



**RESERVE
BANK**

O F N E W Z E A L A N D
T E P Ū T E A M A T U A

Capital Review Paper 2 (Part II): What should qualify as bank capital? Response to submissions

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Summary

After considering the feedback provided in submissions and in meetings, the Reserve Bank has made in-principle decisions with respect to key aspects of the definition of capital. The Reserve Bank has made in-principle decisions to:

- Proceed with the proposals outlined in the consultation paper with respect to contingent debt and contingent preference shares, namely to remove them from the definition of capital;
- Accept non-redeemable, non-contingent, perpetual preference shares as AT1 capital;
- Accept redeemable, non-contingent preference shares and long term subordinated debt as Tier 2 capital; and
- Keep open the option of including in the regime a Tier 1 instrument able to be issued by banks structured as mutual societies.

The Reserve Bank expects to consult stakeholders next year on the details of these decisions, when we consult on redrafts of the Handbook (BS2A and BS2B).

Overview

1. Capital regulations specify not only the minimum amount of capital banks must hold, but also the type of instruments that qualify as regulatory capital. The nature of these instruments, rather than the amount of capital, was the subject of the consultation paper released on 14 July (“Capital Review Paper 2: what should qualify as bank capital?”).
2. The context in which capital regulations operate is an important consideration. In New Zealand, important context is provided by the Reserve Bank’s regulatory approach and philosophy, the bank resolution regime, the international standards issued by the Basel Committee, and the trans-Tasman nature of New Zealand banking.
3. The consultation paper outlined the different types of instruments that currently constitute bank capital, focusing in particular on a class of instruments known as “contingent debt”. Contingent debt is debt that writes off or converts to ordinary shares when a pre-specified event, related to the issuing bank’s financial condition, occurs.
4. The consultation paper also described the context for New Zealand’s capital regulations and the New Zealand experience under Basel III, and presented a number of options for reform. Each option was a combination of measures across 6 dimensions. The options combined reform measures in such a way that moving from Option 1 to Option 5 implied a gradual shift from the *status quo* towards:
 - Greater certainty as to the loss-absorbing quality of regulatory capital;
 - Reduced complexity for the capital regime;
 - A more level playing field; and,
 - A reduced risk of regulatory arbitrage.
5. The consultation period ended on 8 September. 17 submissions were received in response to this paper. In addition, 22 submissions were provided in response to an earlier consultation paper (the “Issues Paper”) and these included quite detailed responses that related to the definition of regulatory capital. Two meetings to discuss what should qualify as capital were also held with banks and invited parties.
6. The purpose of this paper is to provide a response to the feedback provided by submitters and in meetings, and to outline next steps for the Capital Review. Our aim in this paper is not to describe in detail the views of each submitter, but to extract and respond to what we understand to be the key concerns expressed by submitters. Each individual submission provided to the Reserve Bank is available from the Reserve Bank’s website.
7. While the submissions covered a wide range of topics, among the submissions there were several common themes. One common theme was opposition to the proposal

to cease recognising contingent debt as capital. Banks were concerned about the potential impact of this proposal on local financial markets, bank costs, the self-reliance of New Zealand banks, and foreign investor confidence in New Zealand banks.

8. Several of the smaller banks, while acknowledging the competition-levelling effects of removing contingent triggers, indicated that they would prefer new instruments to be included in the regime, rather than the proposal regarding contingent debt. In particular, banks structured as mutual societies requested that a bespoke mutual society Tier 1 instrument be included in the regime.
9. A third key theme was opposition to the proposal that, in order to qualify as Tier 1 capital, perpetual preference shares must be non-redeemable. Submitters expressed concerns about the lack of investor appetite for such instruments. There was also scepticism that banks could be prevented from designing structures that provided an optional call for 'non-redeemable' preference shares.
10. A fourth theme related to tax. The large banks claimed that the consultation paper placed excessive emphasis on the tax treatment of contingent debt. This appears to be an area where the paper's intended message may not have been clear enough. The intended message was that the incentives presented by the tax regime foster contractually-complex capital instruments and this contractual complexity in and of itself is of concern to the Reserve Bank (it is not the case that the Reserve Bank views tax policy on the treatment of contingent debt as inappropriate; the Reserve Bank has no view on tax policy).
11. Other issues raised in the submissions included the timing of any reform, the process that would be used to transition to a new regime, and the approvals process that would apply. This feedback, and the issues raised by it, are not addressed in this paper but will be addressed at a later stage in the Capital Review. Until decisions have been made with respect to measuring and aggregating bank risk, in addition to the capital definition, it seems premature to discuss the transition to a new regime and any approvals process that might apply.
12. By way of a general response to submissions, the Reserve Bank continues to hold the view that contingent debt should not be part of the capital regime and that only common equity and preference shares that are non-redeemable (and have no contingent trigger) should qualify as Tier 1 capital.
13. However, in contrast to the preferred reforms outlined in the consultation paper, and after considering the issues outlined in the submissions, the Reserve Bank accepts, in principle, that redeemable preference shares provide "gone-concern" capital and thus warrant consideration as Tier 2 capital. However, further work is required to develop the specific requirements for Tier 2 capital.
14. The Reserve Bank will also, in principle, consider including a bespoke Tier 1 instrument for banks structured as mutual societies. Such an instrument remains on

the table as an option whose design and properties would need to be explored with the banks concerned.

15. Steps will be taken to give effect to these in-principle decisions over the course of 2018, in a process that will be consultative. As well, public feedback will be sought on the measurement and aggregation of bank risk (the denominator in the capital ratio calculation), and we are targeting the release of a consultation paper on the minimum capital ratio settings in Q2 2018.

The feedback provided by submitters and our response

16. A key theme in many submissions was opposition to the proposal to cease recognising contingent debt as regulatory capital and, instead, for the Reserve Bank to recognise non-contingent instruments (non-redeemable perpetual preference shares as Tier 1 capital and long term subordinated debt as Tier 2 capital). Several arguments were made by submitters when objecting to this proposal and each of these arguments is addressed below (Issues 1 to 6).

