NEW ZEALAND BANKERS ASSOCIATION

Submission

to the

Reserve Bank of New Zealand

on the

Exposure Draft for Capital Review Changes

31 March 2021

NEW ZEALAND BANKERS ASSOCIATION
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About NZBA

1. The New Zealand Bankers' Association (**NZBA**) is the voice of the banking industry. We work with our member banks on non-competitive issues to tell the industry's story and develop and promote policy outcomes that deliver for New Zealanders.

2. The following seventeen registered banks in New Zealand are members of NZBA:
   - ANZ Bank New Zealand Limited
   - ASB Bank Limited
   - Bank of China (NZ) Limited
   - Bank of New Zealand
   - China Construction Bank
   - Citibank N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - Industrial and Commercial Bank of China (New Zealand) Limited
   - JPMorgan Chase Bank N.A.
   - Kiwibank Limited
   - MUFG Bank Ltd
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited

Introduction

3. NZBA welcomes the opportunity to provide feedback to the Reserve Bank (**RBNZ**) on the Banking Prudential Requirements. NZBA commends the work that has gone into developing the BPR documents so far.

4. As the Capital Review applies only to banks that are incorporated in New Zealand, this submission is made on behalf of those banks only.

5. If you would like to discuss any aspect of this submission, please contact:

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General

6. We are supportive of, and generally in agreement with, the BPR exposure drafts as set out. We commend the Reserve Bank on the work done to revise the Banking Supervision Handbook and consider the BPR exposure drafts improve the clarity and accessibility of the documents.

7. As discussed at the recent Capital Workshop, there are areas where the drafting in the Handbook has been carried forward that we consider would benefit from clarification or re-wording. Some of these will require more time to consider than the current timetable allows but we think it important that there is an opportunity for them to be addressed after these documents are finalised. We were encouraged to hear that the Reserve Bank is open to this. We provide some responses to your questions, and our comments on each document (as applicable) in turn.

Responses to the Consultation Paper

8. Paragraph 26, Question C: We find the guidance boxes to be useful in most part and accordingly our preference is Option 1.

9. Paragraph 124: In respect of the last sentence, we suggest that it would be useful if these terms are also included in the Glossary for consistency.

10. Paragraph 128: We prefer Option 3 for ease of reference and clarity.

Comments: BPR100 – Capital adequacy

11. Entities to be included in the Solo Ratio Calculation: The "funded exclusively by the bank" and "wholly owned by the bank" tests at B2.4 now appear to entirely determine whether funds management, securitisation or covered bond special purpose vehicles (**SPVs**) are required to be consolidated in the solo basis calculation. These SPVs will not satisfy the B2.4 tests and therefore will not be consolidated in the solo basis calculation with the current BPR100 wording.[1] We request that the existing requirement for these SPVs to be aggregated and consolidated in the solo capital calculation should be carried forward into BPR100, or the BPR160 A2.1 consolidation requirements are broadened to also require these SPVs to be consolidated within the solo capital 'entity' in line with the banking group consolidation requirements.[2]

12. Funded by trade creditors: B2.4(4)(c) provides that for a subsidiary to be considered "funded exclusively by the bank", liabilities to trade creditors cannot exceed 5% of the subsidiary's shareholders' funds. We are concerned as to how this may apply to

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[1] But we understand they must be consolidated for the purpose of calculating group capital ratios (along with internal RMBS trusts and other securitisation SPVs) under BPR160, A2.1(1)(b). This reflects the position at BS2B, 5.4.

[2] BS2B, 5.4(b) and BS2A, 98(b).

internal RMBS trusts and covered bond SPVs. Internal RMBS and covered bond entities have large balance sheets with extremely low net assets/shareholders' funds. Accordingly, where these entities accrue and pay their own costs (such as audit and trustee fees), the accrual of these liabilities may fluctuate above and below 5% of shareholders' funds. Applying the rules as stated risks creating volatility in the solo ratio which would not be reflective of any substantive change in the bank's position. We suggest that the wholly funded test be amended to require that trade creditors may not exceed the greater of 5% of the subsidiary's shareholders' funds and 1% of the subsidiary's total assets. This would remove volatility in reported numbers while retaining the intent and substance of the wholly funded criteria.

Comments: BPR110 – Capital definitions

Additional Tier 1 capital

13. Consolidation: We agree with the consolidation of the relevant parts of BS2A and BS2B so that Additional Tier 1 capital ("**AT1**") is defined in the same document for the purposes of both the standardised and internal models based approaches.

