Capital Review Paper 2: What should qualify as bank capital? Issues and Options

July 2017
Submission contact details

The Reserve Bank invites submissions on this Issues Paper by 5pm on 8 September 2017. Please note the disclosure on the publication of submissions below.

Address submissions and enquiries to:

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Publication of submissions

All information in submissions will be made public unless you indicate you would like all or part of your submission to remain confidential. Respondents who would like part of their submission to remain confidential should provide both a confidential and public version of their submission. Apart from redactions of the information to be withheld (i.e. blacking out of text) the two versions should be identical. Respondents should ensure that redacted information is not able to be recovered electronically from the document (the redacted version will be published as received).

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The Reserve Bank may also publish an anonymised summary of the responses received in respect of this Issues Paper.
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Summary

Capital regulations need to address not only the minimum amount of capital banks hold, but also the type of instruments that can qualify as capital. The nature of these instruments, rather than the amount of capital, is the subject of this paper.

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.

The Paper is divided into two parts. Part A provides context for decisions about the regulatory definition of capital and Part B outlines the reform proposals.

After outlining the different types of instruments that might constitute bank capital, and focusing in particular on a class of instruments known as “contingent debt”, Part A describes the context for New Zealand’s capital regulations, and describes the New Zealand experience under Basel III.

Part B presents five options for consultation. The options consist of “bundles” of reform measures made across 6 dimensions. The measures are combined in such a way that the options provide a gradual shift from the status quo towards:

- Reduced complexity for the capital regime;
- Greater certainty as to the loss-absorbing quality of regulatory capital;
- A more level playing field; and,
- A reduced risk of regulatory arbitrage.
Complex Regime ↔ Simple Regime

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<th>Option 1: &quot;status quo&quot;</th>
<th>Option 2: &quot;status quo plus&quot;</th>
<th>Option 3: &quot;Limited trigger regime&quot;</th>
<th>Option 4: &quot;No trigger regime&quot;</th>
<th>Option 5: &quot;Equity only regime&quot;</th>
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✓ means the proposed reform in this area is implemented

### Part A The context for reform

#### Overview

1. Bank capital is funding provided to banks by owners and other investors that, while generating income for bank owners and investors, legally need never be returned to them. Capital is raised by banks entering into contracts with owners and other investors (banks are said to “raise capital” or “issue capital instruments”).

2. Bank capital acts as a buffer for bank senior creditors and depositors, providing comfort that they will get paid irrespective of the ebb and flow of bank expenses, revenues and asset values. Capital providers know in advance they may make a loss on their investment if a loss is required to ensure that creditors and depositors get paid. Capital transfers losses from the bank to capital providers and because of this capital is said to be “loss absorbing”.

3. Over time, accumulated losses may be so high as to erode all bank capital, leaving the bank insolvent and with a shortfall of funds to pay creditors. The more capital a bank has, the less likely it is to become insolvent (all else being equal).

4. The Reserve Bank, tasked with responsibility for promoting the maintenance of a sound and efficient financial sector and avoiding systemic financial crises, seeks to ensure that banks hold an appropriate level of capital. An appropriate capital level

¹ Under Options 4 and 5, given the capital instruments permitted under these Options, tax effects are not expected. However, if the capital instrument is part of a wider financial arrangement tax effects may need to be considered.
provides society a degree of protection against the wider costs caused by a bank failure, which is not something individual banks take adequately into account when deciding capital levels. Because the wider costs are borne by society, not by bank owners, private and public incentives diverge. However, there is also a need to consider the costs of requiring banks to hold higher levels of capital than they would privately choose. “Appropriate” in this context must reflect both costs and benefits in setting capital requirements.

5. “Regulatory” bank capital refers to financial instruments that are recognised under the policies of the regulator as bank capital. Other funding provided to banks may have capital-like qualities, but an instrument is only “regulatory capital” if it complies with the definition of capital in the prudential capital regime set by the regulator.²

6. The capital regime needs to address the minimum amount of capital that banks hold, but also the type of instruments that are recognised as regulatory capital. The nature of these instruments, rather than the amount of capital, is the subject of this Consultation Paper. The aim is to identify those instruments that most properly have the qualities required of capital - namely they can be relied upon to be “loss absorbing” and to reduce the risk of bank failure.