Issue 1: Optionality in funding

The submitters' view

17. Our understanding from the feedback we received is that the four large New Zealand banks would not issue to third parties instruments that depart from the international ("Basel III") standards, and in particular, instruments that depart from the Australian application of those standards. At present the Australian regulator, APRA, requires preference shares and debt to include contingent triggers if they are to be accepted as capital (contingent triggers mean the debt or preference share writes off or converts to ordinary shares when a pre-specified event or circumstance arises).
18. The reason the large New Zealand banks may not issue the non-contingent instruments the Reserve Bank proposes to recognise as capital is that the instruments would not be recognised by APRA and thus would not provide qualifying capital for the parent group. At present, the Australian groups have the option of fund-raising through their New Zealand subsidiaries because New Zealand's capital definition largely aligns with the regime administered by APRA.
19. The option of issuing to third parties via their New Zealand subsidiaries is arguably valuable to the Australian groups, as it allows the groups to exploit competitive funding opportunities present in New Zealand.

Our response

20. New Zealand's capital regime must first and foremost reflect the risks facing New Zealand and the unique New Zealand context. While New Zealand seeks harmonisation where appropriate, it is the nature of cross-border banking that parent groups and subsidiaries might be subject to different capital rules. Australia's

interpretation of the Basel III standards is not necessarily appropriate for New Zealand, and in any case, this interpretation is itself being reassessed as part of the Australian capital review.

21. Ceasing to recognise contingent triggers does not prevent New Zealand banks, or their parents, funding themselves with contingent debt or contingent preference shares. If there is indeed investor appetite for these instruments, this will surely remain the case. The only thing that will change under the proposals is that New Zealand banks will not be able to include these instruments as reported regulatory capital.
22. While having the New Zealand subsidiary banks issue to third parties might in theory be cost-effective for the parent group as a whole, this doesn't appear to have been sufficiently attractive very often in the past. Since the present regime took effect in 2013, the majority of the contingent debt issued by the large four banks has been sold to parent entities. Just 22% has been issued to third parties.

Issue 2: Market development

23. Some submitters expressed the view that removing contingent instruments will harm the local financial markets. The argument states that the large New Zealand banks will no longer issue these types of instruments if they are not recognised as capital, despite such instruments having been popular with local investors in the past. Submitters state that such an outcome would harm local investors and hinder the government's financial market development agenda.
24. Another view that was expressed said the exchange traded prices for contingent debt provide valuable signals about the financial health of the issuing bank and, if these instruments were to be no longer issued, less market discipline would be imposed on local banks.

Our response

25. We acknowledge that there are financial stability benefits in having deep and liquid local financial markets. However the large four New Zealand banks have typically opted to not list their capital locally, preferring instead to issue to their parents.
26. Of the NZ\$8.5bn of contingent debt capital that has been issued by the large four banks, only \$1.9bn or 22% has been listed locally. The remainder has been issued to parent entities. None of the \$26bn in equity capital issued by the large New Zealand banks has been listed - it has all been issued to parent entities.
27. The 2016 [NZX Annual Report](#) shows that NZDX has had a noticeable step up in market capitalisation since April 2014 (when the first Basel III-compliant instruments were issued). The \$1.9bn issued by the large four banks, plus approximately \$0.4bn issued by other banks, has contributed to this. To put this in perspective, total new debt listings on NZDX, from all sectors, exceeded \$12bn in the two year period

ending 31 December 2016. Hence, it would appear that NZDX would have grown significantly even without the bank capital issuance that has occurred.

NZX Debt Market Capitalisation



Source: NZX Data

Reproduced from the NZX Annual Report 2016

28. If we were to form the view that New Zealand's capital markets need to be more developed for financial stability reasons, it would seem to follow that we should assess policies that foster the local listing of not only bank debt capital, as submitters have suggested, but also bank ordinary shares. Moreover, it does not obviously follow that under such a scenario contingent debt would be appropriate for the bank capital regime.
29. If, as proposed, New Zealand ceases to recognise contingent debt as regulatory capital, there is nothing preventing Australian banks (or other foreign issuers) from issuing such instruments to New Zealand investors (including listing on NZDX). Australian banks may wish to access the New Zealand retail market for capital, for example, issuing contingent debt instruments in New Zealand as Westpac did in 2016. Thus we are not convinced by the argument that local investors would necessarily face a narrowing of their investment options as a result of the reform proposals.

Issue 3: The cost of capital

30. Two important issues raised by submitters relate to the impact of the proposals on the cost of capital to banks. The first issue relates to whether, and by how much, a change in the capital structure of a bank, prompted by the removal of contingent debt and reforms to preference shares, may impact on the cost of capital, assuming there is no change in foreign investor confidence. The second issue relates to whether a change in the capital regime may impact on foreign investor confidence and thus the returns paid on capital issued by New Zealand banks.

31. These two issues are discussed separately in this paper for clarity, but in practice they are inter-related. For example, foreign investor confidence may in part reflect how banks' capital structures respond to the relative cost incentives present in the new capital definition, and the banks' capital structures may, in turn, reflect banks' views about how foreign investor confidence has changed as a result of the reforms.
32. We do not attempt to model the jointly determined nature of bank capital structures and foreign investor confidence in this paper, nor are we convinced it is necessary. Instead, we adopt a 'worst case', cost-of-capital and investor confidence-related, approach in order to explore how severe the definitional change might be in practice. We assume that banks respond to the proposed reforms by replacing all non-common equity instruments with common equity – and we look to see what such a step might imply. We find, for example, that such a response would be equivalent to increasing the minimum CET1 ratio by 60 basis points each year for five years.
33. A thorough assessment, including a Quantitative Impact Survey (QIS), of the likely cost of capital implications of all the reforms will be done once submissions have been received in response to a third paper in the Capital Review (this paper will address the measurement and aggregation of bank exposures).
34. The funding structure issue is discussed next, and the foreign lender confidence issue, and worst case scenario, are discussed later in the paper.

The submitters' view

35. We received feedback that if only common equity or non-redeemable, non-contingent, perpetual preference shares count as Tier 1 capital, New Zealand banks will be forced to rely on common equity funding - which the banks characterise as relatively more expensive - and the cost of capital to the banks will therefore increase relative to the status quo.¹ The change in the funding structure will, the argument goes, flow through into higher spreads on bank lending that will, in turn, lead to a lower level of investment and thus a lower level of potential economic output.
36. Submitters articulated their concerns in varying ways. For example, one large bank pointed to the higher targeted risk profile required of a bank which holds predominantly CET1 capital (the implicit assumption being that the required return from assets has increased).

