1 August 2019

Bernard Hickey, Newsroom

Via email: [email protected]

Dear Bernard,

On 10 July you made a request under section 12 of the Official Information Act (the OIA) seeking the following:

- Any analysis reported to internal RBNZ committees that compares the profits of banks in New Zealand and overseas.
- Copies of assessments of alternative capital instruments in New Zealand.

In discussions with RBNZ officials you clarified that for the first part of your request you were interested in only RBNZ analysis completed during 2019. For the second part, to manage the scope, you noted that your interest was in material from the early 2000s when the Reserve Bank consulted banks about alternative capital instruments.

The following documents are covered by your request and have been released in full:

<table>
<thead>
<tr>
<th>Date</th>
<th>Name</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 June 2019</td>
<td>International comparison of banks’ return on equity</td>
</tr>
<tr>
<td>7 March 2000</td>
<td>Letter to banking industry: Innovative capital instruments</td>
</tr>
<tr>
<td>3 October 2001</td>
<td>File Note: Innovative Capital Seminar</td>
</tr>
<tr>
<td></td>
<td>File Note: Innovative Capital instruments - Responses to Points made at the seminar</td>
</tr>
<tr>
<td>6 December 2001</td>
<td>Memo to Financial Stability Oversight (FSO) Committee: Innovative Capital Instruments</td>
</tr>
<tr>
<td>6 December 2001</td>
<td>Appendix to FSO Committee: The welfare costs of innovative capital when the capital is held by New Zealander’s</td>
</tr>
<tr>
<td>7 June 2002</td>
<td>Letter to banking industry: Re: innovative capital instruments</td>
</tr>
</tbody>
</table>

The 7 June 2019 paper went to the RBNZ’s Banking Steering Group. This is an internal committee that considers banking policy issues. The issues covered in the paper are all taken from publicly available information.
The paper also notes that while this analysis is useful background information for the Capital Review, it is neither the motivation behind the Capital Review, nor is it being used as an input to determine the appropriate capital framework for New Zealand banks.

For the second part of your request the following the June 2001 Reserve Bank Bulletin article is also relevant:


The Reserve Bank will publish this response to your request, at https://www.rbnz.govt.nz/research-and-publications/official-information-requests.

Under section 28 of the Official Information Act, you have the right to complain to the Ombudsman about the Reserve Bank’s decisions in relation to your request.

Yours sincerely

Serene Ambler

Senior Communications Advisor
**Summary:**
- This brief note provides comparisons of NZ banks’ return on equity with those of banks in comparable small, open economies.
- While this analysis is useful background information for the Capital Review, it is neither the motivation behind the Capital Review, nor is it being used as an input to determine the appropriate capital framework for NZ banks.
- Large NZ banks’ revenues (net interest income and other income) are close to peer country averages, when measured against the size of their balance sheets, while large NZ banks’ expenses (operating expenses and credit impairment expenses) are lower than peer country averages.
- This means that, in the peer group we have looked at, on average, large NZ banks have the second highest profitability (difference between their revenues and costs, relative to balance sheet size).
- Combined with leverage around the peer country average, on average this generates the second highest return on equity (CET1) in the peer group, 18.4 percent.
- Small NZ banks operate with higher cost structures than the large NZ banks, and at lower levels of leverage; this leads to the lowest return on equity in the peer group. The analysis shows that if Kiwibank were to achieve similar levels of operating expense efficiency as the major banks, it would generate a similar return on equity (~17 percent).
- Analysis of ANZ Group data shows the New Zealand geographic division produces decent risk-adjusted performance relative to the other geographies (Australia and Asia).

**Introduction**

1. The NZBA commissioned a report by PwC to establish the relative position of New Zealand banks’ return on equity (RoE) compared to banks in comparable countries, and assess the drivers of RoE. While NZBA did not include the final report from PwC as part of its Capital Review submission, ANZ’s Capital Review submission refers to the report and some of its findings.

2. Given the information used in the PwC/NZBA analysis is available from banks’ public financial statements, in this paper we have replicated the key findings of the report, alongside making some enhancements to the PwC methodology. A full explanation of our methodology is contained in the appendix.

**Interpreting relative returns on equity**

3. We would stress that the relative returns on equity of New Zealand banks compared to peer countries should not, in isolation, be used to argue for a particular setting of regulatory capital requirements.
4. On one hand, it is possible that the large New Zealand banks’ relatively high RoEs are an outcome of disproportionate risk-taking (high leverage), that would not be possible without unpriced, implicit government support. A move to higher capital levels could be justified from a prudential perspective as a way to correct this unintended subsidy. Further work, beyond the scope of this paper, would be needed to substantiate this hypothesis.

5. On the other hand, high RoEs compared to peer countries may be an outcome of the level of (or lack of) competition within the banking sector, and/or due to a risk premium associated with New Zealand equity investments in general. Regulatory capital settings are unlikely to be the right policy tool to address perceived issues with either of these.\(^1\) It’s also worth noting that high firm profitability does not on its own indicate a lack of competition in a particular market.\(^2\)

6. Misdiagnosing the relationship between New Zealand banks’ RoEs and regulatory capital settings, and making a mechanical link between these two, has potentially perverse outcomes. If, for example, banks’ RoEs were to fall due to increasing competition from alternative investment options for depositors’ funds, it’s unlikely we would conclude that regulatory capital settings should correspondingly fall.

Cross country findings

7. As shown in Table 1 and Figure 1 overleaf, the data show that the four large New Zealand banks’ average return on CET1 was the second highest amongst this peer group, behind Canada.

8. The large New Zealand banks’ revenues (net interest income and other income) are close to peer country averages, relative to our preferred measurement of the size of their balance sheets (exposure). Against this same metric, the large New Zealand banks’ expenses (operating expenses and credit impairment expenses) are lower than peer country banks. On average, the large New Zealand banks have the second highest profitability ratio, or difference between their revenues and costs, behind the one Finnish bank in our sample (OP Financial). Combined with leverage around the peer country average, on average this generates the second highest return on CET1 in the peer group, 18.4 percent after tax. Canada has a higher average post-tax return (20.3 percent) which under this methodology can be explained by the Canadian banks operating at a higher level of leverage than New Zealand banks.

9. The small New Zealand banks operate at lower levels of leverage, and with higher cost structures than the large New Zealand banks; this leads to the lowest return on CET1 in the peer group.

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\(^1\) Differences in capital requirements between the IRB and Standardised approaches may however be a distortion created by our framework driving relative returns amongst the New Zealand banks.

\(^2\) When supply curves are upward sloping, market prices in equilibrium will be determined by marginal (higher cost) suppliers, with lower cost suppliers being able to earn a margin above their cost, potentially on a sustained basis. A competitive market is one where marginal suppliers earn normal returns at the market equilibrium price; absent barriers to entry or collusive/exclusionary conduct, marginal suppliers can’t sustain above-normal profits in equilibrium. When using profitability to assess the competitiveness of a market one should therefore focus on the returns of the marginal supplier.
Table 1: Return on equity (CET1) for large banks in peer countries (FY18)

<table>
<thead>
<tr>
<th>Country (number of banks)</th>
<th>Return on Equity = (Total income - Total expenses) X Leverage multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net income CET1</td>
</tr>
<tr>
<td>New Zealand (big 4)</td>
<td>18.4%</td>
</tr>
<tr>
<td>New Zealand (small 5)</td>
<td>8.8%</td>
</tr>
<tr>
<td>Canada (4)</td>
<td>20.3%</td>
</tr>
<tr>
<td>Australia major (4)</td>
<td>16.7%</td>
</tr>
<tr>
<td>Sweden (4)</td>
<td>15.6%</td>
</tr>
<tr>
<td>Singapore (3)</td>
<td>14.5%</td>
</tr>
<tr>
<td>Norway (3)</td>
<td>13.7%</td>
</tr>
<tr>
<td>Austria (3)</td>
<td>13.3%</td>
</tr>
<tr>
<td>Australia minor (3)</td>
<td>12.2%</td>
</tr>
<tr>
<td>Netherlands (4)</td>
<td>11.2%</td>
</tr>
<tr>
<td>Denmark (4)</td>
<td>10.2%</td>
</tr>
<tr>
<td>Switzerland (4)</td>
<td>9.7%</td>
</tr>
<tr>
<td>Finland (1)</td>
<td>9.5%</td>
</tr>
<tr>
<td>Ireland (4)</td>
<td>9.2%</td>
</tr>
<tr>
<td><strong>Peer average (41)</strong></td>
<td><strong>12.9%</strong></td>
</tr>
</tbody>
</table>

Source: Banks' financial statements for the 2018 financial year, RBNZ calculations.
Note: country averages are weighted by exposure amount; peer average is the unweighted mean of countries.