7. After a brief outline of the different types of instruments that are candidates for capital, and a description of current New Zealand capital requirements, we focus on a particular class of instruments known as “contingent debt”.

**Types of bank capital**

*Common Equity*

8. Most (but not all) banks around the world take the form of shareholder-owned body corporates, and this is also the situation in New Zealand. Ordinary shares issued by such companies traditionally constitute the primary source of bank capital. The contractual features of ordinary shares are well established, as this form of corporate structure has a long history.

9. Ordinary shares remain on issue until the company is wound up. There is no “expiry” date and holders can only exit their investment by finding someone to sell the share to. Ordinary shares confer certain rights on holders, generally exercisable in proportion to the number of shares held: the right to appoint directors; the right to vote on issues put to shareholders by the Board of Directors; the right to participate when profits are distributed (the right to receive “dividends”); and the right to share (again proportionately) in the proceeds when the company is wound up.

10. The fact that ordinary shares remain on issue indefinitely, and that the value of the holder’s entitlement to either distributed profits or wind-up proceeds is variable rather

² Capital requirements for banks operating under the ‘standardised framework can be found in BS2A and, for banks operating under the ‘internal models, or AIRB framework, in BS2B.
than fixed (it is dependent only on the number of shares held and on the variable value of profits and proceeds), means ordinary shares are loss absorbing. The holder only receives what is left after other expenses and creditors have been paid.

11. The directors of a bank may opt not to distribute all of the profits earned each year by way of dividends to holders of ordinary shares. Non-distributed profits are known as "retained earnings" and accumulated retained earnings are known as "reserves". Reserves may be earmarked for certain future purposes - for example to absorb an anticipated loss - or may simply serve the purpose of providing an extra buffer against losses.

12. Because of the clear loss absorbing nature of ordinary shares, and certainty about the value that is exposed to loss (the face value of the shares on issue), ordinary shares issued by banks are widely considered to be the most reliable type of bank capital.

13. On the other hand, while still considered high quality capital, the value of undistributed earnings and reserves held as buffers against unexpected loss is less certain than ordinary share capital. The value of the buffer can reflect the scale and timing of future bank payments and receipts, as well as past ones, and other matters requiring the exercise of accounting judgement. The fact that valuing retained earnings and reserves requires the exercise of discretion introduces uncertainty into the value of these capital items.

14. Ordinary shares are a conventional, long-established form of capital and are not considered in need of review.

15. Recognising retained earnings and reserves as regulatory capital may warrant some review and clarification in the future. In particular, some types of reserves are not currently recognised and the value of some reserves appears to be heavily dependent on accounting discretion. However these and other related issues are not addressed in this Paper.

Preference Shares

16. “Preference shares" are another instrument that has loss absorbing features. This label is given to a wide range of contractual terms attaching to shares but traditionally preference shares have the following features:

- no expiry date;
- they provide a fixed stream of income to holders rather than a share in distributed earnings (for example income is based on a reference interest rate applied to the face value of the preference share); and,
- holders have priority in insolvency ahead of ordinary shareholders.
Contingent debt capital instruments

17. The 2007/8 global financial crisis (the “GFC”) delivered many lessons to bank regulators around the world. One lesson was that when a bank is faced with significant losses, bank directors cannot be relied upon to issue new ordinary shares – that is, when a bank most needs ordinary share capital, none might be forthcoming.\(^3\)

18. Several reasons have been put forward for this behaviour.\(^4\) Existing shareholders have little reason to invest more in the bank (the key beneficiaries of strengthening the bank at this point will be creditors, not existing shareholders), nor do they have any incentive to dilute their control by finding new shareholders. And depending on what is known about the bank, there may be little external interest in any offer of new shares at a price existing shareholders would accept.

19. A second lesson from the GFC was that bank regulators, while armed with tools to step in to resolve a failing bank and seeking to contain any contagion effects for the banking sector as a whole, acted too late. They were unable to prevent contagion and, when they eventually did act, they committed considerable tax-payer funds to resolve the bank failure.\(^5\)\(^6\)

20. The inability of regulators to keep pace with financial innovation was a contributing factor to the GFC. Innovation increased complexity and reduced transparency and led to risks arising in the financial sector being underestimated by regulators and creditors.