14. New Zealand law: We consider that the new requirement for AT1 instruments and all constituting documents to be governed by New Zealand law[3] is sensible given that AT1 instruments are required to be legal-form equity under BPR110. However, in our view, this requirement risks presenting a significant impediment to offshore issuance if it was ever contemplated by our members.

15. Interest rate reset: We consider that the addition of a fixed rate being reset as a circumstance that will not be considered an incentive to redeem[4] provides valuable clarity. However, we suggest that the requirement that the reset rate be a "market rate" is not entirely appropriate;[5] it may be more accurate to refer to the new, reset rate as a benchmark rate (being the same benchmark that has been used for a previous interest rate set or reset) plus a margin (which does not change). As fixed rates will be reset by reference to a benchmark rate and a fixed margin, a reset rate will not necessarily reflect market rates at the time of the reset.

16. Zero floor: We consider that BPR110 should also expressly permit a zero-floor to apply:

    (a) to a reset dividend rate, by providing that a zero-floor will not be considered to be a step-up in the margin or any other incentive to redeem; and

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[3] At D2.3(e).
[4] At D2.6(4)(b).
[5] At D2.6(4)(b)(i).

(b) to a benchmark rate (see above at 15), in order to maintain the margin to senior ranking deposits.

Tier 2 capital

17. Consolidation: We also agree with the consolidation of the relevant parts of BS2A and BS2B so that Tier 2 capital ("**Tier 2**") is defined in the same document for the purposes of both the standardised and internal models based approaches.

18. New Zealand law: We consider that the requirement for Tier 2 instruments and all constituting documents to be governed by New Zealand law is problematic in respect of banks' offshore issuance capability, particularly if issuers sought to issue Tier 2 capital under existing US or Euro programmes. While we appreciate that the RBNZ may wish to minimise legal risk in relation to Tier 2 instruments (for example, in an insolvency situation), this requirement is expected to restrict investor demand for Tier 2 instruments. There is little to no reason for New Zealand law to be a requirement for Tier 2 capital[6] (compared to AT1 capital), because Tier 2 instruments are not required to be legal-form equity. We suggest that the New Zealand law requirement not be implemented, and the status quo (which allows for "satisfactory equivalents" to New Zealand law to govern the terms of Tier 2 instruments) be retained.

    If retention of the status quo is not possible, we suggest adopting a hybrid governing law approach similar to that found in the Australian Prudential Standards,[7] whereby both AT1 and Tier 2 instruments may be subject to the laws of other jurisdictions, except that the terms and conditions relating to non-viability conversion or write-off must be subject to the laws of Australia. In the context of the new BPR110 criteria, a hybrid approach in New Zealand might involve the loss absorbency features of Tier 2 instruments (for example, subordination) being governed by New Zealand law, with the instrument and its constituting documents being otherwise governed by the law of a different jurisdiction. We suggest that adopting this hybrid approach may mitigate the concerns that have led to the New Zealand law requirement as it currently stands, while preserving banks' offshore issuance capability and the offshore marketability of regulatory capital instruments.

19. Interest rate reset: See our comments at paragraph 15 above. We consider that this comment applies equally to Tier 2 capital.

20. Zero floor: We consider that BPR110 should also expressly permit a zero-floor to apply:

    (a) to a reset interest rate, by providing that a zero-floor will not be considered to be a step-up in the margin or any other incentive to redeem; and

[6] At D3.3(1)(e).

[7] Prudential Standard APS 111 Capital Adequacy: Measurement of Capital, cl 14 Attachment E and cl 13-14 Attachment H.

(b) to a benchmark rate (see above at 15), in order to maintain the margin to senior ranking deposits.

21. References to dividends: BPR110 refers only to “interest” in relation to Tier 2 instruments (BS2A/BS2B also referred to dividends). While this is consistent with the requirement for Tier 2 instruments to be subordinated debt, we consider that this will be an issue if a bank (for example, a co-operative or building society) sought to issue Tier 2 in equity format.[8]

Comments: BPR110 - Template Terms Sheets

General comments

22. We question the usefulness of the proposed template terms sheets. Our reasons for this are as follows:

    (a) The RBNZ noted in a seminar with NZBA and our members that the template terms sheets are not compulsory. In our view, the wording at D2.2 strongly suggests that the terms sheets are compulsory. If the template terms sheets are retained, we suggest making it explicit that they are not compulsory.

    (b) Whether an instrument complies with BPR110 ultimately depends on the actual terms of the instrument, rather than the summary contained in the terms sheet. In order to meet the requirements of BPR110, the terms of the instrument (as set out in the governing document) will need to comply with the BPR110 requirements (as set out in D2 or D3 of BPR110). Submitting a terms sheet in the prescribed form will not ensure compliance with the requirements of BPR110, nor will it conclusively demonstrate to the RBNZ that the instrument complies (instead the RBNZ relies on a legal opinion from the issuer's lawyers to confirm this).