Our response

37. Balancing the argument about adverse economic impacts several points can be made. Firstly, the theoretical literature (for example, work related to the theorems of

¹ If, as proposed, the preference shares depart from APRA's requirements, New Zealand banks will not issue them to third parties and may not issue them to parent entities if the instruments are poorly understood by foreign lenders. Even if they do issue the proposed preference shares, given they would be non-redeemable and perpetual, the preference shares would be common equity-like and thus more expensive than the currently-permitted preference shares.

Modigliani and Miller), and empirical studies, suggest that changes to a bank's funding structure, that see greater weight given to common equity (or common equity-like capital) do not typically lead to an increase in the bank's overall cost of capital *of the magnitude implied* by a simple comparison of pre-restructure relative yields applied to the new funding structure. Typically the weighted average cost of capital will increase with the shift towards relatively more equity, but not by as much as the simple comparison of pre-restructure yields (or returns required by investors) would suggest.

38. There are several reasons for this. Increasing common equity at the expense of contingent debt, for example, can be expected to reduce the volatility of the bank's equity price (or value) and thus reduce the risk premium associated with that equity. This would lead to a lower required return from common equity, an outcome that would moderate the increase in the bank's overall funding costs (compared to what otherwise would have occurred).²
39. It is not just the equity risk premium that might benefit from a switch towards equity at the expense of contingent debt. Borrowing costs may decline as well.³ Many studies have found evidence that increases in the ratio of common equity to aggregate risk exposures, for example, leads to a decline in borrowing costs and the decline may be sufficient to prevent the overall cost of capital increasing. An example is a Bank of International Settlements working paper from 2016:
- “In particular, we find that a 1 percentage point increase in the equity-to-total-assets ratio is associated with a reduction of approximately 4 basis points in the overall cost of debt funding (deposits, bonds, interbank borrowing, etc.)....A back of the envelope calculation indicates that the greater retention of net income by the bank as retained earnings would almost pay for itself through lower cost of debt, even if the cost of equity, typically approximated by the Return on Equity, is presumed to be quite high.”⁴
40. Empirical studies reviewed by the Reserve Bank indicate that, on average, the pass through of a change in the funding structure of a bank to the bank's cost of capital is just under 50% - i.e. the change in the cost of capital is, on average, just under half of what would be implied by applying pre-restructure relative yields or required returns to the new funding structure.
41. Secondly, it appears that a modest increase in the cost of capital has only a small impact on lending rates and thus economic activity. Hence, accepting that a shift towards common equity-like capital and away from contingent debt is likely to increase the cost of capital, but not by as much as a simple comparison of pre-restructure

² Bank of England (2015). Measuring the macroeconomic costs and benefits of higher UK bank capital requirements. BoE Financial Stability Paper no. 35 December 2015. Page 9.

³ Bank of England (2015). Measuring the macroeconomic costs and benefits of higher UK bank capital requirements. BoE Financial Stability Paper no. 35 December 2015. Page 21.

⁴ BIS working paper [#558](#) (2016)

relative yields would suggest, the economic impact of a modest increase in the cost of capital seems likely to be relatively minor.

42. Based on a literature review completed by the Reserve Bank in 2016, while an increase in Tier 1 capital has been found to give rise to some increase in the cost of capital, the impact on lending rates has been relatively minor (a one percentage point increase in banks' Tier 1 capital ratios was found to lead to a 5-8 basis point increase in lending rates).
43. APRA's view is that an "instantaneous 100 basis point increase in the CET1 capital ratio of the four major banks would, if entirely passed on through repricing of loans and deposits, require an increase in margins of approximately 10 basis points."⁵
44. In terms of the likely economic impact, a 2015 Bank of England study reported that, for every 1 percentage point increase in a risk-weighted capital ratio, lending rates in the UK would increase by 5-10 basis points and that would lead to permanent annual output losses in the UK of 0.01% to 0.05% of GDP.⁶
45. Thirdly, there are aspects of the overall reforms to the capital definition that directly reduce bank capital costs. Under the proposals banks can issue Tier 2 subordinated debt without contractual write off (unlike the present rules) and this means the instruments will potentially be less expensive to banks than current Tier 2 instruments (contractual write off arguably adds to the cost of debt, as it is disadvantageous for investors). Moreover, it is unlikely such instruments will require a tax haircut, unlike the situation for some Tier 2 instruments at present. Similarly, removing the contractual write off/conversion of preference shares would potentially reduce the costs of issuing these instruments (vis a vis instruments with these features).
46. From the small banks' perspective the proposal to accept non-contingent debt as Tier 2 capital certainly offers the prospect of cheaper capital (relative to the cost of Tier 2 capital to these banks under the present regime). Because they typically have no parent to issue to, and thus cannot utilise relevant clauses within the Income Tax Act, these banks have typically accepted a tax haircut on Tier 2 issues under the current regime.
47. Fourthly, a particular aspect of trans-Tasman tax policy has been a significant factor contributing to the low cost of contingent debt relative to common equity for the big four banks. This tax efficiency opportunity is due to be removed in 2018.⁷ This

⁵ [APRA \(2017\) Information Paper](#): strengthening banking system resilience - establishing unquestionably strong capital ratios. 19 July 2017. Page 36.

⁶ Refer Bank of England (2015). Measuring the macroeconomic costs and benefits of higher UK bank capital requirements. BoE Financial Stability Paper no. 35 December 2015. Page 21

⁷ The New Zealand bank could claim interest paid on debt issued to its Australian parent as a tax deductible expense when submitting a return to IRD, while the parent was not required to include the payment in taxable income in its return to the Australian Tax Office. Hence the group as a whole was able to reduce its taxable income by the interest flowing between subsidiary and parent. In the future, the interest flow, if deductible in New Zealand, will be treated as income in Australia (or, the flow may not be

follows a recent decision by the Australian Tax Office (ATO) and the prospect of a coordinated policy response from the IRD.

48. If, as the large banks imply, under the reform proposals, they will be limited to issuing common equity capital only it is possible to estimate the costs of this, the 'worst case' scenario, from a cost-of-capital perspective. Having the large four banks replace all currently issued capital other than common equity with common equity is equivalent to increasing their CET1 ratio by 300 basis points in total or 60 basis points each year for five years. Based on international estimates, this could be expected to lead to an increase in lending rates of 15 to 24 basis points in total or up to 5 basis points each year for five years.
49. Since 2014 the Australian parent banks have increased, or will soon have increased, their CET1 ratios by, on average, 250 basis points, and this change does not appear to have been economically disruptive. For example, average annual GDP growth during this period exceeded 2% p.a.