21. These lessons from the GFC led to an interest in debt instruments that might automatically boost shareholder equity when a bank is in stress and the regulatory intervention is delayed. The idea behind such instruments is that they would address the difficulty in raising common equity when a bank is in stress, as well as mitigate any tardiness of regulator intervention. Banks were expected to find these instruments attractive because it allowed them to issue debt instead of common equity in order to achieve a particular level of capital.

22. The idea was that the debt would cease to be owed by the bank when the bank made large losses. This would be achieved by extinguishing or writing off some or all of the debt. Removing the debt would directly reduce bank liabilities, thereby

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increasing common equity. The removal of the debt would be automatically triggered by a defined event. Investors could be compensated for any debt write off by receiving newly issued shares (an outcome known as “conversion”), but wouldn’t have to be for the instrument to be loss-absorbing.

23. Banks were expected to find these loss-absorbing debt instruments attractive because, if accepted as capital, they allowed the bank to achieve a particular level of capital at a lower cost compared to simply issuing more ordinary shares.

24. Debt instruments with loss absorbing properties existed prior to the GFC. These “hybrid” instruments allowed coupon payments to be suspended and maturities to be extended when bank capital fell below regulatory minima, or at the bank’s discretion. Unwillingness on the part of banks and regulators to trigger the suspension of coupons, because of adverse signalling effects, meant these loss absorbing clauses were not activated during the GFC. Moreover, when regulators eventually resolved the failing banks, the hybrid holders interests were wiped out while those of shareholders remained, reversing the ex-ante ranking of investor interests, and providing perverse incentives to bank management.

25. Thus an interest developed in a new “improved” type of hybrid debt instrument - “contingent debt” (refer Box: taxonomy of loss-absorbing debt). The idea was to remove any discretion from either bank or creditors as to whether or not the loss absorbing clauses would be activated once the bank’s financial situation had deteriorated to a particular level. (Of course, it is important to keep in mind that existing shareholders always have the option of preventing the trigger from being activated by injecting new equity themselves.)

26. The triggers would be variables related to the financial health of the bank that were, ideally, fully visible. A bank’s listed share price, or its regulatory capital ratio, is an example of a visible potential trigger. Triggers would be set at levels well clear of bank failure, meaning contingent debt would boost shareholder capital when the bank was reasonably healthy and well-capitalised, rather than insolvent.

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7 The removal of the debt immediately boosts retained earnings. If compensation for the debt write off is paid in the form of new shares, ordinary share capital increases rather than retained earnings.

27. While the initial proposals were couched in terms of contingent debt with conversion terms, in practice, the majority of contingent debt issued globally has been write-off only - the debt will cease to exist but no new ordinary shares will be issued. Various arguments have been forward for the larger role played by write-off only contingent debt. One possible explanation is that some non-bank financial institutions, wholesale investors that might otherwise be considered a large potential market, may be reluctant to acquire contingent debt because of uncertainty over how the purchase would be viewed by their regulators.

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28. In New Zealand, in contrast, the majority of contingent debt, by value, has included conversion. This arguably reflects the fact that parents dominate as purchasers of contingent debt issued by the big four New Zealand banks. The New Zealand experience is discussed in depth later in the Paper.

29. Proponents of contingent debt do not suggest that such instruments should replace ordinary shares or preference shares, or that contingent debt is capable of removing all risk of a public bail out, but they suggest contingent debt should be accepted as bank capital for regulatory purposes.

30. It is not just the potential for an instrument to be loss absorbing that is important. It is also important to establish the degree to which the instrument can realistically contribute to losses. There may be other claims against the bank caused by the write off of contingent debt - for example a new tax liability - effectively reducing the loss absorbing value of the instrument. The interface between contingent debt and income tax policy is an important issue and one that is discussed in detail later in the Paper.

31. Contingent debt instruments were accepted into the Basel III regime on the basis of theoretical arguments. Such instruments did not exist at the time Basel III was first announced and there was no evidence to draw on as to their performance in the context of bank failure.  

32. Despite quite large volumes of contingent debt issuance in some markets since the GFC, there is limited evidence as to the performance of these instruments when banks suffer large losses. However, there have been two recent developments in the European banking sector that provide some useful lessons.