    (c) When making an offer of capital instruments, banks may typically prefer to use their own form of terms sheet to market the offer, rather than following the RBNZ template. As a result, the bank may need to produce two separate terms sheets (i.e. one for investors and one for the RBNZ) resulting in duplication and the potential for inconsistency.

    (d) The consultation paper cites standardisation as one of the reasons for introducing the template terms sheets. However, in our view, banks should be free to determine the terms of their capital instruments provided that they comply with BPR110. Further, there will necessarily be a degree of standardisation because all instruments must comply with the BPR110 requirements.

[8] See: Financial Markets Conduct Act 2013, ss 8(1)(b)(iii) and 8(2)(b).

23. Given the points set out above, we consider that the template terms sheets may be of little practical use, and risk creating unnecessary complications for banks. In our view, it would be preferable to take a similar approach to the one currently taken under BS16, where the bank completes a self-assessment detailing how the instrument complies with each of the eligibility criteria. This will give the RBNZ greater comfort that the instrument complies with the BPR110 requirements. It will also be more efficient, because the bank will have already gone through this self-assessment process internally in order to ensure compliance.

24. There is inconsistent use of the present and future tense throughout the terms sheets. For example, in the AT1 terms sheet, the "Redemption at the option of the Issuer" section says, "the PPS are perpetual…", whereas the "Payment of Distributions" section says "Distributions will be scheduled to be paid…". We suggest using the present tense throughout where appropriate.

Specific comments: AT1 terms sheet

25. Should the template terms sheet for AT1 be retained, our specific suggestions are set out below.

26. <u>Redemption at option of issuer:</u> We suggest that the requirements in D2.5(3) (i.e. that the tax/regulatory event could not reasonably have been anticipated and was not minor) are reflected here.

27. <u>Payment conditions:</u>

    (a) This section provides that payment of distributions is subject to (among other things) the solvency condition being satisfied. Although a solvency condition is usually included in the terms of AT1 instruments, this is not a requirement under BPR110. It is possible that this was included to reflect the solvency requirement for distributions under s 52 of the Companies Act. However, this is not a prudential requirement, and in any case the solvency condition listed in the terms sheet is not the same as the requirement under s 52. Accordingly, we suggest this item is deleted.

    (b) This section also states that "no event of default arises if the Issuer fails to make a payment because the Issuer does not satisfy the solvency condition". This is not necessary as the next section (Non-cumulative Distributions) provides that non-payment of any Distributions will not constitute an event of default.

28. <u>Set-off and offsetting rights:</u> We query why this wording is in square brackets. It reflects the requirement in D2.3(g), so presumably should not be optional.

29. <u>Conversion or exchange:</u> Conversion and exchange are not permitted for AT1 instruments, so this section will always read "not applicable". As such, we query whether it is required at all.

30. No guarantee: We suggest also including a "no security" section specifying that the instrument is unsecured. This reflects the requirement in D2.3(f).

31. Governing law: This refers to the governing law of "all relevant transaction documents". It should refer to "all constituting documents" for consistency with D2.3(e).

32. Selling restrictions: This is intended to address the requirement in D2.8(1). However, we do not read D2.8(1) as requiring that the terms of the instrument contain a selling restriction preventing the bank or its controlled entities from purchasing, or funding the purchase of, the instrument. Instead, it provides that if this occurs, the instruments will not qualify as AT1 capital. This is a factual matter which is within the control of the bank, and does not need to be built into the terms. We note that there is already an equivalent requirement under BS2A/BS2B, and such a selling restriction has not been included in the terms of any previous capital instruments that we are aware of. Accordingly, we suggest this item is deleted.

Specific comments: Tier 2 terms sheet

33. Should the template terms sheet for Tier 2 be retained, our specific suggestions are set out below. In some respects, these comments replicate our comments in relation to the AT1 terms sheet above, and we have cross-referenced where possible.

34. No guarantee: Same comment as at 30 above – see D3.3(1)(c)(i).

35. Redemption at option of issuer: Same comment as at 26 above – see D3.5(3).

36. Redemption at the option of the Holder: This section currently provides that "Holders have no ability to redeem the Notes before the Maturity Date *other than in a dissolution or liquidation of the Issuer*". Accelerating a debt and proving in the liquidation of an issuer is not strictly the same thing as redeeming the instrument. We therefore suggest deleting the italicised wording.

