RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Summary of submissions and final policy position on capital requirements for reverse mortgage loans, QRRE and the FIRB approach in BS2A and BS2B

Please note that this is not a consultation document.

21 August 2015

1. Between 5 March and 17 April 2015 the Reserve Bank consulted on proposed changes to the capital treatment of reverse mortgages, the removal of the qualifying revolving retail exposure approach in BS2B, and the removal of the foundation internal ratings based approach in BS2B. This document provides a summary of submissions received on the proposed changes, and confirms the Reserve Bank's policy decisions.

Part I – Capital requirements for reverse mortgage loans

Risk profile of reverse mortgages

> Question 13: Do you consider it important that reverse mortgages are subject to specific regulatory capital requirements?

2. Four submissions commented in detail on the proposed changes to the treatment of reverse mortgages. These submissions generally accepted the Reserve Bank's arguments that reverse mortgages are subject to a different risk profile to standard mortgages. In addition to these arguments, it was noted that the quantum of a reverse mortgage increases over time, compared to a standard mortgage that amortises over time, and that reverse mortgages are often limited recourse loans. One submission agreed with the Reserve Bank's position that reverse mortgages are not appropriate for the IRB residential mortgage asset class.

3. However, in other respects two submissions disagreed that a different capital treatment was warranted. One submission explained that two of the key factors in determining the losses on a reverse mortgage portfolio are the gap between interest rates and house price growth, and the 12 month repayment rate. This submission noted that using long run data for these two variables, its actuarial model provided no evidence that the current capital requirements are inadequate. In addition, that bank's own reverse mortgage portfolio had experienced only minimal losses in its history. Another bank noted that the risks that had been identified were already mitigated through lending policies, such as age requirements.

4. It was also argued that the correlation between the performance of reverse mortgages and the economic cycle was less marked than that between property investment loans and the economic cycle, as commented on in the earlier part of the consultation document. One submission noted that the proposed risk weights for property investor loans, justified by their higher correlation, were still far smaller than the proposed risk weights for reverse mortgages, which do not face quite the same cyclical or pronounced risk drivers. On the basis of risk profile, two submissions argued that reverse mortgages should be subject to risk weights somewhere between those for owner occupier loans and investor loans.

5. More generally, two submissions argued that the availability of reverse mortgages is increasingly important in an aging society, and that overly conservative capital requirements that discourage them would be unfortunate.

Policy options/Assessment

> Question 14: Are there any other options the Reserve Bank should consider?

6. In response to this section of the consultation paper, two submitters argued that the LVR used for the calculation of risk weights be updated at regular intervals. In contrast to standard mortgage LVRs, which reduce with principal repayments, if the security value of a reverse mortgage is not updated, then compounding interest will tend to increase the LVR over time.

7. Two submissions noted that the age of the borrower is one of the key risk drivers for reverse mortgages. These submissions suggested that, in addition to LVR, the age of the youngest person with a lifetime right to occupy the property be included in the determination of risk weights, i.e. a two dimensional table of LVR and age. However, one of these submissions noted that to do so would complicate the regulatory capital requirement calculation and therefore add to compliance costs.

8. It was noted that the APRA standards require the regular assessment of security values to ensure that fair values of securities underpin provisioning. This valuation can be performed by qualified internal appraisers or by external valuers. One submission argued that it would be appropriate to revalue the security of a reverse mortgage, and hence recalculate the LVR, once that mortgage reaches an LVR threshold requiring different capital treatment or at a credit event. The submission argued that such revaluation could be undertaken other than through an externally appointed valuer.

> Question 15: Do you have any comments on the Reserve Bank's proposed preferred option of aligning capital requirements for reverse mortgages with the prevailing regulatory requirements in Australia?

9. Two submissions opposed the use of the APRA risk weights for reverse mortgages. The comments on this question reiterated responses to earlier questions, arguing that the risk profile of reverse mortgages in New Zealand was not sufficient to justify large increases in risk weights, in particular, larger than those proposed for property investment loans. One submission welcomed alignment with APRA.

> Question 16: Can you envisage any issues with the proposed implementation of the new requirements as per the exposure draft?

10. One submission suggested that, were the Reserve Bank to implement these changes, it should do so over a reasonable transition period due to the significant increase in the level of capital that would need to be held.

