Reserve Bank of New Zealand
Te Pūtea Matua

Related Party Exposures Standard

Guidance Note

GN XX.1

Guidance Note version history

June 2026	Consultation draft	Relates to the exposure draft of the Related Party Exposures Standard dated [June 2026]
[Day Month] 20XX	First issue date	Relates to [x] Standard version dated [1 July 2028]

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Use and status of the Guidance

The purpose of this Guidance is to assist licensed deposit takers (or **deposit takers**) to interpret and comply with the Deposit Takers (Related Party Exposures) Standard (the **Related Party Exposures Standard**, or the **Standard**). This recognises that the Standard deals with technical subject matter and there may be no case law or other external reference points to assist with its interpretation. Guidance will assist individual deposit takers with their own compliance and support a more consistent approach across the industry.

The Guidance assists by:

- Outlining the context and purpose of the Standard. Technical content is better understood with awareness of the policy intent at the time it was drafted.
- Outlining our preferred interpretation in relation to some clauses, where we have been made aware of differing interpretations by deposit takers.

To assist in using the Guidance:

- The Guidance is designed to be read alongside the Standard. Sections of this Guidance have the same headings as sections of the Standard. Clause numbers are those from the Standard.
- In event of any conflict between the text of the Standard and this Guidance, the Standard prevails. The Standard is secondary legislation made under the DTA, while the Guidance does not have formal status. The Guidance represents our view and is therefore an authoritative indicator of that view. However, ultimately, it is for a court to determine the correct interpretation of the Standard.
- The Reserve Bank will keep under constant review and update the Guidance. We may change our guidance or our interpretation of the Standard if we consider this appropriate. We do not do this lightly and will endeavour to notify deposit takers in advance if we are considering amending the content of the Guidance.
- This Guidance is not legal advice. We encourage deposit takers to seek their own professional advice, as it is their responsibility to determine their obligations and ensure that they comply with the requirements of the Standard.

The Guidance relates to the exposure draft version of the Standard as at [day month year].

We welcome feedback on the Guidance at any time.

Part A: About this Standard

Overview

The Related Party Exposures Standard contains requirements and limits for transactions or arrangements between a deposit taker and its related parties. It is structured as follows:

- Part 1 sets out the meaning of 'related party', 'significant influence' and other interpretation matters, as well as the additional requirements for deposit takers that are subject to group supervision in New Zealand
- Part 2 covers the requirements and limits for related party exposures, including aggregate exposure limits and conduct requirements
- Part 3 details how deposit takers must calculate related party exposures, with specific reference to aspects of the Capital Standard.

This Standard applies to all New Zealand-incorporated deposit takers. It does not apply to overseas licensed deposit takers.

Context and purpose of the Related Party Exposures Standard

This Standard aims to address the potential conflict of interest and large exposure risks inherent in a deposit taker entering into any transaction or arrangement with a related party. Regulatory intervention can achieve this by stipulating that exposures to related parties must not be on more favourable terms than corresponding exposures to non-related parties and limiting deposit takers' total exposures to related parties.

A deposit taker's related parties might take advantage of their position to access credit that could endanger the deposit taker's capital, its overall soundness, and even the stability of the financial system. Such risks could crystallise if, for example, a related party faces financial difficulty themselves and this consequently exposes the deposit taker to potential losses. The Standard also aims to address the risk that a deposit taker might be unduly influenced by a related party, which could compromise the deposit taker's ability to assess the costs and benefits of transacting with that related party in an objective and independent manner.

Principle 20 of the Basel Core Principles recommends regulatory measures to address the risk of conflicts of interest to prevent abuses arising in transactions with related persons. Specifically, it states:[1]

> *To prevent abuses arising in transactions with related parties and to address the risk of conflicts of interest, the supervisor requires banks to: enter into any transactions with related parties on an arm's length basis; monitor these transactions; take appropriate steps to control or mitigate the risks; and write off exposures to related parties in accordance with standard policies and processes.*

By regulating exposures to related parties, the standard will promote safety and soundness of each deposit taker. This will promote the stability of the financial system and public confidence in it, specifically through preventing erosion of capital that might otherwise occur via improper or too large exposures to related parties, and by supporting the good governance of the deposit taker.