Issue 4: Foreign lender confidence

The submitters' view

50. Foreign investor confidence impacts on banks' funding costs. Several submitters expressed the view that international lender confidence would be adversely affected if New Zealand adopted a definition of capital that departs from Basel III. The concern here is that deviating from international standards will make it hard for international lenders to assess New Zealand banks.
51. Foreign investor confidence would be particularly important in the event the Australian parent banks become unwilling to invest more capital, and the New Zealand banks have to seek capital from overseas markets.

Our response

52. It seems unlikely that, if implemented, the proposals would lead to a significant rise in the risk premium and thus the cost of borrowing for New Zealand banks. For example, if, in response to the proposed reforms, the large New Zealand banks restructured their capital increasingly towards common equity, we would expect foreign lenders to have increasing comfort as to the level of creditor risk compared to the present regime.
53. The definition of CET1 is unchanged under the proposals and international lenders appear to place more weight on common equity capital (CET1) than AT1 and total capital, when assessing banks:

- APRA’s recent enquiry into what constitutes “unquestionably strong” capital ratios focused on CET1, for example, stating that the CET1 ratio is “...most likely to engender confidence”.⁸
- Related to the above point, APRA reports that the capital adequacy assessments done by ratings agency S & P, for example focuses on capital that is “roughly equivalent to Tier 1 capital” (not total capital).⁹

54. International ratings agencies have expressed a preference for less complex capital regimes and the capital definition being proposed is less complex than what prevails currently. The value of simplicity in capital regulations was mentioned in S&P’s 2010 submission to the Basel Committee on the capital standard proposals for example.¹⁰

55. In addition to capital, other factors such as bank governance, internal risk processes, concentration risk in the lending book, and so on can be expected to impact on the decisions of foreign investors and thus a bank’s cost of capital.

56. We should also not overlook the possibility that foreign lenders may develop a level of comfort with the unique features of New Zealand’s regime and thus accept the level of reported total capital under the proposed new regime as being a meaningful measure of total capital. We are not proposing novel instruments, after all, but merely propose moving to funding instruments similar to those accepted under the previous Basel regimes (Basel I and II).

57. It is not the case that, in practice, complying with Basel III leads to common instruments issued across different jurisdictions. This is because, while the high level requirements included in the Basel III standards are adopted by compliant regimes, the legal and other regulatory frameworks, and accounting norms, differ meaning that, in practice, the contractual features may differ. These local circumstances are taken into account by ratings agencies and foreign investors.

58. New Zealand has departed from other jurisdictions before, when introducing the statutory management regime or deciding to not introduce the leverage ratio for example, with no obvious loss of investor confidence. Foreign investors, and ratings agencies and others that inform them, have been found in the past to be willing to invest the resources required to understand the particular nuances of the New Zealand regime.

⁸ APRA (2017) Information Paper: strengthening banking system resilience - establishing unquestionably strong capital ratios. 19 July 2017.

⁹ APRA (2017) Information Paper: strengthening banking system resilience - establishing unquestionably strong capital ratios. 19 July 2017.

¹⁰ Refer Standard and Poor’s [submission](#) to the 2009 consultation document published by the Basel Committee (“Standard & Poor’s Response to the Basel Committee’s Proposals On Bank Capital and Liquidity. April 15 2010). Other [submissions](#) to this consultation, from other organisations and S&P, are publicly available as well.

The worst case scenario

59. If we assume that *total capital* is the only factor driving the risk premium applied to New Zealand banks (not Tier 1 capital or CET1 capital), and only CET1 capital held in New Zealand banks is recognised by international lenders, the proposal to adopt a definition of AT1 capital and Tier 2 capital that departs from Basel III would mean that New Zealand banks would have to increase their level of CET1 capital.¹¹ The banks would aim to meet their total capital requirement using internationally-recognised capital – in this case CET1 capital. Only in this way could they maintain international lender confidence and achieve their targeted borrowing at interest rates that would have prevailed had there been no reform.
60. This would also constitute the “worst case scenario” in terms of the cost of capital implications of banks restructuring their funding as a result of the proposals - in this scenario we assume the banks meet their total capital requirement entirely with common equity.
61. If Tier 1 capital, not total capital, is the relevant factor considered by foreign lenders, then the estimates of the new common equity required under the worst case scenario, and related costs, reported below, need to be reduced. This is because the additional CET1 capital would only be required to replace AT1 capital, not Tier 2 capital as well.^{12 13} Similarly, if CET1 capital is the only relevant factor considered by international lenders, no new CET1 capital would be required at all as a result of the proposed reforms being adopted (this is because no change to the definition of CET1 is being proposed).
62. In aggregate, in this worst case scenario, assuming no grandfathering of existing instruments (nor transitional arrangements), the big four banks would immediately have to raise \$8.5bn in new common equity capital (rather than compliant preference shares and subordinated debt that met the new rules), using the proceeds to recall \$8.5bn raised from AT1 and Tier 2 contingent instruments that would be non-compliant under the new regime. \$8.5bn equates to just over 3% of the total risk weighted exposures of the big four banks.
63. In practice, it is unlikely that non-compliant instruments would be de-recognised immediately. Assuming transitional arrangements, for the purpose of this scenario, that required non-recognition of 20% of the face value each year for the first five years, common equity held in the big four banks would have to increase by \$1.7bn each year, for the first five years of the new regime. This equates to 0.6% of aggregate risk weighted exposures. In effect, under this scenario, the big four banks

¹¹ The banks would have to hold sufficient common equity to meet whatever Tier 1 or total capital benchmarks the international lenders apply, since any other capital instruments recognised in the New Zealand regime would not be recognised by international lenders.

¹² AT1 instruments represent 72% of the aggregate face value of all non- common equity instruments issued under Basel III in New Zealand.

¹³ The reform proposals do not extend to the revaluation reserves that currently qualify as Tier 2 capital. Hence, the only Tier 2 capital affected by the reform proposals are the contingent debt instruments issued since 1 January 2013.

would face, over the next five years, the equivalent of an annual increase in the CET1 ratio of 60 basis points.

