RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

Summary of submissions and final implementation decisions of the review of bank capital adequacy requirements for housing loans (stage two) and consequential changes to BS19

Summary of submissions and policy decisions on revisions to BS2A and BS2B for Financial Reporting Act 2013

Please note that this is not a consultation document.

June 2014

Ref #5761472 v1.1

Background

1. On 26 March 2013, the Reserve Bank announced a staged review of bank capital adequacy requirements for residential mortgage loans. Stage one of the review addressed the calibration of the correlation coefficient for 'internal models' banks.[1] As of 1 September 2013, internal models banks have to apply a correlation factor of 20 percent for high loan-to-value ratio (LVR) loans where the LVR is greater than 80 percent but less than 90 percent, and 21 percent for LVR loans greater than 90 percent.

2. Between 20 September and 25 October 2013, the Reserve Bank consulted on stage two of the review. The consultation proposed refinements to definitions in the banking capital requirements, as well as the formalisation of the internal models approval process. A summary of submissions and the decisions on the final policy positions were released in a paper on 20 December 2013.

3. Due to the technical nature of some of the changes required to the capital adequacy requirements to implement the policy decisions, the Reserve Bank consulted on an exposure draft of the new proposed wording between 28 March and 28 April 2014. Consequential amendments to BS19 ("Framework for Restrictions on High-LVR Residential Mortgage Lending") were consulted on at the same time. The consultation document also proposed that the changes would apply as of 01 July 2014.

4. This paper summarises the feedback the Reserve Bank has received on its exposure draft consultation and confirms the final wording and the implementation date for most of the policy items. The Reserve Bank received nine submissions in total. Of those nine submissions, six were from banks, two from representative organisations and one was a private submission.

5. Because of technical concerns raised by stakeholders in relation to a couple of proposals, the Reserve Bank has decided to extend the implementation timeline for those items until a later date this year. The proposal that customers with more than five properties ought to be included in the SME retail or corporate asset class is expected to be delayed until December this year, while the compendium of internal models is expected to come into effect on 01 October 2014.

6. The paper also summarises feedback received on the December 2013 consultation on anti-avoidance issues in BS19 and debt linked to residential mortgages.

7. Separately, the consultation document also included proposed changes needed to BS2A and BS2B to reflect the passage of the Financial Reporting Act 2013, and this paper also summarises the feedback on those proposals and confirms the final wording of the changes.

[1] 'Internal models' banks calculate their capital requirements according to the Banking Supervision handbook BS2B, whereas 'Standardised' banks use BS2A: http://www.rbnz.govt.nz/regulation_and_supervision/banks/banking_supervision_handbook/

Part I Definition issues

Definition of the loan amount in the LVR calculation

8. The exposure draft consultation proposed the following wording to ensure that standardised and internal models banks apply a common definition of what to include in the loan amount when calculating the loan-to-value ratio. Crucially, standardised banks no longer have to add other lending to the home loan amount. This will align them better with what is the requirement for internal models banks.

   BS2A

   Updated Section 37

   (1) The loan-to-valuation ratio for a residential property is calculated by the formula:
   *Loan-to-valuation ratio (LVR) = (loan value/property value)*100*

   (2) In the formula—

   "*loan value is the total amount, as at balance date, of:*
   (i) all claims secured by way of first ranking mortgage over the residential property; and
   (ii) all undrawn commitments to the borrower that when drawn down will be secured by way of first ranking mortgage over the residential property.

   (3) Lending facilities that are treated as unsecured lending and not tied to, nor managed as part of, the residential mortgage, such as credit cards or personal loans, are not normally secured over the residential property and do not need to be included in the LVR calculation."

   BS2B

   New section 4.150A

   "The loan-to-valuation ratio for a residential property is calculated by the formula:
   *Loan-to-valuation ratio (LVR) = (loan value/property value)*100*

   In the formula—

   "loan value is the total amount, as at balance date, of:
   (i) all claims secured by way of first ranking mortgage over the residential property; and
   (ii) the EAD amount of any off-balance sheet exposures secured by way of first ranking mortgage over the residential property and consistent with sections 4.155 to 4.158.

   Lending facilities that are treated as unsecured lending and not tied to, nor managed as part of, the residential mortgage, such as credit cards or personal loans, are not normally secured over the residential property and do not need to be included in the LVR calculation."