33. Italian banks, including the fourth largest Monte dei Paschi di Siena, recognised a significant volume of problem loans in 2016. The bank was deemed insolvent by the Italian authorities during 2017 and is being recapitalised with public funds. Contingent debt had been issued by Monte dei Paschi di Siena to both wholesale and retail investors, both of whom would, in theory, incur losses (thus reducing the need for a fiscal bailout of senior creditors and depositors). €4.5bn of the contingent debt was converted to ordinary shares and existing shareholders interests were wiped out. However the authorities decided to protect retail investors who held €1.5bn of the bank’s contingent debt, deciding the debt had been mis-sold. Thus, the contingent debt sold to retail investors did not, in fact, absorb bank losses and, instead, was treated as senior debt.

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11 For example, see the Bank of America’s submission to the Basel Committee’s consultation document released 17 December 2009 Submissions.
12 Financial Times (2017) “Bailout for Italy’s Oldest Bank Tests Too-Big-to-Fail Rules”. 4 June 2017
34. The Monte dei Paschi di Siena example shows that contingent debt issued to retail investors may not, in fact, be loss-absorbing - tax payers may end up bailing out investors. The failure of Spanish bank Banco Popular in June 2017 delivers several further lessons. Importantly, it shows that contingent debt designed to absorb losses on a “going concern” basis may, in fact, be incapable of doing so, only triggering once the bank is insolvent. The Banco Popular case also illustrates that aspects of the loss absorbing terms of the contract may be vulnerable to legal challenge.

35. Spain’s Banco Popular has been plagued by bad property loans for nearly a decade. In February 2016 it announced significant losses and, in an attempt to strengthen its capital position, raised further ordinary share capital in May 2016. In early 2017, following the recalculation and restatement of its 2016 accounts, the bank reported a positive net asset value of €10.8bn. However confidence in the bank fell and in early June the bank experienced a liquidity crisis, obtaining emergency liquidity funding from Spain’s Central Bank.

36. On 6th June the European Central Bank notified the Spanish authorities that the bank was failing. The following day, existing shareholders’ interests were reduced to zero by the resolution agency; holders of the bank’s AT1 contingent debt incurred losses equal to the face value of their debt holdings; and holders of the Tier 2 contingent debt became the new shareholders of the bank. The bank was then sold to a rival bank for the nominal value of €1. The bank was sold at this low value because independent experts, brought in by the authorities to value the bank, assessed the net asset value of the bank to be negative €2.0bn (a reversal of more than €12bn compared to the value reported in the recently disclosed audited accounts).

37. While the contingent debt did succeed in absorbing losses for the bank, the AT1 instruments did not trigger in time to recapitalise the bank as a going concern. This was despite some of the AT1 instruments having a common equity trigger set at 7%, which is even higher than the Basel standard of 5.125%. In practice, the only meaningful trigger was the non-viability one.

38. Reports suggest the investors who held the bank’s Tier 2 instruments may legally challenge the value attributed to Banco Popular by the independent expert and the

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16 Financial Times 4 July 2017 “Banco Popular's failure leaves questions unanswered”.
17 Banco Popular had €1.9bn outstanding in contingent instruments (debt and preferred securities). The majority of this, €1.3bn, was AT1 capital with a common equity ratio trigger set at either 7% (€750m) or 5.125% (€600m). The balance was Tier 2 capital with a non-viability trigger.
18 Report on Banco Popular by Spain’s resolution authority, the FROB
19 Report on Banco Popular by Spain’s resolution authority, the FROB
sale of the bank for €1. This is creating uncertainty about the financial position of the purchasing bank.

39. The international literature relating to contingent debt is discussed in more detail later in the Paper.

Capital in entities other than shareholder-owned body corporates

40. While it is typical for a bank to be structured as a shareholder-owned corporate, other structures exist. For example, in New Zealand one registered bank is structured as a mutual society.

41. Banks structured as mutual societies can offer contingent debt to investors, however their offers are limited to write-off only instruments. The banks cannot compensate investors for the debt write-off by issuing them ordinary shares.

42. Other banks, while structured as shareholder-owned corporates, may be prevented from issuing ordinary shares to new investors as a result of their Constitution or other factors. In this case, write-off only debt instruments may be the only option available to them.