Figure 2: Average return on CET1

![Average return on CET1](image-url)
Detailed comparison of New Zealand and Australian banks

10. Table 2 overleaf provides the results of each of the New Zealand and Australian banks in our sample, with income and expenses further broken down into their constituents.

11. Compared to their parent banks, on average the four large New Zealand banks have marginally higher net interest income, and lower operating expenses, relative to balance sheet size. They operate at lower levels of leverage than their parents (on our metric), which helps to reduce differences in their resulting returns on CET1.

12. Lower expense ratios in the New Zealand subsidiaries may be explained by cost synergies arising from the use of Group resources (e.g. if management and systems are run centrally from the Group). This may also reflect that certain costlier parts of the New Zealand banking business are run directly from the Group, such as institutional banking, compared to cheaper business lines, such as residential mortgages where there are likely to be increasing returns to scale.

13. Operating expenses per dollar of credit exposure are, on average, twice as high at the small New Zealand banks compared to the four major banks. Kiwibank, for example, generates approximately the same net interest and other revenue as the four major banks per dollar of credit exposure, but spends twice as much on operating expenses to achieve this revenue. Leaving its revenues and leverage unchanged, if Kiwibank were hypothetically able to match the four large banks on operating expense efficiency its RoE would increase from 8.2 percent to around 17.4 percent, higher than BNZ and WNZL.

14. There is considerable heterogeneity among the smaller New Zealand banks. Heartland and SBS have both higher net interest income components, and higher credit impairment expenses (by a factor of 5 to 10 times peer levels). This likely reflects their higher risk business models and loan portfolios, for example the contribution of personal and unsecured business lending which feature both high interest margins and high expected credit losses.

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3 Note that Kiwibank’s $90m impairment charge for CoreMod occurred in the 2016/17 financial year, meaning it is not counting towards Kiwibank’s expenses in the data used in this paper.

4 \((1.87+0.58-0.85-0.05)*0.72*15.6=17.4\).
Table 2: Detailed comparison – Australian and New Zealand banks (2018)

<table>
<thead>
<tr>
<th>Bank</th>
<th>Return on equity</th>
<th>= (Net interest income + Other income - Operating expense - Credit impairment expense - Tax expense) x Leverage multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net income CET1 %</td>
<td>NII Exposure %</td>
</tr>
<tr>
<td>ANZ</td>
<td>14.4</td>
<td>1.52</td>
</tr>
<tr>
<td>CBA</td>
<td>20.1</td>
<td>1.80</td>
</tr>
<tr>
<td>NAB</td>
<td>14.0</td>
<td>1.51</td>
</tr>
<tr>
<td>WBC</td>
<td>17.9</td>
<td>1.77</td>
</tr>
<tr>
<td>Mean Australia major</td>
<td>16.6</td>
<td>1.65</td>
</tr>
<tr>
<td>Bank of Queensland</td>
<td>11.5</td>
<td>1.97</td>
</tr>
<tr>
<td>Bendigo and Adelaide</td>
<td>13.2</td>
<td>2.06</td>
</tr>
<tr>
<td>Suncorp Bank</td>
<td>11.8</td>
<td>1.90</td>
</tr>
<tr>
<td>Mean Australia minor</td>
<td>12.1</td>
<td>1.98</td>
</tr>
<tr>
<td>ANZ</td>
<td>21.5</td>
<td>1.73</td>
</tr>
<tr>
<td>ASB</td>
<td>20.0</td>
<td>1.77</td>
</tr>
<tr>
<td>BNZ</td>
<td>15.1</td>
<td>1.84</td>
</tr>
<tr>
<td>WNZL</td>
<td>14.9</td>
<td>1.64</td>
</tr>
<tr>
<td>Mean NZ large</td>
<td>17.9</td>
<td>1.75</td>
</tr>
<tr>
<td>Co-operative</td>
<td>7.1</td>
<td>2.08</td>
</tr>
<tr>
<td>Heartland</td>
<td>11.7</td>
<td>3.97</td>
</tr>
<tr>
<td>Kiwibank</td>
<td>8.2</td>
<td>1.87</td>
</tr>
<tr>
<td>SBS</td>
<td>9.9</td>
<td>2.37</td>
</tr>
<tr>
<td>TSB</td>
<td>8.8</td>
<td>1.68</td>
</tr>
<tr>
<td>Mean NZ small</td>
<td>9.1</td>
<td>2.39</td>
</tr>
</tbody>
</table>

5 Note this is the arithmetic mean (for all categories); Table 1 uses an exposure-weighted average.
Within-group comparison (ANZ)

15. An additional comparison can be made on the returns achieved within banking groups. Public commentary has at times included claims that the New Zealand units are the “cash cows” of the Australian major banks. To investigate this, we have compared the performance of the ANZ Group’s divisions over time using data collected from its investor reports back to 2011. To measure returns, we calculate the ratio of cash profit (ANZ’s preferred measure of earnings, which excludes certain volatile items) to RWA calculated at the Group (Level 2) on an APRA basis.

16. This will not exactly measure RoE within the Group, as regulatory differences will mean actual equity investments are higher in some divisions than others, altering RoE (e.g. ANZ NZ’s RWA is higher under our rules than APRA’s rules, requiring more CET1 to be invested in ANZ NZ as a proportion of Group CET1 than simply its share of Level 2 RWA). Higher capital ratio requirements in New Zealand following the Capital Review would further exacerbate these differences. Moreover, for Australian shareholders a dollar of earnings from the Australian business is more valuable for a given level of RWA due to the benefit of franking credits.

17. Figure 3 plots the cash profit to Level 2 RWA ratio by geography for ANZ Group. It highlights the failure of ANZ’s “super-regional” strategy, which began in 2008. After a long period of relatively poor returns, ANZ scaled down and exited its retail and institutional businesses in a number of Asian countries. In its submission, ANZBGL highlighted its withdraw from Asia as evidence of the potential consequences of lower returns from New Zealand under our proposals. On this metric ANZ’s New Zealand business has performed well over time, delivering returns on par with the Australian business, and roughly two to three times higher than the Asian business.

Figure 3: Cash profit by geography relative to Level 2 RWA, ANZ Group

Source: ANZ Banking Group Limited, RBNZ calculations.

18. Figure A3 in the appendix provides a further breakdown of divisional performance in the ANZ Group, dividing each geography into retail, commercial and institutional businesses.
Methodology

1. Following the NZBA/PwC analysis, in this paper we compare RoEs in the 2018 financial year of a selection of major banks operating in broadly comparable countries to New Zealand. We undertake a “DuPont” analysis, breaking down RoEs into component parts:
   a. Revenues (net interest income, other income, e.g. from fees)
   b. Expenses (operating expenses, impaired asset expenses, tax)
   c. Leverage (balance sheet size relative to equity)

Figure A1: Decomposition of return on equity

\[
\text{Return on Equity} = \frac{\text{Net income}}{\text{CET1 capital}} = \left(\frac{\text{Net interest income} + \text{Other income}}{\text{Exposure measure}}\right) \times \left(\frac{\text{Opex} + \text{Impairment} + \text{Tax}}{\text{Exposure measure}}\right)
\]

2. Our prefered specification uses the following inputs:
   a. Balance sheet size is measured using “exposure measure” which is the non-risk weighted amount capturing both on and off balance sheet credit exposures used in the Basel III leverage ratio. An alternative (used by PwC) would be risk-weighted assets (RWA), however in our view it is very difficult to make meaningful cross-country comparisons of RWA. While not risk-based, the exposure measure is more consistently calculated across banks and countries. As we do not have a leverage ratio, for New Zealand banks we proxy the exposure measure with credit EAD (IRB banks) and total credit exposure (on and off balance sheet) (Standardised banks).[^6]

   b. Equity is measured using banks’ Common Equity Tier 1 (CET1) capital, instead of the accounting value of equity (shareholders’ funds) used by PwC. When banks report return on equity to shareholders, this figure is generally derived using the accounting value of equity. Prudential filters deduct certain parts of accounting equity (e.g. goodwill) when calculating CET1 as from a prudential perspective these items are likely to have no value at the point of non-viability. By deducting these parts of equity that effectively cannot be used to support banks’ income-generating activities (as measured by RWA or the leverage exposure measure), in our view CET1 provides a more consistent and comparable measure of “equity” for the purposes of profitability comparisons across banks and countries.