9. Most submissions either agreed to the proposed wording or did not comment on it. One submission argued that the text should clarify that secured lending, e.g. motor vehicle loans with security over the car, are also excluded from the definition if not tied to or managed as part of the mortgage loan.

10. The Reserve Bank notes that the new wording is to ensure that both groups of banks, i.e. standardised as well as internal models banks, apply a common definition as far as possible. Standardised banks have thus far had to add unsecured lending to the mortgage loan amount but as a result of this change no longer have to do so. For the avoidance of doubt, the Reserve Bank has decided to amend the wording to refer to lending in general.

> *Lending facilities that are not tied to nor managed as part of the residential mortgage and that are not normally treated as secured over the residential property, such as credit cards or personal loans, do not need to be included in the LVR calculation."*

Property valuation policy requirement

11. The Reserve Bank proposed wording to clarify that banks must have a property valuation policy in place and that the policy requires board approval, and listed some minimum requirements that the policy must contain.

> *"Property value is the value of the residential property determined under a bank's residential property valuation policy when a residential mortgage loan is originated".*

> *"A property valuation policy means a policy governing how a property value is determined for a residential mortgage loan that - (i) is approved by a bank's board of directors; (ii) includes the requirement that only property valuations by independent valuers or a professional valuation service are used for the purpose of calculating the loan-to-valuation ratio;(iii) includes guidance on the appropriate credit risk-related use of different valuation products; (iv) includes guidance on the use of the purchase price of a residential property; (v) includes guidance on the determination of the origination date; and (vi) ensures that its application is invariant to the direction of the movement of residential property prices."*

> *"independent valuer means a person who is not associated with a person who has an interest in the residential property for which a valuation is made and who is: (i) a registered valuer as defined in the Valuers Act 1948; or (ii) another person approved to provide valuation services by rules made under the Rating Valuations Act 1998:"*

> *"For the purpose of this section, a professional valuation service means a service that provides either a statistical or modelled valuation based on market sales price data or a valuation carried out by appropriately qualified valuation personnel overseen by an independent valuer."*

12. Most submissions did not comment on the proposed wording. A minority of submissions contended that it would be impractical or unusual for the Board to sign off on the policy. A small number of submissions sought clarification that the purchase price could be used as a valuation in the LVR calculation, provided the policy contained guidance on when that would be appropriate. The submission also asked the Reserve Bank to explicitly set out the types of valuations that are permitted and under what circumstances they can be used. Another submission asked for the Reserve Bank to include a definition of a credit event and when a valuation may be updated.

13. The Reserve Bank's property valuation policy requirement aims to provide sufficient detail to ensure that a valuation policy leads to an appropriate use of valuations, while not being overly prescriptive. Being too prescriptive can have the effect of making innovation in valuation products unnecessarily difficult. The Reserve Bank's supervisory role will also act as a further check that valuation policies meet its criteria and expectations. Part ii) of the requirement has been updated to clarify that the purchase price can be used as the property valuation, bearing in mind that the policy must contain guidance on its use (see additional wording in bold type). Given the important of a bank's internal valuation policy, the Reserve Bank has decided to maintain the requirement for Board approval.

*"A property valuation policy means a policy governing how a property value is determined for a residential mortgage loan that - (i) is approved by a bank's board of directors; (ii) includes the requirement that only **the purchase price or** property valuations by independent valuers or a professional valuation service are used for the purpose of calculating the loan-to-valuation ratio;(iii) includes guidance on the appropriate credit risk-related use of different valuation products; (iv) includes guidance on the use of the purchase price of a residential property; (v) includes guidance on the determination of the origination date; and (vi) ensures that its application is invariant to the direction of the movement of residential property prices."*

"independent valuer means a person who is not associated with a person who has an interest in the residential property for which a valuation is made and who is: (i) a registered valuer as defined in the Valuers Act 1948; or (ii) another person approved to provide valuation services by rules made under the Rating Valuations Act 1998:"

"For the purpose of this section, a professional valuation service means a service that provides either a statistical or modelled valuation based on market sales price data or a valuation carried out by appropriately qualified valuation personnel overseen by an independent valuer."