43. An important consideration, when designing capital regulations, is the impact of the capital definition on mutual societies.

A focus on contingent debt

Introduction

44. Internationally, there was political and regulatory frustration at the slow response of regulators to the substantial losses emerging in systemically important banks in 2008. Moreover, the unprecedented scale of the subsequent taxpayer-funded bank bailouts led to proposals to reform the global capital standards.

45. Hybrid capital instruments, which had qualified as Tier 2 capital under the pre-Basel III regime, did not, in fact, absorb losses as expected. Hence the reforms included rethinking the type of debt instruments that would qualify as capital. It was agreed that the only debt which would qualify must be contingent, in other words, it must have contractual triggers.

46. The conceptual appeal of contingent debt is that, by being triggered automatically rather than relying on shareholder or regulator discretion, it should result in timely capital injections for struggling banks.

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20 Financial Times 4 July 2017 “Banco Popular's failure leaves questions unanswered”.
47. While prudential regimes in many large economies currently accept contingent debt, the effectiveness of contingent debt remains largely untested. Thus debates as to the merits, or otherwise, of contingent debt are largely couched in theoretical terms. Submissions to the Basel Committee in 2009 illustrate this.

48. Since Basel III came into effect, there have been very few instances of contingent debt having to absorb losses. In the absence of strong empirical evidence to inform the debate, and a lack of consensus as to the theoretical case for and against such instruments, regulators are in the position of having to make nuanced judgements as to the contribution contingent debt might realistically make, given local circumstances. In particular, this requires consideration of the specific terms emerging in the market; the likely added value beyond bank resolution policies; the impact of contingent debt on management incentives; opportunities for regulatory arbitrage; and judgements as to whether the instruments are correctly priced and other matters that impact on the cost of capital for banks.

**Review of the literature**

49. The theoretical literature on contingent debt explores how these instruments might reduce risk (i.e. lower the probability of insolvency) for an individual bank.

50. Two effects have been identified. Firstly, adding contingent debt to a bank's balance sheet directly increases the loss absorbing potential of the bank, relative to issuing pure debt (but not relative to acquiring more common equity). This follows directly from the fact that removing the debt is an essential part of every contingent debt instrument. Secondly, depending on the terms, contingent capital may cause bank management to target a lower level of risk (incentive effects). In other words, in theory, a contingent debt instrument both reduces the probability a bank will incur losses and absorbs losses that do eventuate. Because of both these factors, contingent debt is expected, in theory, to reduce the risk of bank failure.

51. Focusing on the second of these effects, management incentives, it matters whether, when the debt is written off, holders are compensated in the form of newly issued shares (“conversion”). If conversion is on such a scale as to threaten existing shareholders with a loss of control of the bank, it will be optimal for bank

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25 For example, see the Bank of America's submission and the submission from Credit Suisse 2009 Submissions
26 If the risks are under-estimated, the risk of default will be under-priced and this may have implications for the price of risk more generally in the wider economy.
28 This beneficial effect is not present if tax payers bail out holders in the event they incur a loss.
management to target a lower level of risk exposure for a given set of circumstances than would have been the case otherwise.\textsuperscript{30} For example, bank management may be less tolerant of asset volatility,\textsuperscript{31} and more likely to issue new equity to existing shareholders, when capital is low rather than risk triggering conversion.

52. Conversely, to the extent there is any value remaining in a bank when the trigger occurs, write-off only contingent debt is said to incentivise banks to target higher levels of risk than they would have occurred had the instrument not been issued.\textsuperscript{32} \textsuperscript{33} If a debt writes off, but no compensation is paid, debt holders absorb losses ahead of existing shareholders. This protective “buffer” makes it optimal for the bank to target a higher level of risk than it would have in the absence of the contingent debt. The more value there is in the bank at the time the debt writes off, the greater this incentive effect.\textsuperscript{36}

53. The prospect and scale of conversion are not the only features that affect bank incentives. If the trigger is set at a low level – for example, when a bank is, or is close to, insolvent or is in statutory management – contingent debt adds little value compared to simple subordinated debt. This is because both will absorb losses only in the context of a failed bank. Under this logic, where the trigger is low, contingent debt is said to have no equity aspect at all in that it has no prospect of restoring the bank to health. Rather, it is effectively subordinated debt and therefore should not be accepted as equity (i.e. Tier 1) capital.\textsuperscript{37} \textsuperscript{38}

54. Some claim that low triggers introduce the risk of a “debt-induced bank collapse”.\textsuperscript{39} A debt-induced collapse means the bank declares insolvency before conversion occurs.