11. Another submission argued that in defining a reverse mortgage, a requirement that *"a credit assessment process involves the borrower's next of kin such as family and whanau"* should be removed. In the normal course of its reverse mortgage business, this bank requires borrowers to discuss their decisions with their family members, and questions borrowers when this has not occurred. However, the final decision to take out a reverse mortgage remains that of the borrower alone, and this bank requested that this requirement be removed.

Response and policy decisions

12. The Reserve Bank disagrees with the proposition that reverse mortgages should face a similar capital treatment to standard mortgages, due to the nature of the product.

The current risk weightings for residential mortgages under BS2A are not calibrated for reverse mortgages, but for amortising mortgages. As stated in the consultation document, there is an a priori case for aligning the capital treatment of reverse mortgages with those of APRA.

13. On balance, while the Reserve Bank disagrees that the average level of risk weights for reverse mortgages should be only marginally higher than standard mortgages, a more graduated approach to risk weight categories, similar to the treatment of standard mortgages, could be applied, instead of the two-category approach by APRA. As such, the Reserve Bank proposes to introduce an intermediate risk weighting category for reverse mortgages with LVRs between 61 and 80 percent,

14. One of the key differences between standard and reverse mortgages is that, if the origination property value is used, the LVR for a reverse mortgage will increase over time. Due to this property of reverse mortgages, the Reserve Bank agrees that clarity around a valuation policy for the security is desirable for ensuring an appropriate capital treatment.

15. At this time, the Reserve Bank does not wish to revisit its requirements for residential property valuation policies. However, we recognise that due to the nature of reverse mortgages, to insist on the use of origination security values in calculating LVRs may misrepresent risk as these mortgages age. One solution is to require revaluation at certain points after a reverse mortgage is originated. As was noted in submissions, APRA's requirements offer some degree of flexibility in how security values are calculated for LVRs, requiring a formal revaluation of securities by an independent accredited valuer when an ADI becomes aware of material changes in the market values of property in an area or region. The Reserve Bank considers that in allowing for revaluation of the security, it is important to prevent any asymmetric revaluation behaviour across a housing cycle.

16. Accordingly, the Reserve Bank proposes to require that the property value used in the LVR calculation for reverse mortgages be calculated in accordance with a bank's existing residential property valuation policy under section 43 of BS2A (and equivalent section of BS2B), with a valuation taking place when a reverse mortgage loan is originated three yearly thereafter. Provision has also been made to use as a valuer, a property valuer as defined under the laws of another country.

17. For the purposes of calculating the LVR of reverse mortgages, it is proposed that the property value used in the LVR calculation is either:

    a. Where the most recent property value is greater than the property value at origination, the greater of the property value at origination or 80% of the most recent property value, OR
    b. Where the most recent property value is less than the property value at origination, the most recent property value.

18. It is proposed that the changes in BS2A take place from 1 July 2016. The risk weights applying to reverse mortgage loans, which will apply to both standardised and IRB banks are set out in the following table (which incorporates the changes intended for property investment residential mortgage loans).

<table>
<tr><th rowspan="3">Loan-to-value ratio</th><th colspan="4">Risk weight in %</th><th colspan="2" rowspan="3">Risk weight for reverse residential mortgage loan (%)</th></tr>
<tr><th colspan="2">If there is lender’s mortgage insurance that qualifies under section 38</th><th colspan="2">If there is no lender’s mortgage insurance or lender’s mortgage insurance that does not qualify under section 38</th></tr>
<tr><th>Non property-investment residential mortgage loans</th><th>Property-investment residential mortgage loans</th><th>Non property-investment residential mortgage loans</th><th>Property-investment residential mortgage loans</th></tr>
<tr><td>Does not exceed 80 %</td><td>35</td><td>40</td><td>35</td><td>40</td><td>LVR Does not exceed 60%</td><td>50</td></tr>
<tr><td>81 to 90 %</td><td>35</td><td>50</td><td>50</td><td>70</td><td>LVR > 60% and < 80%</td><td>80</td></tr>
<tr><td>91 to 100%</td><td>50</td><td>75</td><td>75</td><td>90</td><td>LVR > 80%</td><td>100</td></tr>
<tr><td>Exceeds 100%</td><td colspan="4">100</td><td></td><td></td></tr>
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Part II – Removal of the qualifying revolving retail exposure option from BS2B