[1] Basel Committee on Banking Supervision. (2023). Consultative document Core principles for effective banking supervision, p 54. https://www.bis.org/bcbs/publ/d551.pdf

Part B: Guidance on the Related Party Exposures Standard

Part 1: Preliminary provisions

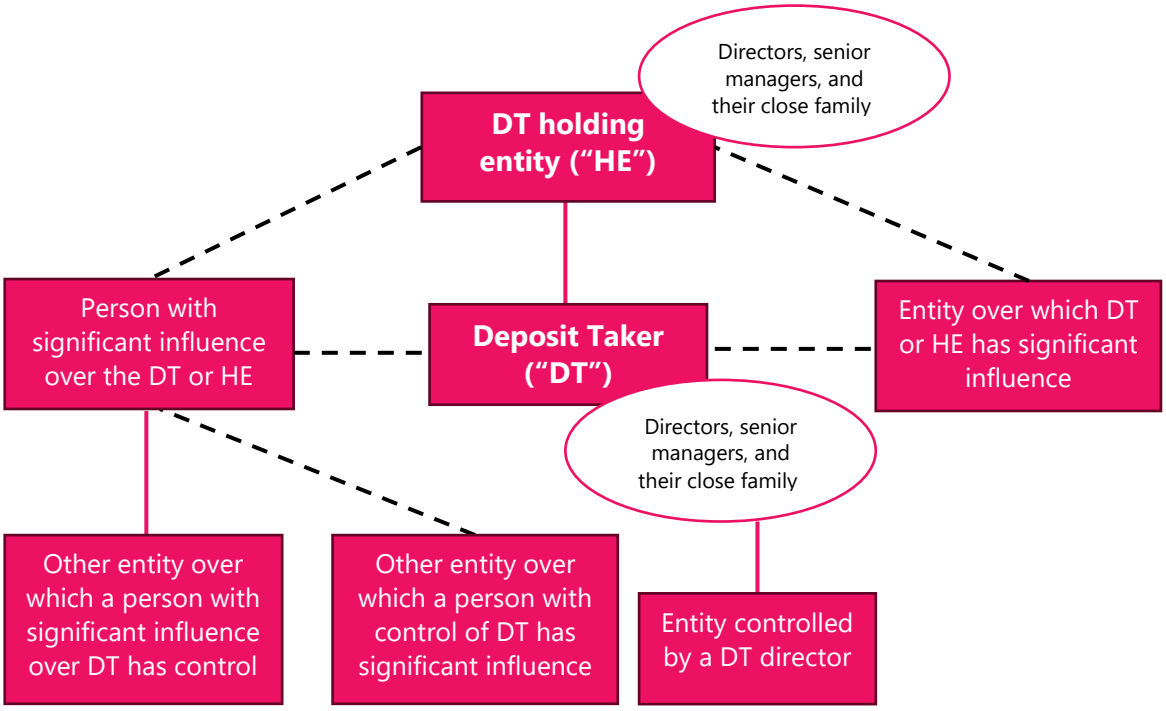
Interpretation (Clause 3)

1. This clause provides definitions that are used in the Standard. Consistent with section 20 of the Legislation Act 2019, words or expressions used in the Standard that are defined in the DTA have the same meaning as in the DTA. For example, 'licensed deposit taker group' has the same meaning as in section 6 of the DTA.

2. A number of other terms used in this Standard are defined in the Deposit Takers (Capital) Standard (the Capital Standard).

Meaning of related party (Clauses 4)

3. These clauses together provide the definition of 'related party' which is used throughout this Standard. The core limbs of the related party definition are set out in Clause 4(1). These can be illustrated by the following diagram, where solid lines indicate control and dashed lines indicate significant influence or control:



4. Clause 4(5) specifies that, despite the definition of related party including an entity over which the deposit taker or its holding entity has significant influence, a member of the deposit taker's licensed deposit taker group is not a related party. This is because the Standard requires deposit takers to calculate exposures of the licensed deposit taker group to its related parties. Therefore, exposures between the deposit taker and its subsidiaries within the group should not be captured. Note that a deposit taker's holding entity is still included in the definition of 'related party', as the exclusion for members of the licensed deposit taker group only applies to Clause 4(1)(e).