64. To put the \$1.7bn annual requirement in context, the big four banks paid out \$2.6bn in dividends on ordinary shares in the past financial year. While ceasing to pay dividends would be a significant step, the point is that, should the *worst case* scenario eventuate, the banks could continue to borrow at rates they envisaged before the reforms if the parent banks forfeited some or all of the dividends payable from their New Zealand subsidiaries, for a period of five years. It should be noted, that this would not mean the parent banking groups could not pay dividends to their shareholders during this time.
65. Relevant context is also provided by APRA's recently released assessment of what constitutes "unquestionably strong" capital ratios.¹⁴ APRA reported that, in the case of the four largest Australian banks, achieving "unquestionably strong" status requires an increase in CET1 capital ratios of, on average, 100 basis points above the December 2016 levels. This increase will come on top of increases that have been occurring since the publication of the first Financial System Inquiry report in mid-2014. APRA says that, since mid-2014, "in meeting this new benchmark ...the four major banks will have, on average, increased their CET1 ratios by the equivalent of more than 250 basis points".¹⁵
66. APRA has indicated that banks will be expected to deliver the additional 100 basis points to the CET1 ratio over the next two and a half years, and ideally sooner. The increase in New Zealand bank CET1 ratios, implied by the worst case scenario, is similar in scale, and potentially deliverable over a similar time frame, as the increases that have occurred, or are due to occur, in Australia since mid-2014. The increases that have occurred in Australia do not appear to have been disruptive to the banks or to the wider economy.
67. Also relevant context is the fact that, in the recent past, in contrast to the upward trend in the CET1 ratio of Australian parents and their international peers¹⁶, with one exception, the reported CET1 ratios of the New Zealand big four banks have declined. APRA reported that between June 2014 and December 2016 the CET1 ratios of the four large Australian banks rose by 100 basis points (or 250 basis points using internationally comparable measures).¹⁷ This compares to an average decline of 23 basis points in the reported ratios of New Zealand's big four banks over the same period.¹⁸

¹⁴ APRA (2017) Information Paper: strengthening banking system resilience - establishing unquestionably strong capital ratios. 19 July 2017.

¹⁵ News release announcing the APRA (2017) Information Paper: strengthening banking system resilience - establishing unquestionably strong capital ratios. 19 July 2017.

¹⁶ APRA (2017) Information Paper: strengthening banking system resilience - establishing unquestionably strong capital ratios. 19 July 2017. Page 20

¹⁷ APRA (2017) Information Paper: strengthening banking system resilience - establishing unquestionably strong capital ratios. 19 July 2017. Page 17

¹⁸ The reported change is a simple average of the change to the CET1 ratio of each of the big four banks.

68. The increase in the large Australian banks' CET1 capital ratio is also relevant for another reason. One submitter suggested it would be "prudentially unsound" for an Australian parent bank to fund an increase in their equity investment in their New Zealand subsidiary with anything other than additional equity. While we don't necessarily agree with this view, if we assume it is true, then the increase in the common equity held in the Australian parent banks since 2014 becomes relevant. The parents seem able to acquire larger equity exposures to their New Zealand subsidiaries, of the scale required in the worst case scenario, because their own equity has increased noticeably in recent years.
69. The smaller banks have tended to be less reliant on contingent debt, but they also typically pay smaller dividends relative to their risk weighted assets. Unlike the big four, and with the exception of one bank, for the small banks the additional common equity required under the worst case scenario would exceed the amount most recently paid out as dividends.
70. In summary, at worst under the proposals, the large four banks would have to replace existing capital instruments valued at 0.6% of risk weighted exposures with common equity capital for each of the first five years in order to maintain international lender confidence. There would be no requirement for the parents to issue large volumes of new equity to fund this increase because suspending dividends would typically be sufficient, albeit unwelcome.
71. Against the possibility that banks may have to increase common equity by very modest amounts, in order to maintain international lender confidence, we have the prospect of, under every scenario, significant benefits arising from having more certainty as to the loss-absorbing effectiveness of bank capital and a less complex regulatory regime. The capital regime will be easier to comply with, easier to administer and better able to handle shocks.¹⁹
72. It is important to note that the above analysis is based on the assumption that there are no changes to the minimum required CET1 ratio, or to the calculation of the risk weighted exposures that form the denominator of the CET1 ratio, occurring at the same time as changes are introduced to the capital definition. The combination of these factors is what ultimately impacts on banks. The interaction of these factors will be taken into account when setting the final calibration of capital requirements.

Issue 5: Dependence on parent entities

73. Some submitters questioned the logic of making banks more dependent on their parents given that the Reserve Bank has made clear its intentions to ensure New Zealand subsidiaries of offshore banks are self-reliant. One bank, referring to the proposal to remove contingent debt instruments from the regime, questioned the outcome:

¹⁹ Refer Herring, Richard J. (2016) Less Really Can be More: Why Simplicity and Comparability Should be Regulatory Objectives. Atlantic Economic Journal 44.

“This will significantly increase [the exposure of] these banks and the broader New Zealand economy to the economic risk profile and investment decisions of their parents. In addition, this outcome is contrary to the Reserve Bank’s broader principle of ensuring banks in New Zealand remain self-reliant, including access to external sources of capital and funding particularly in stressed scenarios.”

Our response

74. 78% of the non- common equity capital issued by the large four banks under the current regime has been to parent entities. Thus, despite the current regime facilitating the issuance of such capital to foreign investors by New Zealand banks, the exposure to the “economic risks profile and investment decisions of their parents” has not reduced significantly under Basel III.
75. Without data to the contrary, we continue to rely on anecdotal reports that there has been very limited involvement of international wholesale investors as purchasers of the contingent debt issued by New Zealand banks. –Sale of the instruments to retail investors potentially entails fiscal risks for the New Zealand government. Our view remains that permitting contingent debt in the regime has not noticeably reduced fiscal risks nor mitigated the exposure of the New Zealand banking sector to the Australian banking groups.
76. Under the proposed reforms, should parent funding become unavailable, the large New Zealand banks have the option of raising capital from third parties through the issuance of ordinary shares, non-redeemable perpetual preference shares and long term subordinated debt. These are all long-standing, well understood funding instruments, albeit lacking (in the case of the latter two instruments) the contingent non-viability triggers introduced by Basel III.
77. On balance, it is our view that the proposed regime does not significantly weaken the ability of the New Zealand subsidiaries to raise capital should the parents get into difficulty.
78. There is a sound rationale for requiring New Zealand banks to have processes in place that ensure they have the legal and practical ability to control and execute core functions (as required under the Reserve Bank’s outsourcing policy). Nothing about the proposed reforms alters that rationale, or the operational independence of New Zealand banks. New Zealand banks can be operationally independent of their parents irrespective of how they are funded.