Other clarifications to the LVR requirements

14. This part of the exposure draft consisted of a minor word change in BS2A to explain that mortgages in excess of a 100 percent LVR should be treated as residential mortgage loans and not as other assets. This was a minor change and no submission commented on this aspect. A second minor change involved the deletion of the word fully in Section 43 of BS2A. There was also no comment on this proposal. Neither wording has been changed as a result.

BS2A

New Table 4.11

Loan-to-valuation ratio	Risk weight (%)	
	If there is lender's mortgage insurance that qualifies under section 38	If there is no lender's mortgage insurance or lender's mortgage insurance that does not qualify under section 38
Does not exceed 80%	35	35
Exceeds 80% and not 90%	35	50
Exceeds 90% and not 100%	50	75
Exceeds 100 %	100	

And to be deleted

Section 36 (2)

"Residential mortgage loans with loan-to-valuation ratios of more than 100% are treated as "other assets" and risk weighted at 100%."

Also new Section 43 (e)

"..a loan ~~fully~~ secured by a first ranking mortgage over a residential property used primarily for residential purposes either by the mortgagor or a tenant of the mortgagor." (section 43 (e))

Distinction between a residential mortgage exposure and other types of exposure

15. This part of the consultation received the most feedback. It concerned the boundary between residential mortgage loans and other types of exposures. Most respondents raised concerns about the clarification that customers with multiple properties ought not to be included in the residential property (retail) asset class. The majority of submissions accepted that these customers were different from owner occupier mortgage borrowers but raised technical issues about the proposed rule and the implementation timeline. A small number of submissions commented on the marketability criterion and the meaning of the term 'predominantly'.

Proposed wording of exposure draft consultation

BS2A section 43 (e)

"Residential mortgage loan" means a loan secured by a first ranking mortgage over a residential property used primarily for residential purposes either by the mortgagor or a tenant of the mortgagor.

A loan may not be classified as a residential mortgage loan if:
a) the mortgaged property would be marketed as a farm or a commercial property; or
b) the mortgaged property is predominately used for farming or commercial activities; or
c) the principal or interest payments are predominantly serviced from the income generated by the use of the property for farming or commercial activity, except for rental income unless (iv) applies.
d) if the bank has recourse to, or is aware of, more than five properties owned and let by the borrower directly or through a company or any other ownership structure of the borrower, and the loan is predominantly serviced from the rental income those properties generate, then the loan can no longer be classified as a residential mortgage loan but should be classified as either income producing real estate or SME retail lending. The bank is required to verify whether the customer has any other rental properties or residential mortgage loans with another lender or lenders as part of its credit origination process.

For the purpose of this section, predominantly means more than 50 percent.

BS2B section 4.7 (a)

Exposures secured by residential mortgages

Residential mortgages are eligible for retail treatment regardless of exposure size.
"Residential mortgage loan" means a loan secured by a first ranking mortgage over a residential property used primarily for residential purposes either by the mortgagor or a tenant of the mortgagor.

A loan may not be classified as a residential mortgage loan if:
a) the mortgaged property would be marketed as a farm or a commercial property; or
b) the mortgaged property is predominately used for farming or commercial activities; or
c) the principal or interest payments are predominantly serviced from the income generated by the use of the property for farming or commercial activity, except for rental income unless (iv) applies.

d) *if the bank has recourse to, or is aware of, more than five properties owned and let by the borrower directly or through a company or any other ownership structure of the borrower, and the loan is predominantly serviced from the rental income those properties generate, then the loan can no longer be classified as a residential mortgage loan but should be classified as either income producing real estate or SME retail lending. The bank is required to verify whether the customer has any other rental properties or residential mortgage loans with another lender or lenders as part of its credit origination process.*

For the purpose of this section, predominantly means more than 50 percent.

16. Although most submissions commented on the clarification that owners of multiple properties should not be included in the residential mortgages asset class (BS2A Section 43 (e) and BA2B 4.7 (a) d respectively), there were also a few comments on the other points listed above. A couple of respondents enquired how to determine whether a property would be marketed as a residential property or as something else (point a). One submission asked whether the marketing at the last sale would be sufficient, while another asked whether zoning should be used as a guide. Another submission requested clarification about what the term predominantly meant in the context of a property's use (point b).