5. The Standard uses the same definition of 'significant influence' as other standards for the purpose of defining 'related party'. However, 'control' has a specific meaning in the definition of

'related party', as set out in Clause 4(2). We note that the definition of 'significant influence' is inclusive of 'control' in this context, which means that when Clause 4 is referencing a 'significant influence' relationship between persons or entities, it can be interpreted as "significant influence *or* control".

6. We note that the 'related party' definition in this Standard is different to the 'related entity' definition that is used in other standards. 'Related entity' includes an entity 'A' if a person has significant influence over both entity A and the deposit taker. This particular element of the 'related entity' definition is broader than the corresponding subclause of the 'related party' definition (refer to Clause 4(1)(f) in this Standard), as entity A in this scenario would only be a related party if the person has 'control' over either A or the deposit taker. 'Related entity' also does not include natural persons such as close family members.

Application (Clause 5)

7. This standard applies to all deposit takers incorporated in New Zealand. It does not apply to overseas licensed deposit takers ('branches').

Group requirements for related party exposures (Clause 6)

8. Clause 6 sets out how the Standard applies when a New Zealand-incorporated deposit taker has one or more subsidiaries that are overseas companies carrying on deposit taking business outside of New Zealand. A deposit taker with this structure is subject to group supervision requirements in New Zealand.

9. Deposit takers that are captured by Clause 6 must comply with all requirements in this Standard, as well as a number of additional requirements at a 'New Zealand deposit taker group' level in relation to related party exposure limits (clauses 8 and 9) and conduct requirements (clause 11). The policy intent of these additional requirements is to ensure that intra-group exposure risks that can impact the safety and soundness of a deposit taker are mitigated.

10. In meeting the additional requirements, relevant deposit takers must apply these clauses to a subset of their group that excludes overseas subsidiaries (this is defined in the Standard as the 'New Zealand deposit taker group'), in addition to applying the requirements to the broader licensed deposit taker group including overseas subsidiaries. This means that there are separate exposure limits that apply to the New Zealand deposit taker group. A deposit taker that is subject to group supervision in New Zealand must not exceed the exposure limits in clauses 8 and 9 for both its licensed deposit taker group and its New Zealand deposit taker group.

11. For the purposes of these additional requirements, the definition of 'related party' is modified such that only members of the New Zealand deposit taker group are excluded from the related party definition under Clause 4(5). This means that overseas subsidiaries of the deposit taker must be treated as related parties for calculating the New Zealand deposit taker group's related party exposures.

12. Clause 6(5) effectively requires that the general conduct requirement contained in Clause 11 must also apply at the New Zealand deposit taker group level for deposit takers that are subject to group supervision in New Zealand. This ensures that exposures of a New Zealand deposit taker to its overseas subsidiaries are not on more favourable terms than corresponding exposures to non-related parties.

Part 2: Requirements and limits for related party exposures

Requirement to determine related party exposures (Clause 7)

13. Clause 7 requires deposit takers to determine related party exposures according to the following equation:

$$Related\ party\ exposures = \frac{(Credit\ exposures) - (Credit\ risk\ mitigations)}{Tier\ 1\ Capital}$$

14. Part 3 of the Standard provides further detail on how deposit takers must calculate aspects of this equation. The remainder of Part 2 imposes requirements on a deposit taker's related party exposures, including exposure limits and a conduct requirement.

Aggregate exposure limits (Clauses 8 and 9)

15. Under Clause 8, deposit takers are subject to an aggregate exposure limit for related party exposures. Exposure limits are expressed as a percentage of Tier 1 capital, consistent with the equation in Clause 7. The exposure limits apply to the end-of-day exposures, and we expect deposit takers to be able to calculate end-of-day exposures for the purposes of compliance with the exposure limits. Intra-day exposures are not subject to the exposure limits and do not need to be calculated for the purposes of this Standard.