3. Using PwC’s specifications (refer tables A1 and A2) does not materially change how we interpret our findings reported in table 1. This can partly be explained by the commonality of business models in the peer comparison group – with most banks focusing on traditional retail and commercial lending activities our lack of adjustment for balance sheet risk profile (through using RWA) is fairly inconsequential.

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[^6]: For the four large Australian banks, APS330 reports show credit EAD is on average 99.4% of the leverage exposure measure. Given similarities in EAD models to their parents, we consider credit EAD can be used as a reasonable proxy of the exposure measure for the four large NZ banks.
4. Our peer group of countries and banks started with the list chosen by PwC. Overall this list appeared reasonable, being major banks with high market shares operating in a range of peer jurisdictions. Changes we made to the PwC list are as follows:
   a. Remove Germany, Japan, UK and US as the major banks in these countries are of less relevance to New Zealand banks (e.g. in terms of business model complexity, scale, diversification and degree of market concentration).
   b. Include three regional Australian banks as relevant comparators, which are approximately half the size of the four large New Zealand banks.
   c. Remove Aktia Bank (Finland), as this bank is approximately in between Kiwibank and TSB in terms of balance sheet size making it less relevant for comparison to the large New Zealand banks.
   d. Correct the data inputs for DNB Bank ASA (Norway), as PwC’s report appears to have erroneously used data for DNB’s covered bond-issuing subsidiary (DNB Boligkreditt).

5. Note that the returns of the Australian banks are from a Group perspective and therefore will incorporate the contribution of their New Zealand subsidiaries. The same also applies to subsidiaries and overseas operations of the other banks in the sample.

6. It is also worth noting that some of the banks in the sample are partly or wholly government-owned, which may affect RoE targets compared to fully private sector banks. For example, Allied Irish Bank, Bank of Ireland and Permanent TSB are still part-owned by the Irish state (71, 14 and 75 percent stakes respectively), and the Norwegian government maintains a 34 percent shareholding in DNB dating back to its rescue of DNB’s predecessor banks in the early 1990s crisis. The Swedish government divested its remaining 7 percent stake in Nordea in 2013.

7. The full list of banks and their approximate balance sheet sizes (in NZD terms) are reported in the table A3.
Table A1: Return on equity (shareholders' funds) for large banks in peer countries (FY18)

<table>
<thead>
<tr>
<th>Country (number of banks)</th>
<th>Return on Equity = (Total income - Total expenses) X Leverage multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net income SHF</td>
</tr>
<tr>
<td>New Zealand (big 4)</td>
<td>14.6</td>
</tr>
<tr>
<td>New Zealand (small 5)</td>
<td>8.6</td>
</tr>
<tr>
<td>Canada (4)</td>
<td>14.3</td>
</tr>
<tr>
<td>Sweden (4)</td>
<td>12.4</td>
</tr>
<tr>
<td>Australia major (4)</td>
<td>12.2</td>
</tr>
<tr>
<td>Singapore (3)</td>
<td>11.1</td>
</tr>
<tr>
<td>Norway (3)</td>
<td>11.0</td>
</tr>
<tr>
<td>Austria (3)</td>
<td>10.9</td>
</tr>
<tr>
<td>Netherlands (4)</td>
<td>9.1</td>
</tr>
<tr>
<td>Finland (1)</td>
<td>8.9</td>
</tr>
<tr>
<td>Denmark (4)</td>
<td>8.3</td>
</tr>
<tr>
<td>Australia minor (3)</td>
<td>8.3</td>
</tr>
<tr>
<td>Switzerland (4)</td>
<td>6.6</td>
</tr>
<tr>
<td>Ireland (4)</td>
<td>6.0</td>
</tr>
<tr>
<td><strong>Peer average (41)</strong></td>
<td><strong>9.9</strong></td>
</tr>
</tbody>
</table>

Source: Banks' financial statements for the 2018 financial year, RBNZ calculations.
Note: country averages are weighted by exposure amount; peer average is the unweighted mean of countries.

Figure A2: Average return on equity (shareholders’ funds)
Table A2: Return on equity (CET1) for large banks in peer countries (using RWA instead of exposure amount (FY18))

<table>
<thead>
<tr>
<th>Country (number of banks)</th>
<th>Return on Equity = (Total income - Total expenses) X Leverage multiplier</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net income CET1 %</td>
</tr>
<tr>
<td>New Zealand (big 4)</td>
<td>18.4</td>
</tr>
<tr>
<td>New Zealand (small 5)</td>
<td>8.8</td>
</tr>
<tr>
<td>Canada (4)</td>
<td>20.3</td>
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<tr>
<td>Australia major (4)</td>
<td>16.7</td>
</tr>
<tr>
<td>Sweden (4)</td>
<td>15.6</td>
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<td>Singapore (3)</td>
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<td>Norway (3)</td>
<td>13.7</td>
</tr>
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<td>Austria (3)</td>
<td>13.3</td>
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<tr>
<td>Australia minor (3)</td>
<td>12.2</td>
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<td>Denmark (4)</td>
<td>10.2</td>
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<tr>
<td>Switzerland (4)</td>
<td>9.7</td>
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<tr>
<td>Finland (1)</td>
<td>9.5</td>
</tr>
<tr>
<td>Ireland (4)</td>
<td>9.2</td>
</tr>
<tr>
<td>Peer average (41)</td>
<td>12.9</td>
</tr>
</tbody>
</table>

Source: Banks’ financial statements for the 2018 financial year, RBNZ calculations.
Note: country averages are weighted by exposure amount; peer average is the unweighted mean of countries.
^: Note we use actual RWA amounts, unadjusted to make them “internationally comparable”. Adjusting the New Zealand and Australian major banks’ RWA amounts to make them more “internationally comparable” to IRB banks in these peer jurisdictions would lead to a lower leverage multiplier and higher income and expense component, but RoE would be unaffected.
### Table A3: List of banks in peer group

<table>
<thead>
<tr>
<th>Country</th>
<th>Bank</th>
<th>2018 exposure amount (NZDb approx)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Australia</td>
<td>ANZ Bank</td>
<td>1,005</td>
</tr>
<tr>
<td></td>
<td>Commonwealth Bank</td>
<td>1,072</td>
</tr>
<tr>
<td></td>
<td>National Australia Bank</td>
<td>943</td>
</tr>
<tr>
<td></td>
<td>Westpac Banking Group</td>
<td>980</td>
</tr>
<tr>
<td></td>
<td>Bank of Queensland</td>
<td>51</td>
</tr>
<tr>
<td></td>
<td>Bendigo and Adelaide</td>
<td>67</td>
</tr>
<tr>
<td></td>
<td>Suncorp Bank</td>
<td>65</td>
</tr>
<tr>
<td>Austria</td>
<td>Bank Austria</td>
<td>179</td>
</tr>
<tr>
<td></td>
<td>Erste Bank</td>
<td>417</td>
</tr>
<tr>
<td></td>
<td>Raiffeisen Bank</td>
<td>272</td>
</tr>
<tr>
<td>Canada</td>
<td>Bank of Montreal</td>
<td>1,003</td>
</tr>
<tr>
<td></td>
<td>Bank of Nova Scotia</td>
<td>1,243</td>
</tr>
<tr>
<td></td>
<td>Royal Bank of Canada</td>
<td>1,612</td>
</tr>
<tr>
<td></td>
<td>Toronto Dominion</td>
<td>1,590</td>
</tr>
<tr>
<td>Denmark</td>
<td>Danske Bank</td>
<td>729</td>
</tr>
<tr>
<td></td>
<td>Jyske Bank Group</td>
<td>143</td>
</tr>
<tr>
<td></td>
<td>Nykredit</td>
<td>322</td>
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<tr>
<td></td>
<td>Sydbank</td>
<td>34</td>
</tr>
<tr>
<td>Finland</td>
<td>OP Corporate</td>
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<tr>
<td></td>
<td>Allied Irish Bank</td>
<td>157</td>
</tr>
<tr>
<td>Ireland</td>
<td>Bank of Ireland</td>
<td>182</td>
</tr>
<tr>
<td></td>
<td>Permanent TSB</td>
<td>37</td>
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Ref #8049906 v1.11
Figure A3: Cash profit by geography and business line relative to Level 2 RWA, ANZ Group

Source: ANZ Banking Group Limited, RBNZ calculations.
Note: The decline in returns in the Australian retail business from 2016 are likely explained by APRA’s increase in IRB residential mortgage risk weights to an average 25% from their previous level of ~15%.
INNOVATIVE CAPITAL INSTRUMENTS

Over recent months we have received a number of enquiries concerning the eligibility of innovative capital instruments for inclusion in tier one capital of banks incorporated in New Zealand. This letter outlines our preliminary views and seeks industry comment.

