the incentives for banks to enhance their risk-management systems and processes, and disguises the importance of the tenor.

20. The level of flexibility in the internal ratings based bank models needs to match the diversity in the corporate book, which holds many industries with a variety of needs. One size fits all does not match the needs of non-farm corporates or account for the development of new industries in New Zealand that have differing needs.

21. There are a number of short term non-farm corporate exposures that by the nature of the product require a term of less than 2.5 years. The banks’ internal modelling already recognises this.

Why internal modelling of the corporate book is good for New Zealand

Banks are useful precisely because they spread risk and enable the transfer of depositors’ funds to borrowers in a relatively safe manner. Large banks assist further by using internal models based on information they hold about customers to assess risk more accurately and at a more granular level.

A business deals with risks from a variety of sources, primarily non-payment (default), industry downturns (systemic) and cash shortages (liquidity). In all these areas, banks are uniquely protected by being involved in everyone else’s business. If an entrepreneur gets shorted by a big customer, that entrepreneur could be in real trouble; banks on the other hand, typically have many more businesses in their portfolio.

If an industry which is part of the corporate book goes through a slow-down, people in the business are more likely to default; but banks' risks are spread across many different corporate industries. Liquidity is similarly more manageable by banks since the variability that business people deal with moderate each other in their interactions as a whole with the banks.

All of this means that when a bank requires collateral (security) from a business, it does so with the knowledge of all the risks the business owner faces. But by lending to many different people in a variety of businesses, the risks to the banks are dramatically reduced. Allowing a granular view of loan terms assists with pricing lending to meet the demands for economic growth and productivity in New Zealand.

We are happy to discuss further categories of non-farm corporate exposures requiring short term flexibility if that would assist.

Sarah Mehrtens
Chief Executive