17. A few submissions argued that the income producing real estate asset class would be unsuitable to customers with multiple properties as, in their opinion, it should be reserved for specialised lending (where there is nor recourse beyond the assets and its cash flows). It was also pointed out that using IPRE would significantly increase the risk weight on those loans. Some submissions argued that customers should either be treated as SME Retail (as proposed) or if the bank's exposure to the customer exceeds $ 1m, as SME corporate. Others stated that they currently did not have an internal model for customers with more than five properties and that new models would have to be commissioned (and of course approved by the Reserve Bank). One bank estimated that this would take 18 months.

18. Most submissions highlighted issues with identifying how many properties existing customers have and verifying a customer's number of properties at the point of mortgage origination. Questions were raised as to whether the five properties had to be located in New Zealand and how to treat part-ownership structures, i.e. do they count in proportion to the share of the customer's stake in the ownership structure? Related to these issues were questions about the treatment of customers that cross the five properties threshold in either direction, i.e. from four to five properties or conversely from five down to four, and how to manage those customers.

19. One submission argued that privacy laws prevented it from enquiring from existing customers how many properties they owned and that the rule should only apply to new customers.

20. Some banks highlighted that they would have to retrain staff on how to treat customers that fall within the five plus category and gave an indicative timeline of six to nine months. It was argued that by not being in the retail asset class, customers would have to be managed on an individual basis which required the bank to obtain more detailed information. That and the higher risk weights could lead to a higher pricing of those loans. The two submissions from parties involved in property investment activity also highlighted concerns about the potential for an increase in the cost of residential property loans for investors with five or more properties.

21. Banks also made suggestions as to how customers with more than five properties could be treated in the interim. Amongst the suggestions made were proposals to start applying the rule to new customers only in the interim and to allow more time for existing customers with more than five properties to be identified. An internal models bank proposed to use the standardised approach for

this group of customers until new models have been developed. Two internal models banks proposed to use an income threshold instead of the count based five properties threshold[2]. That would mean taking loans that are predominantly (i.e. more than 50 percent) repaid from the rental income a residential property generates out of the (retail) residential mortgage asset class and treating them as SME retail or corporate loans. Another internal models bank disagreed with this proposal when asked by the Reserve Bank. The majority of submissions that commented on this aspect of the exposure draft consultation, including all internal models banks, asked the Reserve Bank to delay the introduction of the rule for existing customers at least.

22. The Reserve Bank understands the technical difficulties banks have in implementing the rule and proposes to delay the introduction of the clarified requirement to allow for more time to consider the issues that have been raised and to fine-tune the nature of the requirement. That said, some of the timelines proposed by respondents, such as delaying the implementation by up to 18 months, are unduly lengthy. It has therefore been decided to postpone the implementation of the capital treatment of customers who own and let out multiple properties, i.e. property investors, until December 2014.

23. The Reserve Bank accepts that determining whether a property is ‘predominantly used for farming or commercial activities’ and how a property may be marketed may not always be straight forward. However, the latter criterion was proposed by one of the respondents to the previous consultation. Since the main purpose of this section is to distinguish residential from other types of properties, the order of the criteria has been amended to clarify that farm and commercial properties ought not to be counted as residential mortgage properties. A property’s marketability and the income used for repaying the mortgage loan are the key criteria for determining a property’s use.

New text in BS2A and BS2B

BS2A section 43 (e) new additions

“Residential mortgage loan” means a loan secured by a first ranking mortgage over a residential property used primarily for residential purposes either by the mortgagor or a tenant of the mortgagor.

A loan may not be classified as a residential mortgage loan if the mortgaged property is predominately used for farming or commercial activities. Without limitation, a property will be considered to be predominately used for farming or commercial activity if:

i. the mortgaged property would be marketed as a farm or a commercial property; or

ii. the principal or interest payments are predominantly serviced from the income generated by the use of the property for farming or commercial activity, except where that income is rental income and the property is used for a residential purpose.

For the purpose of this section, predominantly means more than 50 percent.

BS2B section 4.7 (a)

Exposures secured by residential mortgages

Residential mortgages are eligible for retail treatment regardless of exposure size.

[2] One bank made this proposal in a bilateral discussion with the Reserve Bank subsequent to having submitted their formal consultation response.