Our intention had been to align a comprehensive review of our capital adequacy framework for banks with the major revision that is currently underway of the Basel Capital Accord (the international capital adequacy standard for banks). However, given the increasing and serious interest within the New Zealand banking community as to the regulatory treatment of such instruments, and in the knowledge that the international review is likely to take years rather than months to complete, we decided to bring forward an internal policy review of one aspect of capital adequacy, namely, eligible instruments for tier one status. The preliminary position that we have now reached is not to extend the existing list of eligible instruments. That list is outlined in the Capital Adequacy Framework (Document BS2) issued by the Reserve Bank on 8 July 1998.

Our current definition of tier one capital gives effect to the 1988 Basel Capital Accord whereby tier one capital is defined as including “only permanent shareholders equity (issued and fully paid shares/common stock and perpetual non-cumulative preference shares) and disclosed reserves (created or increased by appropriations of retained earnings or other surpluses, eg share premiums, retained profits, general reserves and legal reserves). In the case of consolidated accounts, this also includes minority interests in the equity of subsidiaries that are less than wholly owned. This basic definition of capital excludes revaluation reserves and cumulative preference shares”.

Qualifying instruments have the following essential characteristics. First, they give the holder of the instrument a claim that is subordinated to all other claims on the bank. Second, the shares are fully paid at the point of issue and, third, those funds are freely available to be invested by the bank. Qualifying instruments allow a bank to absorb losses on an ongoing basis and are permanently available for this purpose. Further they allow banks to conserve resources when experiencing stress because they provide a bank with full discretion as to the amount and timing of distributions. Consequently, common shareholder funds (the main form of tier one capital) are the basis on which most market judgements of capital adequacy are made. The voting rights attached to common stock may also provide an important source of market discipline over a bank’s management.

Many bank regulators overseas are now approving innovative instruments for inclusion in tier one capital. Reflecting a concern that capital was potentially being eroded, the Basel Committee in 1998 established a set of criteria for their
approval as a guideline for regulators. These criteria were aimed at allowing the inclusion only of those innovative instruments with the essential characteristics outlined above. In addition, to protect the integrity of tier one capital, the Basel Committee issued a guideline that inclusion of innovative instruments in tier one capital should be limited to 15 percent.

We have decided that there is not a compelling case from a New Zealand perspective to allow the inclusion of innovative instruments in tier one capital.

A common feature of these instruments is to structure them as debt from a legal and tax perspective and as equity from an economic and risk perspective. While this may lower the apparent cost of capital (on some measures), it does mean that these instruments are typically relatively complex in construction. This complexity, from a regulatory perspective, has at least three undesirable characteristics:

- Creditors and other external parties may have considerable difficulty in understanding them. This is a particular problem given the emphasis we place on market discipline through public disclosure. Simplicity is an important ingredient of effective transparency.

- Considerable (scarce) supervisory resources may have to be devoted to establishing whether or not the instruments are, in effect, fully equivalent to equity. The Reserve Bank’s supervisory approach has sought to avoid intensive case-by-case scrutiny and approval of particular instruments, relying instead on having clear rules which can be easily interpreted by banks themselves. Seeking to design clear rules which would adequately cover a broad diversity of complex instruments seems unlikely to be a useful way forward.

- There is an increased risk that the instruments will not perform as intended in a stress situation, given their complexity and the untested nature of some of the legal documentation.

A particular factor underlying our assessment of innovative instruments has been an increasing emphasis on our part on the need to ensure that the New Zealand banking system will be resilient in the face of bank distress. This thinking led us to develop the proposal (which we are currently discussing with banks) to require local incorporation for certain types of banks including those that are systemically important. It has also strengthened our view that it is vital to ensure that banks have a capital buffer in place which is not only adequate in size, but also of sufficient quality, to withstand significant adverse events. Over the next year or so we will be further developing our views on how to ensure that the capital buffer will perform the task expected, and we will be consulting with the industry on those views.
We are therefore of the view that the risks of undermining the quality of the capital buffer and the costs associated with expanding the list of qualifying tier one instruments outweigh any perceived benefits in doing so. Hence our conclusion that the list of qualifying Tier 1 instruments should be restricted to the current list at this stage.

In examining the mechanics of innovative tier one instruments it became apparent that our capital adequacy rules need amending to prevent the effective repatriation of equity to a parent bank. Whereas currently subsidiaries cannot, by law, purchase shares in their parent bank, there is nothing to stop banks investing in instruments that are in legal form debt. We therefore propose to amend our rules so that investments in capital or subordinated debt instruments issued by a related party are deducted from capital. The approach that we are contemplating is that, where such an instrument is described in the related party’s accounts as a capital or subordinated debt instrument and/or it counts as capital under Basel rules, then it should be deducted.

We would welcome your comments on the proposals in this letter. In the first instance please send written comments to me by 31 March 2000.

Yours sincerely

Peter J Ledingham
Chief Manager
Banking System Department
This file note summarises discussion at the innovative capital seminar held in the Level 2 Seminar Room, at 2.00pm, on 3 October. An agenda for the seminar is attached. The seminar was attended by around 45 participants, including representatives from banks, audit firms, and academia.

Messrs Burnell and Harrison briefly outlined the key points of papers provided to participants prior to the seminar, and as the arguments and conclusions contained in these presentations are well summarised in Ian Harrison’s overview and discussion paper, this file note will instead focus on banks’ reactions to them. Suffice to say that the modelling of the economic welfare impacts of allowing innovative capital instruments to substitute for ordinary equity in tier 1 capital indicates that the outcome would most likely be negative.

This file note will first outline banks’ stated reasons for wanting to issue innovative capital instruments, and then set out some of the criticisms of the economic welfare model, as well as other issues banks have with existing RBNZ policy of not allowing innovative capital instruments to be included in tier 1 capital. However, it should be noted at the outset that a key issue for banks is that the Burnell model assumes that all bank capital is held by foreigners, whereas the most likely structures would involve significant investment on the part of New Zealand investors.

Westpac and ANZ personnel were the main presenters of banks’ views on innovative capital instruments at the seminar.

Comments From Banks – Reasons for Using Innovative Capital Instruments

- ANZ has only 3% of its shareholders in New Zealand, but 15% of its assets and profits in New Zealand. The sale of innovative capital to New Zealanders would better align the geographical location of shareholders with the geographical dispersion of ANZ’s business.

- it would also diversify the types of shareholders ANZ has access to, and this would provide economic benefits to ANZ. Currently 80% of ANZ’s shareholders are institutions, whose key interest is to outperform share market indices. This approach raises ANZ’s beta, and hence its cost of capital. By broadening the shareholder base to retail investors, share price volatility would decline relative to the market, reducing beta, and thus ANZ’s cost of capital.
there is a high demand on the part of New Zealanders for hybrid investments, and blue chip company stocks generally. By not selling innovative capital, New Zealanders would miss out on investment opportunities currently not available.

- By issuing shares in New Zealand dollars, innovative capital removes New Zealanders’ exposure to the foreign exchange risk that is present when they invest directly in ANZ shares.

- New Zealanders also would like to have greater access to bank risk than that which is currently available on the New Zealand stock market.

- Innovative equity reduces banks’ cost of capital.

- Innovative capital instruments do not cause any problems with the New Zealand tax authorities, and banks seek to comply with tax law in issuing them. The Westpac structure has IRD sign-off, and it was proposed to obtain IRD sign-off for the ANZ structure.

- Similarly, banks seek to ensure other relevant regulators or market players are fully informed and satisfied as to compliance issues and the adequacy of proposed structures. For example, the SEC when the ANZ issued an innovative capital structure in the US, and the rating agencies more generally.

Comments From Banks – Benefits of Innovative Capital Instruments

- Banks’ primary focus in relation to innovative equity structures is on the general objective of seeking the most efficient form of capital issuance. But different structures might produce different outcomes in terms of welfare effects.

- In line with the above comment, the analysis assumes deductibility against New Zealand income, but there is no a priori reason why that should be so. Deduction might be against income earned in a foreign jurisdiction, in which case, the economic welfare of New Zealanders could increase as a result.

- As innovative capital instruments reduce the hurdle rate for lending, banks can lend more at the margin. This is positive for growth, employment, and tax paid in New Zealand, and will result in increased economic welfare, and better protection for New Zealand depositors.