19. The Basel II framework for IRB banks (BS2B) includes a ‘Qualifying Revolving Retail Exposure’ (QRRE) category of retail loans. The QRRE category is intended to be used for short-term unsecured revolving lines of credit, e.g. credit cards and certain types of overdraft facilities. To date, no bank has been granted approval to use the QRRE classification, as the Reserve Bank considers that some of the underlying assumptions of the QRRE category are not applicable in the New Zealand context. The Reserve Bank did not consider that the evidence supplied by banks when seeking approval for QRRE demonstrated the validity of these assumptions.

20. The Reserve Bank proposed to remove QRRE as an option from its capital requirements in BS2B, and to group credit card and revolving retail loans in the ‘other retail’ category. This would improve clarity in BS2B, with no direct impact on banks, as none has been given approval to use the QRRE approach.

Proposal for addressing the issue

Question 17: Do you have any comments on the Reserve Bank’s rationale for and proposal of removing the QRRE category from BS2B?

21. Only one submission expressed a strong objection to the Reserve Bank’s proposal. This submission disputed the Reserve Bank’s rationale, in particular around the sensitivity of credit card portfolios to systematic risk. This submission argued that the current calibration of the correlation coefficient is based on outdated research, and that more recent evidence suggests that credit card defaults are related to systematic risk drivers, with a higher relative effect on low-default sub-portfolios. This submission suggested that a single correlation coefficient for the QRRE category is inappropriate, and that it should be replaced with an equation that links the coefficient with PDs, as in the corporate capital equation.

22. Further, the submission said it would be inappropriate to group credit cards in the Other Retail category, which is in effect a residual category that was not designed for credit cards. It proposed that banks resubmit models for the QRRE category with updated historical data, and for the Reserve Bank to inquire about updates that the Basel Committee plan to make to the QRRE category. On this basis, the RBNZ could work with the updated data to design an appropriately calibrated QRRE equation for New Zealand.

23. Two submitters stated that, assuming that the Reserve Bank would not grant approval to use the QRRE classification for credit cards in the foreseeable future, they have no objection to its removal as per the proposal. No other submissions had specific comments on the proposal.

24. The Reserve Bank accepts that to place QRRE within the residual category of Other Retail is a deviation from the Basel Committee’s recommendations, however as stated the Reserve Bank believes that the country-specific circumstances outlined in the consultation document can justify this decision. The determination of the correlation factor in the Other Retail class achieves in substance the capital outcomes that the Reserve Bank believes is appropriate for QRRE in New Zealand.

And, at the margin, the removal of the QRRE category achieves the objective of the Reserve Bank of simplifying its Banking Handbook, with no direct impact on banks as no bank has been given approval to use the QRRE category.

25. Taking these submissions into account, the Reserve Bank will proceed as indicated. Please note that the preceding analysis constitutes the Regulatory Impact Assessment for this policy decision.

Part III – Removal of foundation IRB approach

26. The foundation IRB approach in BS2B is a hybrid between the standardised approach and the advanced IRB approach, which lets banks use their own approved internal models for estimating PDs, while other parameters required for calculating RWA are prescribed by the Reserve Bank. No bank has ever sought approval to use the FIRB approach, and the Reserve Bank considers it unlikely that a bank would seek approval under the FIRB approach in the future. The Reserve Bank considers the advanced IRB approach sufficiently flexible to be more prescriptive where required. Consequently, the Reserve Bank proposed to remove the FIRB approach from BS2B, which would improve clarity and contribute to the objectives of the Reserve Bank's regulatory stocktake.

Question 18: Do you have any comments on the proposal to remove the foundation IRB approach from BS2B?

27. There were no submissions opposing the removal of the FIRB approach from BS2B. It was noted that its removal would improve clarity in the Reserve Bank's Banking Supervision handbook, without imposing any costs on industry. Consequently, the Reserve Bank will remove the FIRB approach from BS2B. Please note that the preceding analysis constitutes the Regulatory Impact Assessment for this policy decision.