37. Set-off and offsetting rights: Same comment as at 28 above – see D3.3(1)(d).

38. Conversion or exchange: Same comment as at 29 above.

39. Selling restrictions: Same comment as at 32 above – see D3.9(2).

Comments: BPR120 – Capital adequacy process requirements

40. We generally support the new notification-only approach. However, it is important to us that members retain the ability to engage with the RBNZ throughout this process to mitigate compliance risk relating to regulatory capital instruments.

41. Same face value or issue price: C2.2(1)(c)(i)(B) of BPR120 introduces a new requirement that replacement instruments have the same issue price per share or

face value per note (as applicable). In the Guidance to C2.2, the RBNZ suggests that (2)(c)(i) requires replacement capital issues to have the same total value as the capital they replace. We doubt (2)(c)(i)(B) actually achieves this; instead, it seems to require that the face value or issue price of each individual instrument is the same as for the instrument it is replacing. In our view, a requirement explicitly addressing the aggregate capital value of a replacement instrument issue would be more appropriate.

42. Tax or regulatory event threshold: The guidance to C2.2 in BPR120, in relation to tax and regulatory events, differs from the equivalent guidance under BS16. The equivalent guidance in BS16 provides that the RBNZ will not permit repayment of an instrument if the bank "could have anticipated" the tax or regulatory event at the time of issuance. The guidance in BPR120 provides that redemption will not be permitted if the bank "should have anticipated" the event. This wording also differs from the relevant requirements in BPR110, which use the expression "could reasonably have been anticipated" (see D2.5(3)(a) and D3.5(3)(a)). We suggest that the BPR120 guidance should be aligned with BPR110.

Comments: BPR120 – Template legal sign-offs

Appendix 1 – Draft legal sign-off for AT1/Tier 2 instruments

43. NZBA provides the following comments on the draft legal sign-offs on the understanding that these comments reflect the views of a leading legal firm in this area.

44. Paragraph 1: This paragraph contemplates the inclusion of the aggregate issue price or face value of the instruments. This may not have been determined when the opinion is issued, so we suggest some flexibility is built in.

45. Paragraph 2:

    (a) This paragraph and others refer to a terms sheet supplied in accordance with BPR110. As discussed in our comments on the template terms sheets in Part 1, we question the usefulness and suitability of those terms sheets. If terms sheets were not used (and therefore not referred to here), the sign-off would still contain a confirmation that the terms of the instrument comply in all respects with the BPR110 requirements, which should provide sufficient comfort to the RBNZ.

    (b) The reference to the terms of the Capital Instruments being "prescribed" in certain documents seems strange to us. We query whether "set out" or "specified" would be more suitable. This expression is also used elsewhere in the sign-offs.

    (c) The reference to the "fully executed" copy of each Constituting Document may not always be suitable – e.g. a company constitution will be relevant for AT1 capital instruments, but is not typically signed.

46. Paragraph 3(a): This paragraph states that the law firm accepts responsibility to the RBNZ for the confirmations and opinions given. Having spoken with external counsel, we would prefer it to also clarify that:

    (a) the law firm has not acted for the RBNZ in relation to the issue of Capital Instruments; and

    (b) notwithstanding the provisions of the sign-off, the law firm reserves the right to represent and advise the Issuer (if instructed) in relation to any matters relating to the issue at any time in the future, and the fact that the law firm has provided the sign-off to the RBNZ will not be deemed to have caused any conflict of interest in relation to the giving of such advice.

47. Paragraph 3(c): This paragraph contains a confirmation that the Constituting Documents are the only documents that prescribe the terms of the Capital Instruments. This is a factual matter rather than a legal one, and we do not think it is appropriate for external legal counsel to give this confirmation unqualified. If this confirmation is required, we suggest qualifying it to say "To the best of our knowledge, the Constituting Documents are the only documents that prescribe the terms of the Capital Instruments", or words to that effect.

48. Paragraph 4(d): This paragraph states that the relevant law firm's confirmations and opinions do not extend to subsequent or amended versions of BPR110. We suggest clarifying that the opinions and confirmations are "based on the version of BPR110 in effect as at the date of this opinion, and do not extend to subsequent or amended versions of BPR110".