- The analysis assumes banks will exchange ordinary share capital for innovative share capital. This may not necessarily be the case – rather, it is more likely that tier 2 instrument usage will decrease, thus raising the quality of capital.

- Innovative capital structures are in essence leveraged structures in relation to those using ordinary share capital, and other things equal, this factor actually increases the amount of tax paid vis-a-vis the case where no innovative capital has been employed in the capital structure.

- The welfare model assumes that innovative capital and ordinary equity instruments are identical, but this is not the case. In fact, these instruments are not perfectly substitutable, and to account for this, innovative capital should generate higher yields
to New Zealand investors than ordinary equity instruments. Other things equal, this effect will also increase the amount of tax paid.

- Banks don’t need an excess rent from these instruments to derive benefits from them. The marginally greater loan growth and market share obtained from their use will create a higher share price than would otherwise be the case, and this benefit alone justifies their use.

**Banks – Issues on Bank Policy**

- Banks questioned on what basis the RBNZ had received a mandate to examine the economic welfare effects of issuing innovative capital instruments, and suggested that tax issues related more to IRD policy. The Bank noted that the desire to tackle the efficiency issue had originally been stimulated by criticism from banks themselves, and in particular, that by restricting the use of these instruments, benefits to bank customers would be reduced. More generally, the welfare economics approach fits with the efficiency objective set out in the Reserve Bank of New Zealand Act 1989. In relation to tax issues per se, the Bank is “agnostic”, or neutral.

- The RBNZ assumes bank depositors are better protected by higher levels of capital within the banking system – has the RBNZ considered other means to achieve this objective, say, through deposit insurance? On this point, the Bank explained that its role relates to promoting financial system stability and efficiency, rather than protecting depositors, and that one of the key tools it uses to promote financial system stability is to ensure that, at a high level of statistical confidence, there is sufficient capital within the system to absorb unexpected losses.

- The RBNZ’s policy approach creates a non-level playing field. Since the IRD is happy to approve these structures, non bank financial institutions and corporates will be able to use them, whereas banks will be restricted by RBNZ prudential policy. The result will be that non bank financial institution market share will grow at the expenses of banks’ share.

- G-10 central banks are comfortable with innovative capital issues. The G-10 central banks review and approve structures. If the RBNZ does not follow, this will also create a non level playing field - for example, Citibank New York will have a competitive advantage in lending to New Zealand corporates, and by taking margins and profits that would otherwise be available to New Zealand banks, this also reduces New Zealand’s welfare.

- Banks consider that the RBNZ is overdoing the problem it has identified in being required to intensively scrutinise innovative capital deals for compliance reasons. For example, the BIS rules are clear, and here, compliance is only a matter of “ticking the box”. In the context of New Zealand’s disclosure regime, director/auditor attestations on compliance could also be used to good effect, and as an example, APRA requires disclosure of such deals in annual reports. Intensive legal scrutiny is already required for US issues, where the ANZ pays up to a $1m for legal sign-off in that jurisdiction.

- Other methods the RBNZ could use to constrain the use of innovative capital instruments include placing a limit on the amount which can be used in tier 1 capital
(eg 25% of the total), and to require conversion into ordinary equity if tier 1 capital falls below a specified amount, say 5%.

**Other Discussion**

During the discussion it was observed that there is nothing in Reserve Bank prudential policy which necessarily prevents innovative capital instruments being issued to New Zealand investors. For example, these instruments could be issued by a sister subsidiary of the New Zealand incorporated bank; or issued as other than tier 1 capital instruments by the registered bank itself. On this basis, it was implied that the market impact of RBNZ policy is probably more benign than the outcome which has been suggested by banks.

Also, as the impact of market structure, and in particular the type of competition which exists in the banking industry, is a key factor influencing outcomes under the Burnell model, there was some discussion as to whether oligopoly or perfect competition is the appropriate model.

Mr Burnell supported the oligopoly case, noting the abnormally high returns available on equity; the difficulty new entrants have in getting a foothold in New Zealand markets; the small number of banks operating in New Zealand, particularly in the retail markets; and the fact that banks spend a considerable amount of time establishing their names and reputations, which would not be necessary if the market were perfectly competitive.

On the other hand, David Tripe suggested that returns data becomes more normal when market values of equity are used, rather than book values. He also commented that there is no consistent evidence for oligopoly pricing in the banking market in New Zealand.

**Conclusion**

Mr Harrison stated that Dr Burnell’s model is a first cut at the economic welfare impacts of allowing innovative capital instruments to be introduced into tier 1 capital, and that those impacts could be re-examined under a different set of assumptions, eg, an open economy; different market structures; a multi-period steady state equilibrium; and under the interaction of tax regimes across different countries. In that sense, the efficiency issue is still on the table.

The seminar concluded with participants agreeing to evaluate whether further work on the efficiency impacts of innovative capital instruments needs to be conducted.
MEMORANDUM FOR FSO Committee

COPIED TO

FROM Ian Harrison
Senior Adviser Banking System Department

DATE 6 December 2001

SUBJECT Innovative Capital Instruments

FOR YOUR Decision

Introduction

About two years ago we made a decision not to change our existing policies on the recognition of tier one capital instruments. This meant that, unlike many overseas regulators, that we would not recognise so called “innovative” capital instruments as tier one instruments. This decision was made on prudential grounds.

We were aware that banks would be likely to contest this decision on “efficiency” grounds. We informed banks that if our decision not to allow innovative capital to count as tier one capital could be shown to have a negative effect on economic efficiency then we would reconsidered our decision.

We commissioned Dr. Stephen Burnell of VUW to produce an academic analysis of the welfare implications for New Zealand of the issue of innovative capital. The analysis was driven by the tax effects that are the primary rationale for innovative capital issues. In our view the analysis showed that New Zealand’s welfare was likely to be negatively affected by the issue of innovative capital.

In September we held a seminar where Dr. Burnell presented his paper and banks and other interested parties had an opportunity to present their views. A summary of points made at the seminar is attached.

I have analysed the arguments made in favour of recognising innovative capital made at the seminar. The paper is attached.

The arguments fall into two main classes.

Non-tax efficiency gains

It was argued in a number of ways that innovative instruments don’t need a tax advantage to be attractive to investors. Hence they can be assumed to bring efficiencies to the market without the tax driven effects that were assumed in the Burnell paper. On analysis these arguments turned out to be either wrong, or were really based on tax advantages, or were trivial. It can be safely concluded that there are no significant non-tax efficiency gains from the issue of innovative instruments that would overturn our prudentially based decision not to recognise these instruments as tier one capital.
Tax efficiency gains

The Burnell paper analysed the welfare implications for New Zealand when innovative tax instruments are issued for their tax advantages and when the holders are Australian.

It was argued that two other cases that might be more beneficial for New Zealand were not examined.

The first is that innovative instruments may exploit a third country tax base and the negative welfare effects that follow from the loss of New Zealand tax revenue will not occur. However, it is unlikely that New Zealand, as opposed to the foreign owned issuing bank, will benefit. So there will be no welfare gain either. While these instruments would be neutral from a New Zealand perspective we obviously would not want to approve an instrument on the condition that it was only exploiting a foreign tax base.

The second case is where the innovative instrument is issued to New Zealand investors. I have analysed this case and have come to the following conclusions. (a copy of the paper is available on request, but be warned, it is a swamp):

- it is possible to generate positive welfare outcomes though negative and neutral outcomes can also occur;
- overall it is likely that the welfare results are more likely to be more positive than if the investors are Australian;
- it is still not clear that the expected welfare gains are positive.

Others might be able to generate more positive results but I have come to the view that we should ignore any tax driven gains in making a policy decision on innovative equity. My reasoning is as follows. There is a reasonable presumption that, tax effects apart, these instruments are inefficient. The Westpac case shows that there is a cost to issuing a small, idiosyncratic and relatively illiquid tranche of capital. The main reason that they are issued is their tax advantage. It may turn out that this generates a welfare advantage to New Zealand. But this would be a second best result. If there is a gain to New Zealand it implies that New Zealand tax rules are inefficient. The first best tax policy is to change those rules because banks would not have to issue an inefficient instrument.

In other words we should not change decisions made on prudential grounds to achieve a second best efficiency outcome when responsibility for a first best policy rests with other agencies.