16. The applicable limit depends on the deposit taker's credit rating, as set out in Table 1. A deposit taker that is exempt from having a credit rating must apply the lowest exposure limit, as indicated in the table.

Table 1: Aggregate credit exposures limits in the Related Party Exposures Standard

Credit rating of the deposit taker[2]	Related party exposure limit (% of the deposit taker's capital group Tier 1 capital)
AA/Aa2 and above	75
AA-/Aa3	70
A+/A1	60
A/A2	40
A-/A3	30
BBB+/Baa1 and below, or exempt from having a credit rating	15

17. Clause 9 imposes an additional limit on a deposit taker's exposures to non-deposit taker related parties of 15% of the group's tier 1 capital ('non-deposit taker related party' is defined in Clause 3 of this Standard). It is important to note that non-deposit taker related party exposures must also

[2] The rating scales in this column are presented as "Standard & Poor's scale/Moody's Investor Services scale", noting that Fitch Ratings' scale is identical to Standard & Poor's.

be included in the calculation of aggregate related party credit exposures. This means that, for example, a deposit taker with a BBB+ credit rating that has non-deposit taker related party exposures of 15% of Tier 1 capital could not take on any additional related party exposures under either the Clause 8 or Clause 9 limits.

Credit rating requirements (Clause 10)

18. Clause 10 clarifies which credit rating should be used for the purpose of determining a deposit taker's rating-contingent related party exposure limit under Clause 8. If a deposit taker is subject to a credit rating downgrade, it also clarifies that a 3-month grace period is allowed starting from the date of a downgrade for deposit takers to reduce their related party exposures to the new rating-contingent limit.

Conduct requirements (Clause 11)

19. Clause 11 imposes a general requirement that related party exposures must not be on more favourable terms than corresponding exposures to non-related parties. For example, interest rates on related party exposures should reflect market rates. The intent of this requirement is to ensure that all transactions are entered into on an arm's length basis.

20. Exposures to related parties under standard staff banking packages are not considered to be on more favourable terms than corresponding exposures to non-related parties for the purposes of Clause 11.

Part 3: Calculating related party exposures

General calculation principles (Clause 12)

21. Clause 12 sets out a number of general calculation principles that deposit takers must take into account when identifying and calculating related party exposures.

22. In general, we expect that credit exposures should be identified and calculated in accordance with the Capital Standard. This includes both on- and off-balance sheet exposures included in either the banking or trading book, and instruments with counterparty credit risk.

23. An asset deducted from regulatory capital must not be included in related party exposures. For example, assets that have been written off should not be included in the definition of exposure, as long as the deposit taker has reduced their capital commensurately. This is because, if an exposure has Tier 1 capital held against the value of the exposure, there is no prudential benefit from an added limit to the size of the exposure relative to capital.

24. Only eligible credit risk mitigations that are specified in this Standard can be recognised for the purposes of calculating related party exposures. Some deposit takers may take into account other relevant factors such as credit quality in their internal risk management framework to set internal exposure limits to their counterparties, including related parties. These internal measures must not be recognised for the purpose of this Standard.

On-balance sheet value (Clause 13)

25. Clause 13 provides two options for calculating the exposure value of on-balance sheet exposures. Deposit takers can either deduct impairment allowances attributable to the exposure in accordance with the Capital Standard, otherwise, as a conservative alternative option, deposit takers may use the gross exposure value without deductions.

Off-balance sheet value (Clause 14)

26. Clause 14 requires that off-balance sheet items be converted into the credit equivalent amount by using a credit conversion factor (CCF) of 100%. This flat 100% CCF is applicable only when deposit takers calculate an exposure value for the purpose of this Standard. This is because the Related Party Exposures Standard is focused on the maximum possible loss that could arise in the event of the sudden failure of a related party and therefore it is appropriate to assume that a related party will take all possible actions to prevent its failure (e.g., drawing on any funds available to it in order to prolong its existence as a going concern).