Appendix 2 – Draft legal sign-off for amendments to terms of AT1/Tier 2 instruments

49. Paragraph 2: Same comments as at 45 (b) and (c) above.

50. Paragraph 3(a): Same comment as at 46 above.

51. Paragraph 3(c): Same comment as at 47 above.

52. Paragraph 4(d): Same comment as at 48 above.

Comments: BPR130 – Credit Risk RWAs overview

53. Calculation of total credit risk RWAs by IRB banks: NZBA considers the proposed calculation of IRB RWA from 1 January 2022 (with the introduction of the output floor) to 30 September 2022 contains a drafting error. The calculation during this transition period is inconsistent with the calculation that applies from 1 October 2022 (once both the output floor and scalar increase is implemented). As a result, IRB banks' total RWA may be greater than that intended by the RBNZ from 1 January to 30 September 2022. To correct this inconsistency, the following change should be made to C1.4(3)(a):

    3) On and after 1 January 2022 and on and before 30 September 2022, the calculation is the sum of–

(a) the greater of–

(i) 1.06x the total RWAs calculated using the IRB approach on all credit exposures falling under subsection C1.2(1); and

(ii) 0.85 x total standardised equivalent RWAs calculated in accordance with section C1.3; and

(b) 1.06 x total RWAs calculated using the standardised approach on all credit and other exposures falling under section C1.2(2).

Alternatively, we suggest that the timing of the standardised output floor should be deferred to 1 October 2022.

Comments: BPR131 – Standardised credit risk RWAs

54. Credit ratings: The Guidance to B1.1 states that "For residential mortgages, the risk-weighting categories take into account loan-to-value ratios (LVRs) *at time of origination…".* While the LVR at the time of origination determines the initial risk weighting, subsequent risk weights are derived using the formula in C3.5(1) which uses the *current* loan value divided by the property value at time of origination. We suggest that the italicised text in the Guidance to B1.1 be updated to reflect the formula at C3.5(1), or deleted to remove any inconsistency.

55. Issue-specific and inferred credit ratings: B1.4 requires that where a bank has a claim on a borrower and the claim has an issue-specific credit rating from a rating agency, the bank must determine the rating grade for the claim using that issue-specific credit rating. B1.5(2) then states that if a borrower has a long-term issuer credit rating, the bank must treat any claim on the borrower falling within the scope of that rating as having the same credit rating. The scope of B1.4 is unclear – is it limited so that an issue-specific rating from a rating agency must be used instead of the issuer rating by that agency, or is it so wide that an issue-specific rating by an agency overrides issuer ratings from all other agencies (i.e. where other agencies haven't issued their own issue-specific rating, their issuer ratings should be ignored)? We suggest that guidance be added to B1.4 to clarify that the use of an issue-specific rating from one rating agency does not preclude the inclusion of issuer ratings from other rating agencies in determining the ultimate risk weighting to be applied under B1.7.

56. Multiple ratings: In relation to B1.7(2), it is unclear which credit rating must be used if there are three or more credit ratings that apply to a particular claim that produce different rating grades and more than one risk weight. We suggest guidance would be valuable on this point in order to make clear that in this situation the bank must use the middle rating.

57. Original maturity: Original maturity is a clear concept for instruments that terminate (for example, derivatives and bonds), but it is also applied for instruments with no specified end date (such as bank accounts, credit cards and overdraft facilities) to determine the applicable Credit Conversion Factor to be applied under BPR131.[9] For instruments without a maturity date, should the original maturity be interpreted as >1 year (on the basis that no maturity date exists), or is it the minimum period

[9] At D2.2.

until the funds can be withdrawn or the facility can be cancelled? We suggest that a definition be added to the BPR001 Glossary along the lines of:

> **Original maturity** is the time between the issue and maturity date of an instrument. For a loan, the issue date is the date the loan is first drawn down. For a derivative, the issue date is the trade date. For instruments with no specified end (such as credit cards, overdrafts, or non-term deposit accounts) the maturity date is the earliest date on which the bank can cancel the facility or withdraw its funds.

58. Claims on sovereigns and central banks: In our view, it may be useful to add Guidance to C2.2 around the treatment of government entities, such as export guarantee offices, where those entities have implicit (rather than explicit) guarantees from the relevant government. The intent would seem to be to treat these as a sovereign risk in order to facilitate trade, but the risk weight treatment is not clear.

59. Past due non-mortgage loans: We request some guidance or clarification on whether the 20% allowance for impairment at C2.12 includes both the collective provision on the past due loan where no specific or individual provision has been made (IFRS stage 3 collectively assessed) as well as the specific or individual provision (including suspended interest) for an impaired loan in IFRS stage 3 (individually assessed) or whether it only applies to the latter scenario. Our preference is the latter interpretation which is more consistent with the previous IAS 39 approach.