\textsuperscript{34} Calomiris, C., and Herring, R. (2013) “How to design a contingent convertible debt requirement that helps solve our too-big-to-fail problem”. Journal of Applied Corporate Finance, Volume 25, Issue 2 Spring 2013


\textsuperscript{38} Reflecting this, in Basel III contingent capital that only triggers when the bank is non-viable can only be Tier 2 capital.

55. A related issue is the nature of the trigger. If the trigger is defined in terms of historical financial values it relies on a delayed indicator of the financial strength of the bank. In this case, even if the trigger is set at a high level, in reality the trigger will only activate when the bank is or close to being insolvent. This is a widely accepted weakness of accounting-based triggers such as regulator-defined capital ratios.

56. Many studies have shown that the majority of banks that required government intervention during the GFC reported Tier 1 capital ratios in excess of 6% prior to the onset of the GFC.

57. In theory, there are alternatives to accounting-based triggers. One could use the share price or the market value of bank equity as a trigger. However, there are problems with market triggers as they can be subject to market manipulation, making the instrument itself a source of instability for the bank.

58. As far as we are aware, with the exception of regulator-action non-viability triggers, no contingent debt issued globally since the GFC has been issued with anything other than an accounting-based trigger.

59. While all write off-only debt is expected to incentivise banks to adopt more risk, the incentive effect increases with higher trigger levels (i.e. the higher the trigger level in write-off only instruments, the greater the incentive effect). This is because the buffer provided to shareholder capital by the debt is greater (i.e. there is more shareholder value present in the bank), the higher the level of the trigger.

60. Even in the rare instance where the going-concern trigger is set at 7%, most instruments issued globally only require write-off, not conversion. Despite the high trigger, these instruments do not threaten existing shareholders with a potential loss of control and thus, instead, could have perverse incentive effects.

61. Another potential concern is whether or not contingent debt reduces fiscal risks in practice. If holders are retail “mum and dad” investors, politicians may be unwilling to see losses imposed on them. In that case, the contingent debt may not absorb losses, but will be at least partly “bailed out” by tax payers. The Monte dei Paschi di

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Siena situation is a case in point. There, the state ensured unsophisticated investors in contingent debt did not incur losses.

62. Another potential problem is one shared with the pre-GFC hybrid capital instruments – just as the earlier cessation of coupons could signal bank distress to the market, so too can a contingent debt trigger event. In 2016, the prospect that contingent debt issued by Deutschebank might not pay coupons (an event that precedes any trigger) had exactly this signalling effect, leading to a sell-off in the bank’s shares and leading to a softening of the rules relating to contingent capital coupon payments in the EU.48

63. To the extent regulators are involved in any aspect of the trigger event, the instruments will be difficult to price accurately because to do so requires assigning a probability to regulator action. Even a trigger based on CET1 capital requires the regulator to confirm that the ratio has been breached.

The international experience

64. Despite the acknowledged weakness of low triggers, accounting measures of financial health, and write-off only terms, these features play a predominant role in the instruments issued globally.50 51 52

65. Issuance of contingent debt has been greatest in Europe and the Asia Pacific region. The requirement to account for contingent debt as equity in the United States has led to very little issuance of contingent debt in that market.53

66. It is generally accepted that for banks the primary appeal of contingent debt is an attractive tax treatment relative to equity. Coupons are tax deductible unlike dividends paid on shares.54 55 In the absence of tax advantages, there would appear to be little appetite from banks to issue contingent debt. In the table below, the figures for “North America and Latin America” captures capital issued in Canada and Latin America as little has been issued in the United States.

67. Banks may also find the instruments attractive if they are permitted to issue to retail investors and retail investors do not adequately price the risks involved.