To conclude: we have no strong evidence that that not recognising innovative equity reduces New Zealand welfare; it is highly likely that any successful argument will be tax driven; and we should not take these arguments into account because they are essentially an argument for other agencies to change their rules.
Recommendations

It is recommended that:

(i) we inform banks that we will not be recognising innovative capital instruments as tier one capital;
(ii) we provide banks with our analysis of their arguments and the additional analytical work.
Appendix One

The welfare costs of innovative capital when the capital is held by New Zealander’s

The following is a brief, low-tech analysis of the possible welfare impacts when innovative capital is issued to New Zealand investors rather than to the foreign parent as was assumed in the Burnell model.

It is assumed that the logic behind the innovative instrument is to stream New Zealand imputation credits to New Zealand shareholders. This has the effect of avoiding the double taxation of New Zealand profits.

The analysis is effected by the assumption as to how the innovative instrument is structured to allocate the benefits of the imputation credits. In practice the benefits would probably be shared. If the investors got all of the tax benefits then banks would not issue them because they would get little or no advantage. If banks received all of the benefits then investors would not buy them – they might as well buy the existing, conventional shares.

Rather than making a particular assumption as to how the benefits are allocated we explore the outcomes when all of the benefits go to investors and when all go to the issuing bank. Actual outcomes are likely to be a combination of these two cases.

Case One. New Zealand investors get all of the benefit

The major effects are as follows:

The cost of capital to the bank remains the same. There is, therefore, no impact on the price of bank services.

The initial impact on the government account is a loss of tax revenue. However, unlike the Burnell model (where the tax is lost to foreigners and is a welfare loss to the economy), this is not a welfare loss because the benefits go to New Zealanders. There may be a net welfare loss because the tax base is a little smaller (on the assumption that the welfare distortions of other taxes are an increasing function of the tax rate) but this effect is likely to be small.

The other factor to consider is what happens to New Zealand investors’ portfolios. The funds that are invested in the innovative instrument have to come from somewhere. They could come from consumption, property, fixed interest, New Zealand equities and foreign equity investments. I examine three possibilities that I think would be the most important.
(i) New Zealand equities.

It is assumed that the shares are fully imputed and that the replacement investor will be foreign. The foreign investor does not benefit from the imputation credits. That means that there is no tax loss to the government and no need to increase other taxes. As bank charges are unchanged there would be no impact on New Zealand welfare in a Burnell type model. New Zealand investors would have slightly more diversified portfolios, which would be welfare positive. We don’t have a model that would allow us to evaluate the size of this gain but I not would expect it to be large.

The net impact in this sub-case is a small negative tax effect and a small positive diversification effect. The net effect is unlikely to be material.

(ii) Funds come from fixed interest investments.

These funds are replaced by borrowings from foreigners who are assumed not to pay New Zealand tax (actual tax payments would be trivial). The impact on government revenue will be negative because it will lose the tax revenue on the fixed interest investment. There is likely to be a small negative welfare effect because the government will have to rely on other more distorting taxes.

The overall effect is more strongly negative because the government also has to replace the lost bank revenue.

(iii) Funds come from other foreign shares.

The government loses the tax revenue from the dividends on foreign shares. This is likely to be relatively small. As with the above case there is likely to be a small welfare loss if the government has to increase taxes which are at the margin more distorting than the tax on foreign dividends.

If the funds come from a combination of the above then the net effect will obviously depend on the relative weightings. Any net effect is likely to be small.

Case two – The bank gets all of the initial benefits.

There are two relevant cases here that were explored in the Burnell paper. In the first the benefits are bid away by competition. In the second the banks retain all of the benefits.

(i) Benefits eventually accrue to bank customers

As with the Burnell model the benefits to the bank are returned to New Zealanders through lower charges on banking services.
The impact on the government revenue will again depend on where the funds come from. As in the above case three possibilities are examined.

(a) Funds come from New Zealand shares.

If the replacement investor is a foreigner who doesn’t receive imputation credits then there is no net loss of tax revenue. There is no need, therefore, to increase other taxes that would have a negative welfare effect.

The net effect is positive. New Zealanders get the benefit of lower bank charges with no negative impacts from taxation. At first sight this seems too good to be true. Is there really a free lunch here? This depends on whether you buy the model assumptions that drive this result. The key assumptions are that share prices at set at the margin by foreigners and these prices already reflect the fact that they cannot use New Zealand imputation credits. They are prepared to take additional shares from New Zealanders without any impact on the share price or the cost of capital of their New Zealand investment.

(b) Funds come from fixed interest investments.

As in the above example there will be a tax loss and other taxes will need to increase. This loss is likely to be smaller than the gain from lower tax bank charges because the return on bank equity is higher than the return on fixed interest investments. Offsetting this should be a penalty for increased risk. NZ in will be more leverage because it has essentially purchased shares in an Australian bank with increased borrowing from offshore. It is not clear whether there would be an overall welfare gain or loss.

(c) Funds come from foreign shares

The New Zealand government will miss out on the tax on dividends and capital gains on foreign shares. If the loss of revenue is equivalent to the tax revenue saved by the Australian bank then the net effect will be similar to the Burnell model – probably somewhat negative.

(ii) Benefits of lower cost of capital are not passed on by banks.

The net benefit to New Zealand in all of the sub examples will be lower by the amount of the benefit that is not passed on. It is likely that for most mixes of the cases outlined above the net effect would be negative.

Finally even where the benefits of innovative capital are assumed to be passed on in the price of banking services this will not happen instantly (whereas the full costs are incurred when the innovative equity is introduced.). This reduces the likelihood that there will be a net gain.
Assessment

The lessons I would draw from the above analysis are the following:

- It is extremely difficult to assess the welfare impact of an innovative capital when
  the instrument is held by New Zealanders. Outcomes will depend on a range of
  assumptions.

- In general there is more likely to be a positive impact than when the instruments
  are held by Australians as was assumed in the Burnell paper.

- It is still not clear that there would be a net welfare gain. Depending on the design
  of the instrument and assumptions about market structures the outcomes could be
  positive or negative.

- The likelihood of net gains would be improved if the Reserve Bank only approved
  instruments with the right kind of structure. However, we would be very
  reluctant to go down that path. We would need a good deal of knowledge (which
  we don’t have) about what structures work and which don’t and would, in effect,
  involve the Reserve Bank in instrument design.

More fundamentally, there is an issue as to whether the Reserve Bank should be
concerned at all with welfare gains that arise because of the tax system. If the
introduction of innovative tax instruments generate a welfare gain to New Zealand
then it is likely that this is because New Zealand has a suboptimal set of tax laws.
Innovative equity is a way of getting around these laws. It is probably more efficient
to address the laws which are the souse of the problem. The Reserve Bank should not
have to overturn decisions made on prudential grounds because allowing innovative
instruments is a second best way of tackling the underlying problem.
Innovative Capital instruments - Responses to Points made at the seminar

Introduction

The following are a set of responses to the issues raised by banks and other participants at the seminar on innovative capital held at the Reserve Bank. We have taken the file note of the meeting as an accurate representation of participants' views. A copy of the note is appended. We apologise to those who made the comments if their points were not accurately reported or properly interpreted.

There was one further point that was not recorded in the meeting note that is important, and which has been analysed in some detail in an appendix. An important point made at the meeting was that the Burnell model only examined the case where the innovative capital is held by foreign investors. However, some prospective issuers propose to sell the instruments to New Zealand investors. The question is what difference would this make to welfare outcomes. This issue is analysed in some detail in an appendix.

The responses to participants’ comments are set out in the same order as they appear in the file note.

Comments about banks’ reasons for using innovative capital instruments

1 & 2 Innovative instruments allow a bank access to individual New Zealand investors.

The reference here was to a proposed ANZ innovative capital issue. One of the motivations for the issue was that the ANZ wanted to have a closer geographical match between its investor base and its banking business. In particular ANZ wanted to target New Zealand retail investors. They wanted more retail investors because this should result in less volatility in the share price. Our understanding is that the proposed issue would have had a particular attraction to New Zealand investors because tax advantages (New Zealand imputation credits) would have been streamed to those investors.

Our first point is that the ANZ already has access to New Zealand investors – they could more aggressively market ordinary shares to them. The innovative equity instruments are more attractive only because of the tax advantage.

Second, there is no guarantee that New Zealand retail investor would pick up most of the issue. Institutional investors may take the lions share unless special provision was made for retail investors.

Third, it is not clear that enough capital would be issued to New Zealand retail investors to make a material difference to the volatility of the stock even if it were true that retail investors are less volatile than wholesale investors.
Fourth, a bank always has the option of issuing innovative equity and obtaining whatever diversification benefits are available. The only thing it can’t do is to count it as New Zealand tier one capital for regulatory reporting purposes.