27. Clause 14 also clarifies that contingent credit exposures to related parties arising from unfunded contingent credit protection arrangements (e.g. guarantees, credit derivatives and indemnities) must be excluded from the definition of exposure value for the purpose of this Standard. For clarity, unfunded contingent credit protection provided by Related Party A against a failure of Related Party B must not be recognised. Unfunded contingent credit protection provided by an entity other than a related party against the failure of a related party can be recognised.

Calculation of exposure value for trading book positions (Clause 15)

28. Clause 15 is relevant only for a deposit taker whose licensed deposit taker group holds positions in financial instruments issued by a related party for a trading purpose.

29. This clause requires that the exposures relating to these financial instruments must be calculated in accordance with Part 6 of the Capital Standard and must be added to a deposit taker's exposures to the related party that lie in the banking book for the purpose of this Standard. Clause 15 also clarifies that a deposit taker must not offset long and short positions in financial instruments issued by a related party across the banking and trading books.

Recognised credit risk mitigations (Clauses 16-18)

30. In accordance with the general formula provided in Clause 7, a deposit taker may reduce the value of an exposure to a related party by the amount of an eligible credit risk mitigation (CRM), such as a guarantee.

31. Clauses 16 to 18 are concerned with the recognition and calculation of CRMs in the reduction of related party exposures. These clauses apply where a deposit taker has recognised CRMs for the purpose of its risk weighted average (RWA) calculation for credit exposure under subpart 5 of Part 5 of the Capital Standard.

32. As a conservative alternative option, a deposit taker may choose to use gross exposure values without recognising eligible CRMs to calculate exposures applicable to the related party exposure limits.

Eligible credit risk mitigations

33. Only the CRMs recognised under subpart 5 of Part 5 of the Capital Standard are eligible CRMs for the purpose of this Standard. To be an eligible CRM, all elements of the eligibility conditions must be met. Deposit takers must not recognise eligible CRMs that are not recognised for the purpose of RWA calculation for credit exposure. This means that any other types of CRMs that are eligible only for internal-ratings based modelled exposures (for example, real estate and collateral for lease financing) must not be used to reduce exposure values for the purpose of this Standard.

34. For the purposes of clarity, the Capital Standard sets out a range of eligible CRMs. This includes the use of on-balance sheet netting. This means that for the purposes of calculating related party

exposures, netting arrangements may be recognised, so long as that netting is done in a way that is consistent with the Capital Standard.

35. As noted above, to be an eligible CRM, all elements of the eligibility conditions must be met. For example, a deposit taker enters into a bilateral netting agreement with the foreign branch of a domestic counterparty. The Capital Standard clarifies that, in this scenario, the phrase "laws of all relevant jurisdictions" means "the law of the jurisdiction in which the branch is located". This means that a bilateral netting agreement involving a foreign branch of the counterparty can be eligible, but a subsidiary of the counterparty cannot be eligible.

36. A deposit taker must use the standardised supervisory haircuts specified in subpart 2 of Part 6 of the Capital Standard and must not use any internally-modelled haircuts.

Maturity mismatch

37. A deposit taker must not recognise a credit risk mitigation that has an effective original maturity of less than 12 months and a maturity mismatch with the underlying exposure. Clause 17 states that if there is a maturity mismatch in respect of recognised credit risk mitigations, the adjustment of the credit protection for the purpose of calculating related party exposures is determined using the mismatch maturity adjustment in subpart 3 of Part 6 of the Capital Standard.

Using a simplified approach to credit risk mitigation

38. Clause 18 clarifies that, for deposit takers that have the choice of using either the comprehensive approach or the simple approach for recognising collateral eligible for CRM under subpart 5 of Part 5 of the Capital Standard, the same approach must be selected under both this standard and the Capital Standard. A deposit taker must not use the simple approach for one of these standards and the comprehensive approach for the other.

39. If the simple approach is selected, a deposit taker may use the same eligible credit risk mitigations calculated in accordance with this approach, except it must use the gross value of its exposure to a related party. The net value of an exposure must not be used if the simple approach has been selected.