Issue 6: The loss-absorbing effectiveness of contingent debt

The submitters' view

79. The banks submitted that they believe contingent debt provides effective loss-absorbing capital. They pointed to the legal effectiveness of the contract terms and several submitters expressed the view that AT1 contingent debt will trigger in time to be useful on a going-concern basis.
80. One submitter suggested raising the trigger level to address concerns about contingent AT1 instruments.

Our response

81. The main arguments for removing contingent debt from the capital framework remain compelling. The most important of these arguments are as follows:

- *Loss-absorbing effectiveness:*
We have considerable doubt as to the loss-absorbing effectiveness of contingent debt, not necessarily from a legal perspective (unlike contingent preference shares, contingent debt contracts, while untested in New Zealand, appear to in theory be legally effective), but from an economic perspective. The theoretical and empirical literature suggests that the sort of contingent debt that has been required under Basel III, has emerged in the market place, and is likely to emerge, will not be triggered in time to provide going-concern capital. In other words, contingent debt is unlikely to absorb losses in such a way as to prevent bank failure (in this way, contingent debt is inferior to common equity as the latter requires no trigger in order to absorb losses). Since contingent debt is likely to only ever trigger when a bank is non-viable, contingent debt has no regulatory value given, when a bank is non-viable, the issue of accumulated losses will be addressed by bank resolution policies (meaning there is no requirement for contractual loss absorption). Recent cases in Europe are consistent with contingent debt being incapable of providing going-concern capital, even when a 'high' trigger is used (reported CET1 capital falling below 7% of risk weighted assets).
- *Fiscal risks*
As well as being ineffective at absorbing losses on a going-concern basis, and unnecessary on a gone-concern basis (given bank resolution policies), contingent debt may be ineffective at preventing fiscal bailouts. This is because when contingent debt has been sold to retail investors there is evidence that, under some circumstances, governments may be unwilling to impose losses on the holders of these instruments. As well, contingent debt sold to parent entities is not free of fiscal risk where systemically important local banks are owned by a few large entities domiciled in a country that is important politically for New Zealand. In practice, it appears that no material volume of contingent debt has been sold to parties other than these. Where

fiscal risk remains, such instruments entail an element of moral hazard which is disadvantageous for financial sector stability.

- *Regime complexity*
Capital regulations do not exist in a vacuum. Local legal frameworks, accounting standards, economic structure, other regulations and the philosophy, framework and resourcing of bank oversight are all relevant factors that shape capital regulation. An especially important context for New Zealand's bank capital regulations is the regulatory philosophy and framework applied by the Reserve Bank.

82. The Reserve Bank's regulatory philosophy and framework has led to a regulatory regime with a number of unique features relative to other jurisdictions, including a narrower range of regulatory requirements; an emphasis on 'self-discipline' that imparts ultimate responsibility for risk management to directors and senior management, and; relatively high importance attached to the role of 'market discipline' from depositors, policyholders, investors, rating agencies and other market participants in contributing to the soundness of a financial institution. In contrast, other regimes may place considerable emphasis on intensive bank supervision, including on-site inspection. Reflecting this context, we have a preference for avoiding unnecessary complexity in the capital regime (and in other areas of bank regulation).

83. In fact, having a less complex regulatory regime is arguably justified on other grounds as well. Less complex regimes are considered by the Bank of England's Chief Economist Andrew Haldane and others, for example, as being better able to handle shocks.²⁰

84. Contingent debt instruments are inherently more contractually complex than ordinary shares, subordinated debt that is not contingent and (non-contingent) preference shares. This inherent contractual complexity reflects the contingent nature of these instruments. This inherent complexity requires an approach to oversight and enforcement that is, if it is to be effective, at odds with the Reserve Bank's supervisory framework.

²⁰ Andrew Haldane, in a [speech](#) made at the Federal Reserve's economic symposium Jackson Hole, Wyoming 31 August 2012, made the point that complex regulation is not only "costly and cumbersome, but sub-optimal for crisis control".

Issue 7: Preference shares and optional calls

The submitters' view

85. The consultation paper proposed recognising only non-redeemable preference shares as bank capital. Submitters were unanimously of the view that preference shares, accepted as capital, should be redeemable. The banks report there is "no investor appetite" for non-redeemable preference shares. Hence these banks do not support removing the optional call from eligible preference shares.
86. The banks also say the fact that, under the current rules, preference shares cannot be redeemed without Reserve Bank agreement, guarantees the capital qualities of preference shares.
87. Other feedback pointed out that, under Basel II, banks got around the requirement that preference shares be non-redeemable by simple structuring strategies. Another entity (typically related to the bank) was given the right to buy the preference shares from investors. The claim was that such strategies would be used again if redeemable preference shares are not permitted in the regime.

Our response

88. It is worth noting at the outset that preference shares have not featured a great deal in the current regime. Only 15% of non-common equity capital issued by the large four banks has been in the form of preference shares and, in all cases, the preference shares have only been issued to the parent entity. The small banks have tended not to issue preference shares.
89. We have no way of assessing the factual accuracy of the claim that there is no investor demand for non-redeemable preference shares, but it does beg the question whether there would, in fact, be investor demand if an appropriate rate of return was offered.
90. The arguments against allowing redeemable instruments as Tier 1 capital relate to the implications for the permanence of capital. If the shares are redeemable, the capital may only be available to the bank until the first optional call date or, if the shares are not redeemed on the first optional call date, depending on the specific terms and conditions, until any quarter thereafter. In contrast, a well-capitalised bank will have permanent, committed funding.
91. The adverse implications of having uncommitted capital - i.e. capital that can be redeemed - are easy to see. If a bank gets into difficulty, it may be reluctant to compound its deteriorating reputation by failing to redeem its preference shares on the first available call date. Contrast this to ordinary share capital which remains permanently available to the bank, whatever the bank's condition. So rather than being a stabilising force for the bank, redeemable shares can be a source of added pressure and instability at a time the bank is already under stress.