60. Definitions applying in relation to RMLs: We recommend that the Guidance to **owner-occupied residential property** at C3.4 be improved as to the inclusion of “minimal” rental income. The reference to “minimal” rental income is subjective, and the existing Guidance does not cover instances such as properties that are periodically available on websites such as Airbnb where income estimates are unknown (or not able to be estimated), but the rental income could be substantial. We suggest that clarification in the Guidance as to what will constitute “minimal” rental income would be valuable.

    Furthermore, it would be useful if there was guidance regarding the meaning of the words “intends to occupy the property as a principal residence”. For example, if a purchaser intends to occupy a property as their residence, but due to an existing tenancy cannot move in immediately, it would be useful to have guidance regarding how long this position could continue before they are no longer considered to be owner-occupied (e.g. you would need to occupy the property within 12 months of purchase).

61. CCFs for off balance sheet exposures: We suggest that the Guidance to D2.2 should provide more clarification on the definitions of transaction types in Table D2.2. For example, there are more explicit descriptions of what will be a “commitment” in BIS and in other RBNZ papers such as the LVR and DTI guidance notes. We recommend that similar guidance is provided in this section or that references are provided to a common description, where is it intended that that description should be applied across multiple reports. In our view, this would remove uncertainty and improve consistency.

Comments: BPR132 – Credit Risk Mitigation

62. Currency mismatch adjustment: Collateralised exposures are typically made up of derivatives impacted by cash flows in a number of different currencies. We suggest that some Guidance would be useful to illustrate how the currency mismatch adjustment rules are to be applied in practice, or otherwise make clear that the currency of a collateralised exposure is the Base Currency in the Credit Support Annex (or equivalent documentation) that governs the calculation of the exposure value and the subsequent amount of collateral to be posted. For example, in relation to the former (if the Base Currency is not considered the currency of the collateralised exposure):

    (a) In terms of identifying a currency mismatch, where a bank measures and manages the FV of its collateralised exposures in NZD:

        (i) If the bank has an NZD:USD FX derivative:

            (aa) If the counterparty posts cash collateral in NZD, presumably this is same currency and no mismatch arises?

            (bb) If the counterparty posts cash collateral in USD, is this also same currency given USD is one of the legs of the derivative – or is there a mismatch because collateralised exposures are measured and managed in NZD?

        (ii) If the bank has an HKD interest rate swap (i.e. no NZD flows):

            (aa) If the counterparty posts cash collateral in NZD, is there a currency mismatch – given collateralised exposures are managed in NZD?

    (b) If a collateralised counterparty exposure contains a mix of derivatives – some giving rise to a currency mismatch while others do not – how ought the portion of the collateral to be haircut be calculated?

Comments: BPR140 – Market Risk

63. General comments:

    (a) We have some concerns regarding the rewrite of the BS6 Market Risk policy and guidance into BPR140. In the context of RBNZ's capital agenda, we would be keen to participate in an industry approach to emphasise the shortcomings of the current market risk capital requirements. Our specific concerns are set out at 64 below.

    (b) The exclusion of equity from the interest rate risk calculation is counter intuitive, as equity balances will be funding a proportion of a bank's balance sheet assets, and excluding equity from the interest rate risk

calculation leaves a substantial structurally long position, resulting in a larger outright position than actually held.

It is also the case that as a bank's capital requirement is increased, the outright long position in the market risk capital model increases; even if the net asset position is unchanged (i.e. more of the assets are equity funded, with a corresponding liability funding reduction). Effectively, because equity is excluded, a bank's capital requirement is increased; making the bank appear to be riskier from a market risk perspective, and, is contrary to the reason for holding more capital, which is to reduce risk.

We suggest including Equity in the interest rate calculation along the lines of Basel/APRA and treating it similarly to Rate Insensitive Retail Products (i.e. with a risk-weight distributed over a number of time-bands), as this will more accurately represent a bank's Market Risk Capital exposure. We understand that such a profiling was not included in the original Basel documents as their application was limited to trading books only (i.e. assets equalled liabilities).

64. Specific comments:

(a) At A1.1, it would be valuable to expressly note the extent to which the Basel documents can be referenced for application purposes.

(b) The extent to which treatment of derivatives (e.g. decomposition and netting) is applied to derivatives at B1.3(2) and B1.4 is incomplete. For example:

(i) with regards to decomposition, B1.4 makes reference only to interest rate swaps, forward rate agreements and compound/hybrid instruments. It does not provide guidance for other types of derivatives, such as futures or forward starting derivatives; and

(ii) with regards to netting, B2 does not explicitly extend netting to decomposed derivatives. Consider a strip of forward rate agreements: with full netting applied: the residual principal exposure should be first and last principals in the strip. Under the existing B2 approach, netting is applied to the instrument only (as opposed to netting the decomposed instrument). This results in inflated values filtering into the basis risk calculation, thereby overstating (or understating) the total Interest Rate Risk.