"Residential mortgage loan" means a loan secured by a first ranking mortgage over a residential property used primarily for residential purposes either by the mortgagor or a tenant of the mortgagor.

A loan may not be classified as a residential mortgage loan if the mortgaged property is predominately used for farming or commercial activities. Without limitation, a property will be considered to be predominately used for farming or commercial activity if:

- *i.* *the mortgaged property would be marketed as a farm or a commercial property; or*
- *ii.* *the principal or interest payments are predominantly serviced from the income generated by the use of the property for farming or commercial activity, except where that income is rental income and the property is used for a residential purpose.*

For the purpose of this section, predominantly means more than 50 percent.

Part II Internal models requirements

24. This part of the exposure draft requested feedback on the wording of the proposal to incorporate the process criteria for internal models changes in BS2B and the establishment of a compendium of approved models between the Reserve Bank and each of the internal models banks. There was general agreement on the proposed wording but a few submissions asked for clarification on a small number of aspects. Some of the required clarifications on the models compendium may require further discussions with banks. Given the importance of accurately recording information in the compendium, the Reserve Bank is amenable to delaying its introduction by three months until 01 October 2014.

25. Some of the banks that commented on the formalisation of the model change requirements stated that calculating the capital outcome under the standardised approach was currently being done outside the capital engine and therefore less robust. They requested clarification that this would be acceptable to the Reserve Bank. Other comments requested the deletion of the requirement to report changes in model parameters due to significant portfolio shifts to the Reserve Bank since, according to that submission, it was not sufficiently clearly articulated and would become visible by changes to model estimates, structures or judgements in any case, and to clarify whether risk weighted assets and capital impacts should be calculated at the four data points. One bank asked how the quarterly window process the Reserve Bank has been operating would be captured by the requirement.

26. A couple of respondents sought further explanation on when the compendium should be updated and how RWA and capital information should be captured. One of those submissions remarked it assumed that further detail would be included in the conditions of registration.

27. The Reserve Bank accepts that calculating the outcome under the standardised approach might have to be done outside the capital engine for now and that as long as banks do that on a genuinely best endeavours basis its requirement is met. Long term, the Reserve Bank strongly expects banks to be able to carry out the calculation in the capital engine. The Reserve Bank is, however, not minded to delete the requirement that it be notified of large portfolio shifts. They help bring to our attention changes in risk weighted assets and can provide the explanation as to why they are happening.

28. The requirement to calculate impacts at four consecutive data points refers to the risk weighted assets and capital impacts. This requirement has been in place for almost one year now.

29. The Reserve Bank's quarterly model change window has been operated on a best endeavours basis and will continue to do so. As such, it does not form part of a bank's capital requirements and does not need to be included in BS2B.

30. However, the Reserve Bank accepts that some of the questions around the models compendium raised by stakeholders are reasonable and that further clarification is warranted. Since the compendium will form part of a bank's conditions of registration, it is important that the information included is accurate and that there is no ambiguity as to the kind of information required. The Reserve Bank has therefore decided to delay the introduction of the compendium by three months until 01 October 2014. This will allow the Reserve Bank and the affected banks ample time to discuss the technical aspects of the compendium and how to update it. The requirements for seeking model change approvals, however, will come into effect as planned on 01 July 2014.

New section (XY) in BS2B

Types of changes

Banks must advise the Reserve Bank of all proposed changes to their estimates and models before implementing them. There are two types of changes:

a. Periodic changes driven by new data (e.g. changes reflecting compositional changes in the loan book). The Reserve Bank should be informed of these, so it can consider whether they need to be approved. In principle compositional changes are not likely to need approval. Notification of these changes provides the opportunity to check for plausibility to satisfy the Reserve Bank that they do relate to compositional shifts, and to track changes through time.

b. Changes to model structures, estimates or judgments (including any changes proposed to PD, LGD and EAD estimates). These changes require Reserve Bank approval and include, but are not limited to, the recalibration of a model due to, for example, material portfolio changes, the omission or addition of variables, the re-estimation of variables or the reclassification of asset classes or segments within a model. These changes are subject to the formal submission requirements set out below.