92. This fundamental dynamic is not made any less real by the requirement that Reserve Bank approval be obtained before a bank redeems its preference shares. If the bank is weak and approval is not given, the reputation of the issuing bank still deteriorates when the preference shares are not redeemed. So rather than being a stabilising force for the bank, redeemable shares can be a source of added pressure and instability.
93. The fact that distributions on preference shares are, in legal terms, discretionary, and that debt ranks ahead of preference shares in liquidation, means the distributions payable on preference shares are technically capable of being loss absorbing. Moreover, the fact that failing to pay distributions on preference shares cannot be an event of default means the loss can, in theory, be absorbed by preference shares while the bank remains a going concern. Distributions can be nil - imposing a loss on holders of preference shares - yet the bank can continue without the threat of default from preference share-holders. This outcome points to preference shares, in theory, providing going-concern capital.
94. However practical considerations suggest preference share distributions will typically only provide meaningful loss absorption on a *gone-concern* basis. Unlike ordinary shares, there is no potential upside with preference shares. Hence the sole emphasis of holders of preference shares is on distributions. It will be less damaging to the bank's reputation to pay no dividends on ordinary shares (holders have the upside to look forward to), than cease paying distributions on preference shares. Hence it seems likely that banks have an incentive to pay distributions on preference shares for as long as possible, even in the face of unexpected losses.
95. If the only binding constraint on paying distributions to preference shares is the insolvency test, it seems reasonable to conclude that only when the bank is close to insolvency, will distributions on preference shares not be paid (and hence will preference shares be loss absorbing). This argument points to preference shares being accepted as gone-concern capital only.
96. Despite the presence of a conservation buffer, we believe it is possible that distributions may continue to be paid on preference shares even though the bank may be close to being non-viable.²¹

²¹ The distributions that can be made in aggregate on Tier 1 capital (including AT1 preference shares) are subject to an aggregate cap when the bank's reported common equity ratio ("CET1 ratio") falls below 7%, this being the sum of the minimum required CET1 ratio (4.5%) and a conservation buffer (currently set at 2.5%). A sliding scale applies. For example, if the bank's reported CET1 ratio lies between 4.5% and 5.125%, none of the bank's post-tax earnings (measured as accounting profits) can be distributed. If the measured ratio lies between 5.125% and 5.75%, 20% of post-tax profits can be distributed. If the measured ratio lies between 6.375% and 7%, 60% of bank post-tax profits can be distributed. Our view, based on the literature and examples from overseas, is that a *non-viable* bank may nevertheless have a reported CET1 ratio in excess of 5.125% and thus may continue, in practice, to pay distributions on AT1 instruments.

97. The GFC experience overseas is consistent with this argument. In the initial stages of the GFC distributions were not deferred, as issuers and regulators were worried about adverse signalling effects. Only when the crisis was well advanced did regulators impose losses on holders of hybrid capital instruments that resemble preference shares.^{22 23}
98. The arguments about redeemable preference shares failing to provide committed funds, and acknowledging that preference shares are unlikely to absorb losses on a going-concern basis via distributions, together suggest redeemable perpetual preference shares should not be accepted as Tier 1 capital.
99. Whilst we do not believe redeemable preference shares realistically provide meaningful loss absorbency on a going-concern basis, we acknowledge the instrument is subordinate to depositors and senior creditors and thus valuable in wind up. Given that subordinate debt instruments may have fixed terms and/or optional call dates, and thus have comparable “commitment” issues, it seems reasonable in principle to treat redeemable preference shares (whether perpetual or not) and subordinated long term debt equally within the regime.
100. A relevant question becomes what class of capital *non-redeemable* preference shares should be, given the distributions may not, in practice, be loss absorbing on a going-concern basis. On balance, because the capital is committed and does not contribute to a bank being deemed insolvent, we recommend retaining the proposal outlined in the consultation paper - namely, accepting non-redeemable, non-contingent perpetual preference shares as going-concern (AT1) capital.²⁴

Issue 8: Tier 1 instrument for mutual society banks

The submitters' view

101. Feedback from banks structured as mutual societies was that the proposed regime would, as the current regime does, confine their Tier 1 capital to retained earnings and thus constrain their growth. Rather than remove contingent debt from the regime, the mutual society banks suggested extending the capital definition to include in Tier 1 instruments issued by mutual society banks.

“Rather than restrict capital products, New Zealand would benefit from widening its requirements as have other jurisdictions, such as Canada, where parliament has enacted legislation that enables co-operatives and mutual organisations to issue alternative instruments that qualify as Tier 1 capital”.

²² Forbes magazine, [15 June 2016](#)

²³ IMF (2011). Pazarbasioglu, C., Zhou J., Le Lesle, V. and Moore, M., “Contingent Capital: Economic Rationale and Design Features”. [IMF staff discussion note](#) January 25, 2011. SDN/11/01

²⁴ In order to qualify as AT1 capital, non-redeemable preference shares would have to meet other requirements too, such as having non-cumulative dividends and not being sold to related parties controlled by the issuer. These details will be developed later in the Capital Review process, with public consultation.