(c) We suggest that more granular time-bands be adopted. Currently, time-bands under BPR140 are very wide and the steps between risk weights are large, leading to significant over/understatement of risk where cash flows do not coincide with the middle of the band (Table B4.1). Adopting more granular time-bands with small steps between risk weights could mitigate these large cliff effects, while still maintaining the existing zones. We consider that this is one opportunity to improve the relevance of the model without materially changing the methodology, given that RBNZ has

indicated the standard will remain in place for some time. We suggest adopting the BCBS time-bands, so that 13 time-bands would be provided instead of the existing 8:

BCBS			
		Risk Weight	Yield curve changes
Zone 1	0 - 1 month	0.00%	1.00%
	1 - 3 months	0.20%	1.00%
	3 - 6 months	0.40%	1.00%
	6 - 12 months	0.70%	1.00%
Zone 2	1 - 2 years	1.25%	0.90%
	2 - 3 years	1.75%	0.80%
	3 - 4 years	2.25%	0.75%
Zone 3	4 - 5 years	2.75%	0.75%
	5 - 7 years	3.25%	0.70%
	7 - 10 years	3.75%	0.65%
	10 - 15 years	4.50%	0.60%
	15 - 20 years	5.25%	0.60%
	over 20 years	6.00%	0.60%

BPR140			
		Risk Weight	Yield curve changes
0 - 1 month	Zone 1	0.00%	1.00%
1 - 6 months		0.30%	1.00%
6 - 12 months		0.70%	1.00%
1 - 2 years	Zone 2	1.30%	0.90%
2 - 4 years		2.00%	0.80%
4 - 6 years	Zone 3	3.00%	0.70%
6 - 10 years		3.50%	0.60%
Over 10 years		4.40%	0.60%

(d) It is unclear whether the start-points and end-points of time-bands are included in the relevant time-band itself. For example, tables B3.3, B3.4, B4.1, and B6.1 all refer to bands of “more than 1 month but less than 6 months” and “more than 6 months but less than 1 year”.

(e) As noted below at67(c), the introduction of the ‘carrying amount’ concept at B1.3(3)(d), C1.3(4) and D1.3(1)(e) is inconsistent with a principal repricing model.

(f) The introduction of “updated in line with the current market valuation” at B1.3(3)(b) is inconsistent with a principal repricing model and confuses a principal repricing model with an internal discounted cash flow sensitivity model.

(g) Guidance on how foreign currency contingent products (for example, off balance sheet contingent liability in foreign currency) should be treated in the foreign exchange risk calculation would be useful.

Responses to questions: BPR140 – Market risk

65. Does BPR 140 need to give guidance on what should be included?[10]

Yes, BPR140 should give guidance on the definition of recognised and unrecognised financial instruments, and what unrecognised instruments should be included.

[10] Reserve Bank of New Zealand “Changes to the Banking Supervision Handbook: Commentary on new document BPR140: Market Risk” at 6.

Furthermore, BPR140 does not explicitly specify treatment of recognised financial instruments (presumably covered under "other financial instruments").

66. Do you agree that "face or contract amount" is still a suitable valuation approach for such instruments?[11]

Yes, face or contract amount is a suitable measure for instruments such as these.

67. Do you agree that adopting the original Basel version of the valuation approach is an improvement?[12]

The proposed requirements remain challenging and unclear for the following reasons:

(a) In our view, it is unclear what the B1.3(3)(b) requirement for derivative face values to be "updated in line with the current market valuation of corresponding actual instruments" means in practice. Does it mean that swaps hedging items carried at fair value (such as liquidity books) should be included at their market value while those hedging items recorded at amortised cost (such as loans) should remain at their face value? If so, then this requires directly relating each derivative to a specific balance sheet item, where risk from amortised cost and fair value positions is passed to a central interest rate risk management unit, then aggregated and hedged to market at a bank level — this will not be possible.

(b) Alternately, if the intent is that all derivatives should be adjusted for the changes in market value of all underlying actual instruments, then this increases the mismatch as derivative values will be updated for value changes while the non-derivative positions will remain at carrying value (the vast majority of which are at amortised cost). Furthermore, such an approach still faces the issue of differentiating between positions that are hedged with derivatives versus those that are hedged using offsetting balance sheet positions.

(c) The B1.3(3)(d) requirement for other financial instruments to be at the carrying amount of the instrument overlooks that carrying amounts are subject to a number of accounting adjustments that market risk systems will typically not have visibility of – these include collective provisioning and fair value hedge accounting adjustments.