3. **Innovative equity is not really a share but a hybrid instrument that gives an enhanced return to New Zealand investors. New Zealand investors will miss out if it is not available.**

What difference the enhanced return makes to New Zealand’s welfare depends on why the instrument is not “really” a share and hence why it offers an enhanced return. If the difference is just its tax advantage then this aspect is analysed in detail in the attached note. If it is different because it is more complex and hence more risky or less liquid than conventional equity (which would account for part of the premium) then this is one reason why the Reserve bank is reluctant to give these instruments tier one status.

If one of the reasons for the higher yield is that the market for these instruments is less liquid than conventional instruments then this would seem to be a dead-weight loss. The only reason they can be issued is because of their tax advantages.

4. **Innovative capital removes New Zealanders’ exposure to the foreign exchange risk that is present when they invest directly in ANZ shares**

The reference here is to the proposed ANZ issue and may not apply to all innovative issues. It is hard to see how this instrument could remove foreign exchange risk to New Zealanders. As we understand it the capital value and dividend stream of this issue track the head share. It follows that the real exchange risk should be the same, or nearly the same, as the head share (streaming of local imputation credits may or may not make some difference to this conclusion). The fact that the instrument might be denominated in New Zealand dollars will not make any difference to this conclusion.

5. **New Zealanders would like to have greater access to bank risk than is currently available on the New Zealand stock market.**

New Zealand’s can buy as much bank risk as they like now by buying Australian or other foreign bank shares. If investors specifically wish to buy shares that are listed on the New Zealand stock market then banks can meet that demand if they chose. An innovative instrument is not required, and as noted above, there is in any event no impediment to banks issuing these instruments. It just cannot be counted as local tier one capital. If investors want more exposure to New Zealand bank stocks then an instrument that tracks the parent share will not meet this demand. Locally incorporated banks can meet this demand by issuing ordinary shares in the local entity. As these shares would attract New Zealand imputation credits this would get around the double taxation problem using conventional equity.

6. **Innovative equity reduces banks’ cost of capital**

This is not in dispute. The issue is whether the issue of innovative capital increases New Zealand’s welfare.
7. **Innovative capital instruments are compliant with New Zealand tax law**

The argument here is that if the tax authorities are happy to sign off innovative tax instruments as being compliant with New Zealand tax law why should the Reserve Bank worry about possible negative welfare implication for New Zealand of these instruments? Surely this is the responsibility of the IRD and/or Treasury?

The answer is that we are not worried about the negative welfare implications as such. Rather the decision to place a moratorium on giving innovative capital tier one status was made on prudential grounds. We did not believe that innovative instruments would necessarily be a perfect substitute for innovative equity in a crisis situation or that the approval process for innovative instruments was consistent with our general approach to supervision. The reason that we looked at the efficiency or welfare implications of innovative instruments was that we were alert to the possibility that there could be *gains* to New Zealand through their issue. If there were an argument that welfare impact was positive and material, then we would be bound to rethink our decision. We would have to consider whether the efficiency gains forgone outweighed the gains we saw from a prudential perspective of not allowing innovative equity to count as tier one capital. As it turned out the Burnell model did not show that there were significant welfare losses from forgoing innovative capital (indeed the conclusions tended to point the other way) so we are not faced with a soundness/efficiency trade-off.

The fact that innovative equity instruments are consistent with New Zealand tax law would not be relevant unless it could be argued that New Zealand would not have a tax law unless it was beneficial to the economy. Or in other words our assessment that innovative equity instruments are neutral or negative in their efficiency impact is at odds with the view implied in the IRD approval.

Our response is that not everything that is consistent with New Zealand tax law is necessarily good for New Zealand. We do not believe that the IRD has analysed the economic implications of their approval of these instruments. The decision would have been made on legal grounds. Thus the RBNZ is not at odds with an IRD view of the economic implications of innovative equity - there isn’t one.

8. **Banks ensure that other regulators are informed and satisfied as to compliance issues and adequacy of the proposed structures.**

The perspective of the home country regulator may not be the same as the host country regulator. There may be legitimate reasons why the host and home country regulators would come to differ view as to the merits of innovative capital in general or of the merits of a particular issue.
9. *Provides the most efficient form of capital issuance*

This is the same argument as 6.

10. *The instrument might be efficient because it allows deductibility against a foreign jurisdiction.*

If the deduction was from a foreign tax base and some of the benefits of a lower cost of capital was passed onto New Zealand users of bank services then this would be a welfare gain to New Zealand.

There are two problems with this kind of argument. First, it is unlikely that the benefits of exploiting the rules of a foreign tax base would be shared with New Zealand bank customers. For that to happen there would need to be competitive pressures which would force the banks to reduce the price of New Zealand bank services. This would only occur if there was some direct linkage between the instrument that exploits the foreign tax base and products offered to New Zealand customers. We doubt if this is the case.

Second, and more importantly, the Reserve Bank would not like to get involved in a process that would involve the checking of documentation to ensure that tax advantages were obtained from an offshore jurisdiction. This would not be consistent with our general approach to supervision, which is to avoid the detailed scrutiny and approval of particular instruments. Further, the Bank would not like to be seen as complicit in the design or approval of financial arrangements that would only be approved if they impacted on foreign tax bases.

11. *Innovative instruments reduce the hurdle rate for lending which is positive for growth, employment and tax paid in New Zealand*

These effects are analysed in the Burnell model.

12. *The analysis assumes that banks will exchange ordinary share capital for innovative share capital. It is possible that tier two capital usage will decrease, thus raising the cost of capital.*

If it is intended to substitute for tier two capital then there would be no need to seek approval to include innovative capital as tier one capital.
13 Innovative capital instruments are in essence leveraged structures in relation to those using ordinary share capital, and other things being equal this factor actually increases the amount of tax paid vis a vis the case were no innovative capital has been employed in the capital structure.

It is not clear what is being said here. We suspect that it is a similar argument to 6 and 11.

14. The welfare model assumes that innovative capital and ordinary equity capital are identical, but this is not the case. As they are not perfect substitutes innovative capital should generate higher yields to New Zealand investors than ordinary equity instruments. This will also increase the tax paid.

This seems to be a similar argument to 3. If innovative instruments have a higher return to investors than ordinary equity then how could they reduce a bank’s cost of capital? The answer has to be that there must be some form of tax advantage. One form of tax advantage has been examined in the Burnell model and an extension is set out in the appendix.

15. Banks don’t need an excess rent from these instruments to derive benefits from them. The greater loan growth and market share obtained from their use will create a higher share price and this benefit justifies their use.

We think that this argument is covered in the Burnell model in the case where all benefits to issuing banks of innovative equity are eventually bid away

Issues on Bank policy

16. Does the RBNZ have a mandate to examine the economic welfare effects of issuing innovative capital instruments?

The bank’s response to this question is, we think, reasonably well made in the overview paper that was presented at the seminar. See also the response to 7.

17. Has the RBNZ considered means other than capital to protect depositors?

This question is answered comprehensively in the overview paper.

18. The RBNZ’s policy creates a non-level playing field. Since the IRD is happy to approve these structures, nonbank financial institutions and corporates will use them; whereas banks will be restricted by RBNZ prudential policy.

The RBNZ’s policy does not stop banks from issuing innovative equity. It simply stops them from counting it in their tier one capital. This actually preserves the level playing field. Nonbanks do not have an officially approved capital standard. Hence their issue of innovative capital does not improve their position against an official standard. Banks do have an officially approved standard but the issue of innovative equity does not improve their position against that standard. Banks and non-banks are therefore in the same position.
19. The G-10 banks are comfortable with innovative capital issues. If the RBNZ does not follow, this will create a non-level playing field - for example Citibank New York will have a competitive advantage in lending to New Zealand corporates and that by taking margins and profits that would otherwise be available to New Zealand banks, this also reduces New Zealand’s welfare.

This case where banks could have either a branch or incorporated presence in New Zealand was not considered in the Burnell model. It assumed that all banks were locally incorporated and that there was no competition from foreign banks. Assessing the affects on New Zealand welfare of competition from branches of banks located in third countries is a complicated matter and we are not in a position to model the possible outcomes. However the following points are worth considering.

First, innovative capital does not affect the competitive position of New Zealand owned banks. There is no double taxation of profits because these banks receive imputation credits.

Second, we are not concerned with the New Zealand generated profits of overseas-owned banks as such. These profits do not directly affect New Zealand’s welfare.