Content of submissions

Submissions must clearly set out the following in relation to each proposed change:

a. The rationale for the change, including the reasons as to why the new model is an improvement on the existing model, and supporting material.

b. 'Before' and 'after' comparisons with respect to the risk parameters affected (PD, LGD, EAD). Unless otherwise agreed, these comparisons should cover at least four consecutive periods, e.g. quarters or at the half year.

c. The risk weighted asset[3] and regulatory capital impacts, and how these impacts are calculated.

d. Any linkage to the bank's ongoing accreditation requirements.

e. Confirmation that what is proposed is consistent with the bank's conditions of registration.

f. A comparison with the capital outcome under the standardised approach.

[3] Information on risk weighted assets should include the impact in terms of dollars (e.g. 'increase from $10m to $12m') and as a percentage of exposures (e.g. 'increase from 20% to 24%').

Next steps

31. All changes except the asset class treatment of customers with more than five properties and the introduction of the models compendium will be implemented on 01 July 2014. The Reserve Bank will consult with the banks on the necessary changes to the conditions of registration in the coming days.

32. The Reserve Bank will arrange workshop with the banks on the outstanding items to discuss the technical detail around their implementation. We currently envisage that the internal models compendium will come into effect on 01 October 2014. The target date for the asset class treatment of customers with more than five properties owned and let out is December 2014.

Part III Consequential updates to BS19

33. The Reserve Bank proposed changes in the definitions of a number of terms in the Handbook document BS19, "Framework for Restrictions on High-LVR Residential Mortgage Lending". These terms are defined by reference to BS2A and BS2B, and the updates to BS2A and BS2B allow greater consistency between the definitions applicable to IRB banks and those applicable to other banks. So corresponding updates to the definitions in BS19 allow more consistent application of the LVR policy between the IRB banks and the other banks.

34. Submissions were generally supportive of the proposed changes. Some banks noted that the same concerns about timing arose with BS19 as with BS2A and BS2B. However, provided that banks are able to switch to the new definitions in BS2A and BS2B apart from the deferred change in the residential mortgage classification as described above, the Reserve Bank believes that banks will be able to use the new definitions in BS19 corresponding to the first set of BS2A and BS2B revisions from the same date.

35. One bank noted that it can have estimates of over 100% for Exposure at Default (EAD) on its residential mortgage loans, which means that the "loan value" as defined in BS2B can be greater than the total of on-balance-sheet claims and off-balance-sheet exposures relating to the property. This bank feels that for the purposes of the LVR policy (as opposed to capital adequacy), it is sufficient for the loan value to include the full amount of the off-balance-sheet exposures, but not more than that.

36. The Reserve Bank agrees with this point and has revised the definitions of "loan value" and "loan-to-valuation ratio" for IRB banks accordingly. The revised new definitions are as follows –

"loan value", for a residential mortgage loan,—
(i) if made by an IRB bank, has the same meaning as "loan value" as defined for the purpose of defining "loan to valuation ratio" in section 4.150A of BS2B for the residential property on which the residential mortgage loan is secured (except that when incorporating any off-balance sheet exposures in the loan value, the bank may apply a credit conversion factor of 100% rather than using its own EAD estimates); and
(ii) if made by any other registered bank, has the same meaning as "loan value" as defined for the purpose of defining "loan-to-valuation ratio" in section 37 of BS2A for the residential property on which the residential mortgage loan is secured

"loan-to-valuation ratio", in relation to a residential mortgage loan,—
(i) if made by an IRB bank, has the same meaning as in BS2B (except that if the bank has varied the calculation of "loan value" as permitted in these definitions, the bank must use that loan value in calculating the loan-to-valuation ratio); or
(ii) if made by any other registered bank, has the same meaning as in BS2A

37. The changes to BS19 will otherwise be as consulted on.

Part IV Updates for Financial Reporting Act 2013

38. Separately from the proposed changes relating to housing lending, the Reserve Bank also consulted on changes to BS2A and BS2B needed to handle the replacement of the Financial Reporting Act 1993 ("FR Act 1993") with the Financial Reporting Act 2013 ("FR Act 2013").

39. One bank suggested that where terms are defined in the Financial Markets Conduct Act 2013 ("FMCA") as well as in the FR Act 2013, BS2A and BS2B should refer to the definition in FMCA rather than to that in the FR Act 2013, since the financial reporting requirements for banks that were previously in FR Act 1993 are now in FMCA. The concept of a group to which capital adequacy (and other prudential) requirements apply is aligned with the financial reporting concept of consolidation.