(d) To address these problems requires valuing both "non-option derivatives" and "other financial instruments" on the same basis. We suggest that this basis could be:

(i) Market value. However, this approach is problematic due to the valuation issues it creates in terms of the credit margins on banking book positions like mortgages and deposits (which are not hedged by swaps) – creating a mismatch.

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[11] At 6.

[12] At 6.

(ii) Valuing off a swap curve only (i.e. exclude credit risk).

(iii) Valuing at notional/face value.

Of the above, our suggested approach would be to use notional/face amounts for all positions (both derivative and underlying). We believe that notional amounts are a fair representation of the benchmark interest rate exposure.

68. Do you agree this is a problem? Can you suggest any amendment to the rule text or additional guidance to address the problem?[13]

Yes, this can be a problem – in our view, the simplest solution would be to explicitly provide guidance to BPR 140.B1.3(3)(a) that contractually committed but unsettled debt transactions should be included as (offsetting) positions to the recognised derivative(s).

69. Would it help if we could also present this calculation in the form of mathematical formulae?[14]

Yes, it would be helpful for those new to BPR140 and unfamiliar with BS2A and BS2B to present the horizontal disallowance (yield curve risk) as a mathematical formula, and as a worked example as per BS6 / Basel Market Risk 1996.

70. Are the recognised/unrecognised categorisations out of date? Are these descriptions still applicable?[15]

Yes, these categorisations are out of date and inconsistent with the approach taken in B1.3 for interest rate risk.

71. Is the option to use the "present value" approach useful / meaningful?[16]

72. Yes, it is useful to be able to use present value for reporting currency risk. Present value correctly represents exposure to currency risk.

Comments: BPR001 – Glossary

73. We agree with the purpose of a common Glossary. We have only minor specific suggestions, as follows:

(a) Precious metal derivative: The cross-reference to *"BS2B para 4.83(q)"* should be *"BS2B para 4.83(p)"*.

[13] At 7.
[14] At 10.
[15] At 10.
[16] At 11.

(b) Rate insensitive asset, rate insensitive liability, rate-insensitive product: The cross-reference to *"section B1.3 of BPR140"* should be *"section A1.3 of BPR140"*.

74. More generally, we note that various definitions in BPR001 cross-refer to other documents that then cross-refer to other documents (for example, the definition of "Tier 1 capital" refers to the definition in the local OiC, which refers to BPR110). We suggest simply referring directly to the document that contains the actual definition.

Comments: Amendments to Orders in Council

75. We consider that the proposed amendments to the disclosure Orders in Council are largely consistent with the BPR documents. We have only minor comments.

76. Our comments on the disclosure Order in Council for locally incorporated banks are as follows, by reference to page numbers:

(a) Page 4: Suggest defining BPR130, given it is referenced at page 63 (see comment (d) below).

(b) Page 9: As with the Branches Order, the revised definition of "subsidiary" is broader than its predecessor; it encompasses the Companies Act definition and includes any entity that is classified as a subsidiary in any applicable financial reporting standard.

(c) Pages 48 and 63 ("Equity holdings (not deducted from capital) traded on NZX50 or overseas equivalent"): As NZX50 is an index, not an exchange, equity securities cannot be traded on it. Suggest adopting the BPR132, B1.2(1)(d) definition:

> a listed equity instrument that is included in the NZX 50 or an overseas equivalent share market index.

(d) Page 63: The reference to BPR130 appears incorrect. We suggest it should read "BPR130: Credit Risk RWAs Overview", and that it should be defined at page 4.

77. Our comments on the disclosure Order in Council for branches are as follows:

(a) Page 7: The revised definition of "subsidiary" is broader than its predecessor; it encompasses the Companies Act definition and includes any entity that is classified as a subsidiary in any applicable financial reporting standard.

(b) Pages 44, 45 and 50: References to "BPR140: Market Risk Exposure" should read "BPR140: Market Risk".

Comments: Amendments to BS1 Principles

78. We have only minor comments on the proposed amendments to BS1, as follows:

(a) BPR documents should be referred to in a consistent manner. At present, the following references are all present on page 14:

(i) BPR 131 (Standardised Credit Risk RWAs);

(ii) BPR133: IRD Credit Risk RWAs; and

(iii) BPR100 “Capital Adequacy”.

(b) Page 50: In condition of registration 1C, we suggest that before the definitions of Additional Tier 1 capital instrument and Tier 2 capital instrument it is added “For the purposes of this condition of registration, —”.

(c) Page 52: “BPR151: AMA Operation Risk” should instead read “BPR151: AMA Operational Risk”.