The issue for us is how a shift between the competitive position of branches and subsidiaries affect New Zealand’s welfare. With respect to retail banking and systemically important banks the problem will largely go away. These banks are required to incorporate in New Zealand so the issue of competitive advantage will not arise.

With respect to wholesale banking there will continue to be an issue. If there is indeed an advantage to branches then the branch will either undercut the prices offered by the New Zealand incorporated banks or these banks will be forced to lower their prices. If they do the latter, and nothing else changes, then the only impact is on profits earned by the foreign bank. This would be positive for New Zealand’s welfare.

If on the other hand the business goes to a branch or is booked with the parent of a locally incorporated bank then New Zealand’s welfare could be affected. The capital that supports this business will not be locally based and New Zealand will forgo the tax on this capital.

The issue is how important is this effect. The fact that locally incorporated banks and branches have co-existed in the same business space without obviously large changes in market share would suggest that the substitution effect, if it exists, is not large. If this is the case it is hard to see why allowing innovative capital would make much of a difference.

20. The Reserve Bank is overstating the problem of scrutinising innovative capital deals. For example BIS rules are clear, and compliance is only a matter of ticking the box.

We do not accept that this would be a simple box ticking exercise. Overseas jurisdictions tend to have issue by issue approval regimes and we think that the same would be required in New Zealand. We do not think disclosure is a sufficient or realistic discipline. Innovative capital instruments are generally too complex to disclosure in a way that can be readily understood. Placing responsibility on auditors and directors probably won’t work. They will inevitably seek the comfort of RBNZ approval.
The financial cost of scrutinising individual proposals is not our major concern. Rather we have a philosophical objection to being drawn in a more detailed scrutiny process with the risks of getting it wrong and the moral hazard that this would imply.

21. The RBNZ could constrain the use of innovative capital

If innovative capital is not a good idea then the optimal level is zero.
7 June 2002

Re: Innovative Capital Instruments

Dear «Title» «LastName»

In September of last year the Reserve Bank held a seminar on innovative capital instruments. The seminar served two main purposes. The first was to present a paper written by Dr. Burnell of Victoria University that analysed the welfare implications of allowing innovative capital instruments to count as tier one capital. The second was to give banks and other parties an opportunity to comment on the paper and to present their arguments for giving innovative instruments tier one status. I wish to thank participants from all the banks involved for attending the seminar, and for the useful contributions that were made during the discussion.

A summary of arguments made by banks in favour of granting tier one status and the Reserve Bank’s responses to those arguments is attached.

As we see it the nub of the issue is as follows. The Reserve Bank has made a preliminary decision, on prudential grounds, not to allow innovative capital instruments to count as tier one capital. The reason for this decision is that from a regulatory perspective innovative instruments have three undesirable characteristics:

- Creditors and other external parties may have difficulty in understanding them. This is a particular problem given the emphasis we place on market discipline through public disclosure. Simplicity is an important ingredient of effective transparency.

- Considerable supervisory resources may have to be devoted to establishing whether the instruments are fully equivalent to equity. This would be at odds with the Reserve Bank’s general approach to supervision, which has been to avoid intensive case-by-case scrutiny, relying instead on clear rules which can be interpreted by banks themselves. Seeking to design clear rules that would adequately cover a broad range of complex instruments would probably not work.
There is a risk that the instruments will not perform as intended in a stress situation, given their complexity and the untested nature of some of the legal documentation.

However, we were mindful of bank arguments that the use of innovative instruments could reduce the cost of capital of subsidiaries of foreign banks in New Zealand. Given the structure of the New Zealand and Australian tax systems, in particular, this argument has some force. It does appear that some banks may be subject to double taxation that increases the cost of capital of their New Zealand subsidiaries. The attraction of innovative equity is that it allows banks to avoid some of that double taxation.

However, this argument is not conclusive. The key point is not whether foreign banks benefit but whether the reduction in their cost of capital is likely to improve New Zealand’s welfare. Ultimately all public policy measures have to be assessed against that standard. If a good case could be made that innovative equity improved welfare then the Reserve Bank would be bound to reconsider its initial decision that was made solely on prudential grounds.

From our internal analysis and assessment of the results of the Burnell model we came to a preliminary view that it is unlikely that New Zealand’s welfare would be improved. At the seminar some of the participants also presented arguments that a lower cost of capital would benefit New Zealand. In general we did not think that they added to the arguments incorporated in the Burnell paper and were not convinced that a case for a welfare improvement had been made.

However, there were some other arguments that needed further consideration. The first was that the Burnell model only considered cases where the innovative instrument was held by foreign investors. It is likely that instruments could be issued that specifically targeted New Zealand investors. This might make a difference to welfare outcomes.

The second was that an innovative instrument could be designed to benefit from a foreign country tax base and that this would increase the likelihood of a welfare gain to New Zealand.

The third is that the New Zealand incorporated banks would be at a competitive disadvantage to foreign banks that have a branch presence in New Zealand because these banks can count innovative instruments as tier one capital.

We thought that the first point might have merit and undertook a preliminary analysis of the welfare outcomes when the innovative instrument is issued to New Zealand residents. The analysis turned out to be extremely complex with the results turning on particular assumptions about the design of the instrument and the structure of markets and tax regimes. Overall the results did not make a difference to our earlier conclusion that the introduction of innovative instruments are more likely to reduce New Zealand’s welfare than improve it.
While this analysis was only preliminary we do not think that there is value in conducting more work on these lines. First, we do not think that the application of more sophisticated models to the problem will generate results that are any more conclusive. More fundamentally, however, we have doubts as to whether welfare gains or losses generated by the tax characteristics of innovative instruments are relevant to the design of prudential policy. Suppose that we could generate a reliable result that allowing innovative instruments to count as capital would generate a welfare gain for New Zealand. What this would be telling us is that the design of the New Zealand tax system was generating negative welfare results. It seems to us that the first best policy response would be to change the tax system to reduce the cost to banks of deploying conventional equity in New Zealand. This would obviate the need to issue innovative equity, which the Bank has determined is a second-best instrument from a prudential perspective. If banks can make a case that innovative equity is good for New Zealand then they can also make the case to the tax authorities that the relevant tax rules should be changed to achieve the same outcome using conventional equity.

On the second point we agree that New Zealand would not be worse off if the advantages of an innovative instrument came from a foreign tax base. Indeed New Zealand could be better off if some of those advantages were passed on to New Zealand bank customers- though it is not clear to us why this would happen. However, the implication of this argument is that we would only approve innovative instruments that could be demonstrated to be exploiting a foreign tax base. Obviously, however, the idea that the Reserve Bank would write and implement rules that were specifically targeted at foreign tax regimes does not have much appeal.

On the third point, it is true that the innovative capital could introduce a non-neutrality between the branches and the subsidiaries of at least some foreign banks. There is an issue here as to whether this is a problem for New Zealand or for the banks that appear to be disadvantaged (we suspect that the cost is to the latter) but, again, the more fundamental point is whether we should be designing a regulatory regime to counter international tax non-neutralities. We live in a world where there are all sorts of tax non-neutralities that make international banking anything but a level playing field. For the most part banks have to live with them. There doesn’t seem to be a strong case for changing prudential rules to counter the possible non-neutrality that the non-availability of innovative instruments to the New Zealand subsidiaries of foreign banks could introduce.

To sum up we have come to a reasonably firm view that we should not change our preferred prudential regime to counter tax induced distortions in the banking system.
If we do not take the tax efficiency element of innovative instruments into account, banks may still wish to make the argument that there is some non-tax advantage of innovative instruments that will eventually be positive for New Zealand. Some arguments along these lines were made at the seminar. It appeared to us that they either really relied on a tax advantage or that they were otherwise unconvincing.

We suspect that it would be difficult to make the case that innovative instruments have strong non-tax advantages. We would expect that if a bank wanted to raise capital then the most efficient way to do so would be to raise conventional equity. It is difficult to see why a specialised tranche of equity, which would be less liquid than the conventional equity, would be a cheaper form of issuance.

Our inclination, therefore, is to stick with our original decision not to allow innovative instruments to count as tier one capital. We are, however, prepared to consider further submissions from banks along the lines set out above. That is, if it can be demonstrated that innovative instruments offer efficiency advantages (that do not flow from their tax characteristics) and that there is a reasonable likelihood that some of these advantages will flow to New Zealanders, then we will take these arguments into account in making our final decision on this matter.

If your bank wishes to make written comments on the matters raised in this letter and in the other material then could you please send them to me by 31 July 2002.

Yours Sincerely

Peter J Ledingham
Head of Financial System Oversight