40. The Reserve Bank accepts this point and has revised the proposed new definitions of "subsidiary" in BS2A and BS2B accordingly. This approach allows a simpler definition, since the earlier proposed definition needed to exclude various irrelevant types of "entity" as defined in the FR Act 2013 that could be classified as a subsidiary in an applicable financial reporting standard. The definition of "entity" in FMCA is narrower and is appropriate for prudential requirements applying to banking groups. The revised definition in paragraph 5 of BS2A and sub-paragraph 2.2(o) of BS2B is as follows:

    "subsidiary"—

    (i) has the same meaning as in section 6(1) of the Financial Markets Conduct Act 2013 (unless paragraph (ii) applies); or

    (ii) if the Financial Reporting Act 1993 applies to the registered bank, means a subsidiary within the meaning of sections 5 to 8 of the Companies Act 1993 and includes any company or body corporate or association of persons that is classified as a subsidiary in any applicable financial reporting standard.

41. The Reserve Bank will also take this point on board when imposing revised conditions of registration on New Zealand-incorporated banks to implement the changes to BS2A and BS2B: the definition of "banking group" will be updated to refer to the FMCA definition of "group", rather than to the FR Act 2013 definition.

42. Other minor drafting comments have been taken on board, and the final form of the other revised definitions is as follows:

    (1) Replace sub-paragraph 107(2) in BS2A with the following –

    For the purposes of these definitions,—

    (a) the terms "parent", "associate" and "joint venture" are determined in accordance with generally accepted accounting practice, where "generally accepted accounting practice"—

        (i) has the same meaning as in section 8 of the Financial Reporting Act 2013 (unless paragraph (ii) applies); or

        (ii) means generally accepted accounting practice within the meaning of section 3 of the Financial Reporting Act 1993 if the Financial Reporting Act 1993 applies to the bank;

(b) the term “subsidiary” has the same meaning as in paragraph 5 in “Part 2 – Capital Definition”.

(2) Replace the end section of paragraph 6.1 in BS2B with the following –

For the purposes of these definitions,—

(a) the terms “parent”, “associate” and “joint venture” are determined in accordance with generally accepted accounting practice, where “generally accepted accounting practice”—

(i) has the same meaning as in section 8 of the Financial Reporting Act 2013 (unless paragraph (ii) applies); or

(ii) means generally accepted accounting practice within the meaning of section 3 of the Financial Reporting Act 1993 if the Financial Reporting Act 1993 applies to the bank;

(b) the term “subsidiary” has the same meaning as in subparagraph 2.2(o) in “Part 2 – Capital Definition”.

(3) Replace sub-paragraph 119(1)(b) in BS2A (Part 9) with the following –

“generally accepted accounting practice”—

(i) has the same meaning as in section 8 of the Financial Reporting Act 2013 (unless paragraph (ii) applies): or

(ii) means generally accepted accounting practice within the meaning of section 3 of the Financial Reporting Act 1993 if the Financial Reporting Act 1993 applies to the bank;

(There is no equivalent to this revision needed in BS2B.)

Part V

Anti-avoidance and ‘unsecured’ debt linked to residential mortgages (Report back on December 2013 consultation paper)

Unsecured debt linked to residential mortgages

43. Most submitters agreed that it would be appropriate, given that most unsecured lending to a mortgage customer is not counted in that customer’s LVR, for BS19 to note that unsecured lending to mortgage customers under terms that “are substantially different to that which would apply under normal risk management practices or are determined in reliance of the security provided by an all-obligation mortgage” could be considered avoidance activity.

44. Several submitters noted that banks may offer terms on unsecured debt to mortgage customers that reflect improved information flows about the customer resulting from the broader view of the customer’s business, or to provide a “loyalty incentive”.

45. One submitter suggested that if products were constructed on a basis that made it difficult for them to be an effective way to avoid the LVR policy, they should not be considered avoidance.

RBNZ response

46. We agree that offering marginally better terms to mortgage customers is not necessarily avoidance or contrary to normal risk management practice.