Our response

102. In principle, it seems reasonable to recognise as Tier 1 instruments (with appropriate features) issued by banks structured as mutual societies. However it is not clear what, if any, collection of features will deliver an instrument that is both sufficiently capital-like to qualify as Tier 1 capital, and that will appeal to investors. The mutual society instruments that have been accepted overseas are contractually very complex, for example.
103. The instruments used to create membership in a mutual society may not naturally qualify as common equity instruments under Basel III, for example. The Basel III standards require holders of “common” shares to be “entitled to a claim on the residual assets that is proportional with its share of issued capital”. In contrast, the amount of surplus assets each mutual society member can access in the context of wind up may or may not be proportional to the scale of their business with the bank. If there is any suggestion that the amount an investor is entitled to in wind-up is fixed in any way, rather than variable, the instrument begins to resemble debt, a claim against the bank and thus not “capital”.
104. Similarly, the distribution rights conferred by mutual society membership may be a poor fit with Basel III. In order to qualify as common shares (and thus common equity), under Basel III, an instrument must meet the requirement that “the level of distributions is not ...subject to a contractual cap”. Depending on the society’s rules, there may be such a cap.
105. Members’ voting rights are also different to what is envisaged in ordinary shares. Members typically have one vote each, irrespective of the scale of their activity with the bank. In contrast, one vote per share is the norm for ordinary shares.
106. Thus, membership rights in a cooperative society may not fit comfortably with the Basel III conceptualisation of ownership (i.e. “common equity”). That leaves the prospect of mutual society banks raising capital by issuing other instruments - not relying on membership rights - and having these instruments accepted as common equity. This, however, introduces a dilemma related to subordination.
107. If the cooperative society wishes to raise capital that qualifies as common equity, the providers of this capital must be the most subordinate of all - they must rank behind members when it comes to participating in surplus assets in wind up. However, members are inherently the most subordinate of all - with the society’s rules defining “surplus assets” as what is left after amounts contributed by non-members are paid. Reconciling the Basel III most subordinate requirement for a common equity instrument with the inherent subordinate nature of mutual society membership is problematic.
108. Note that under Basel III mutual society banks have been able to issue Tier 2 capital. This has taken the form of subordinated long term debt that ranks above members rights.

Issue 9: Tax considerations

The submitters' view

109. Several submitters expressed concerns about the tax commentary in the consultation paper. These submitters seemed to be of the view that the complexity of the tax treatment of contingent debt, and the tax policy applying to contingent debt, were significant factors leading the Reserve Bank to suggest removing contingent debt from the capital regime. These submitters argued that contingent debt is taxed appropriately, that the tax effects of contingent debt are not difficult to work out, and that where conversion is envisaged no tax haircut is warranted (in fact, we have no view on the first point and disagree on the last two points).²⁵
110. One submitter included a report which showed that, among other things, by imposing tax haircuts when an instrument is issued, the Reserve Bank is an outlier internationally. Some submitters proposed that, if we are concerned about level playing field arguments, we should keep contingent debt instruments in the regime and simply remove the tax haircut provision.
111. More generally, some submitters said that the tax-related aspects of contingent debt featured too prominently in the consultation paper and they strongly disputed that any “regulatory arbitrage” has gone on.

Our response

112. It is not the case that the Reserve Bank has concerns about the tax policy treatment of contingent debt (it is not part of our mandate), nor do we have concerns about the complexity of the tax treatment of contingent debt (although this has made oversight of capital instruments difficult). What we are concerned about is the added and unnecessary complexity of the financial arrangements used to issue capital, with complex features put in place in response to the tax treatment of contingent debt.

²⁵ On the issue of whether the tax outcome of contingent debt absorbing losses is clear and well-established in tax rulings, we disagree with the banks. We disagree because there are circumstances where there is a clear contractual intention to *not* issue new shares, with loss absorption being achieved by write off. This is an outcome clearly envisaged and intended in many contingent debt contracts. Until recently, this intention has not been addressed in the tax rulings provided by banks (since 1 April 2017 this omission is relevant only for debt issues to third parties, not intra-group issues. Prior to then, it was potentially relevant for all contingent debt issues that included conversion terms).

We also disagree with the banks when it comes to the reasonableness of imposing tax haircuts at all. The banks claim that the likelihood tax would be payable by a bank when a contingent debt instrument is triggered is negligible. They say that, at the time an instrument is triggered, it is likely that conversion will occur (i.e. shares will be issued) and, even if not, substantial tax assets would be available to the bank meaning no payment would have to be made to IRD. In contrast, our view is that it is that it is quite possible conversion may *not* occur and for a number of reasons a bank may not be able to utilise any accumulated tax assets (if any exist). The issue of probability was carefully considered and dismissed during the process leading to the introduction of Basel III in New Zealand. However an element of “slippage” emerged in practice with the Reserve Bank accepting narrow tax rulings from banks.

Issue 10: Approvals and transitioning

113. Some submitters included suggestions about transitioning to the new regime, and about the approvals process applying to capital instruments.
114. We believe it is premature to respond to this feedback before decisions have been made in relation to the measurement and aggregation of bank exposures, and the setting of minimum capital ratios. However we will revisit this feedback later in the Review.

Decisions and next steps

After considering the feedback provided in submissions and in meetings, the Reserve Bank has made in-principle decisions with respect to key aspects of the definition of capital. The Reserve Bank has in principle decided to:

- Proceed with the proposals outlined in the consultation paper with respect to contingent debt and contingent preference shares, namely to remove them from the definition of capital;
- Accept non-redeemable, non-contingent, perpetual preference shares as AT1 capital;
- Accept redeemable, non-contingent preference shares and long term subordinated debt as Tier 2 capital; and
- Keep open the option of including in the regime a Tier 1 instrument able to be issued by banks structured as mutual societies.

Further in-principle decisions relating to the definition of capital will be announced in due course.

A work programme aimed at giving effect to these decisions will commence shortly, and detailed proposals will be released for public consultation as soon as possible.

Appendix 1: Background to the capital review

Through conditions of registration the Reserve Bank imposes minimum capital requirements on locally incorporated registered banks.

In March 2017 the Reserve Bank announced it is undertaking a comprehensive review of the capital regulations applying to locally incorporated registered banks (the “Capital Review”). The aim of the Capital Review is to identify the most appropriate capital regulations for New Zealand, taking into account the lessons learned from applying the current regime; the policies and experiences of other countries; and evolving ideas internationally about what constitutes best-practice bank capital regulation. The aim is to conclude the Capital Review in 2018.

Throughout the Capital Review the Reserve Bank will have regard to six high-level principles:

1. Capital must readily absorb losses before losses are imposed on creditors and depositors.
2. Capital requirements should be set in relation to the risk of bank exposures.
3. Where there are multiple methods for determining capital requirements, outcomes should not vary unduly between methods.
4. Capital requirements of New Zealand banks should be conservative relative to those of international peers, reflecting the risks inherent in the New Zealand financial system and the Reserve Bank's regulatory approach.
5. The capital framework should be practical to administer, minimise unnecessary complexity and compliance costs, and take into consideration relationships with foreign-owned banks' home country regulators.
6. The capital framework should be transparent to enable effective market discipline.

In addition, in setting capital requirements the Reserve Bank will continue to recognise the relative costs and benefits of different capital requirements.