47. We also considered carefully the submission which suggested that more substantially preferential terms should not be considered avoidance if adequate safeguards are built in. Our key interest is ensuring the LVR policy is effective in constraining the share of high-LVR lending. So an innovative consumer credit product with safeguards that make it very difficult to be used (in combination with a low-LVR mortgage) to achieve a high LVR across the two products would not be of concern to the Reserve Bank. For this reason we propose to add the italicised subclause to the relevant BS19 clause (and make other minor amendments as shown below):

    Providing unsecured consumer lending to a borrower who has a residential mortgage loan with that registered bank where the terms of the unsecured consumer lending:

    (i) are substantially different to that which would apply under normal risk management practice; and/or

    (ii) are determined in reliance of the security provided by an all-obligation mortgage,

    unless eligibility for such unsecured consumer lending is effectively restricted in circumstances where, had the unsecured lending been part of the residential mortgage loan, the residential mortgage loan would have counted as a high-LVR loan for the bank.

48. The Reserve Bank will engage with banks that appear to be offering unsecured lending to mortgage customers under substantially preferential terms to understand the nature of the safeguards being employed to ensure the product does not create a substantial BS19 avoidance opportunity.

Deposit verification – anti-avoidance policy

49. The consultation paper proposed an anti-avoidance clause covering cases where the bank is aware a borrower's deposit has been or will be funded by unsecured lending from the same bank, backed up by a guideline that the banks should use normal internal procedures to check on the sources of deposits. As an alternative the paper considered the option of a more formal condition of registration that was more prescriptive about the approach used to verify the source of the deposit. Most submitters felt the proposed policy was appropriate and a formal condition of registration on deposit verification was not required.

50. The consultation paper asked submitters whether banks would generally be aware when a customer has used other unsecured credit from the same bank in order to generate a mortgage deposit. Most submitters felt that bank credit origination practices would reveal unsecured borrowing that a potential mortgage customer already had at the same bank. Other submitters pointed out that it would not always be clear whether unsecured borrowing had provided a deposit (e.g. a credit card can be used for supermarket purchases while salary is saved for a deposit). Banks had a range of approaches to ascertaining the source of deposit funds (from verbal questions and verbal attestation to requirements that the customer provide documentary evidence).

51. The Reserve Bank did not propose to implement a formal deposit verification requirement but asked what resource requirements might be required by one. Respondents noted that verification/identification can be incorporated into existing credit check processes, with scale of system changes dependant on the form of requirement (e.g. manual checks only vs. automated systems). Key considerations would be the development of appropriate standards of evidence and associated data systems to record this. Principal cost to banks would relate to front-end lending/credit staffing costs (e.g. re-training) and in the near term the changes could increase loan processing times. Few submitters provided quantitative estimates of time or cost requirements (though one submitter estimated that system re-work would cost in the vicinity of $500k with a lead time until full integration of up to 6 months.)

Response

52. The Reserve Bank considers the planned anti-avoidance approach is indeed workable and will pursue it. If indicators suggest there is surprising growth in unsecured debt and it can be linked to mortgage customers, the Reserve Bank could consider more onerous regulatory options.

53. The Reserve Bank agrees that it will not always be apparent when unsecured credit has indirectly facilitated savings, for example through being spent down while salary is saved for a deposit. (Indeed, this is part of the reason that we have additional anti-avoidance clauses seeking to ensure that mortgage customers do not get highly preferential access to non-mortgage debt, as this could make the LVR policy ineffective.) We are not asking banks to conduct flow of funds analysis on individual customers, instead to use their existing practices to identify any attempts to more directly use unsecured debt to fund a deposit.

Data on anti-avoidance

54. Submitters agreed that banks would be able to provide data on non-mortgage credit extended to mortgage customers, although some time and resources would be required. One submitter suggested the Risk Managers Roundtable (an informal gathering of bank risk officers) would be a useful point for coordinating on the nature and standards of the data.

55. The Reserve Bank is pleased that it appears feasible to obtain data on non-mortgage debt of mortgage customers and will consider this against other data collection priorities. The Reserve Bank accepts that templated regular provision of this data may take some time to arrange, but this should not be of concern unless there is evidence of a change in industry practice in this area (in which case we may need to seek one-off data in this area more urgently).