68. It appears that Australia and New Zealand are the dominant countries issuing contingent debt that includes conversion and is accepted as AT1 capital (see shaded cells in the table below). In contrast, the rest of the world seems more likely to issue write off only Tier 2 contingent debt or preference shares.\(^{56}\)

\(^{56}\)The information presented in the table is based on the data set published by Moody’s – Moody’s Coco M Q1 2017 – with the aggregation done by the Reserve Bank.
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<th>Contingent capital market, as at 31 March 2017</th>
<th>Global total</th>
<th>Asia Pacific</th>
<th>Euro area</th>
<th>North and Latin America</th>
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<td>2.0</td>
<td>19.5</td>
<td>42.9</td>
<td>31.6</td>
</tr>
<tr>
<td>- which has write down only, US$bn</td>
<td>139.4</td>
<td>97.2</td>
<td>2.0</td>
<td>2.5</td>
<td>37.6</td>
<td>1.2</td>
</tr>
<tr>
<td>i) and is classed as Tier 1 capital, US$bn</td>
<td>1.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>1.0</td>
<td>0.0</td>
</tr>
<tr>
<td>ii) and is classed as Tier 2 capital, US$bn</td>
<td>138.4</td>
<td>97.2</td>
<td>2.0</td>
<td>2.5</td>
<td>36.6</td>
<td>1.2</td>
</tr>
<tr>
<td>- which includes conversion US$bn</td>
<td>52.9</td>
<td>30.5</td>
<td>0.0</td>
<td>17.0</td>
<td>5.3</td>
<td>30.5</td>
</tr>
<tr>
<td>i) and is classed as Tier 1 capital, US$bn</td>
<td>8.4</td>
<td>7.9</td>
<td>0.0</td>
<td>0.5</td>
<td>0.0</td>
<td>7.9</td>
</tr>
<tr>
<td>ii) and is classed as Tier 2 capital, US$bn</td>
<td>44.4</td>
<td>22.6</td>
<td>0.0</td>
<td>16.5</td>
<td>5.3</td>
<td>22.5</td>
</tr>
<tr>
<td>Contingent preference shares, US$bn</td>
<td>251.5</td>
<td>69.5</td>
<td>69.9</td>
<td>19.6</td>
<td>92.4</td>
<td>23.8</td>
</tr>
<tr>
<td>- which has write down only, US$bn</td>
<td>115.4</td>
<td>21.3</td>
<td>47.5</td>
<td>7.6</td>
<td>39.1</td>
<td>0.0</td>
</tr>
<tr>
<td>- which includes conversion US$bn</td>
<td>136.1</td>
<td>48.3</td>
<td>22.4</td>
<td>12.1</td>
<td>53.3</td>
<td>23.8</td>
</tr>
</tbody>
</table>

Source data: Q1 2017 Moody's CoCo Monitor, data aggregated by the Reserve Bank
The cost of capital

69. Like all funding, capital comes at a cost to the bank. Because holders of subordinated debt rank ahead of shareholders in liquidation, investors in long-term subordinated debt are expected to require a lower return than ordinary shares. Debt is also likely to be less costly to banks than ordinary shares if the interest payable on the debt is a tax deductible expense and the dividends payable on ordinary shares are not.

70. In theory, because contingent debt absorbs losses ahead of other subordinated debt, yields on contingent debt will exceed yields on other subordinated debt of the same maturity issued by the same bank. The higher yield compensates the holder for the greater risk of loss.

71. A 2013 study, published by the BIS, found that, on average, yields for contingent debt exceeded yields for subordinated debt issued by the same bank by 280 basis points. The premium relative to senior unsecured debt was on average 470 basis points. Within the sample, the yield difference varied depending on whether the debt only writes off or whether there is conversion (yields were lower if there was conversion), and whether the trigger was set at a high or low level (yields were lower for low triggers).

72. The effect of changes in capital structure on the cost of capital is much debated in the literature. A simplistic view is that if the return investors require from contingent debt is less than the return required from common equity, a switch to common equity at the expense of contingent debt might increase the overall cost of capital to banks. However, to the extent the risk of both debt and equity is reduced because the bank holds more common equity, the overall cost of capital might not increase materially.

73. Furthermore, changes in the cost of capital may also reflect private costs to banks that are not costs to society as a whole (such as higher tax payments, that are a cost to the bank but a benefit to the government). To the extent changes in the cost of capital are private costs only, they may be of secondary importance in determining the socially optimal mix of different types of capital.

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57 Put another way, the rates of return required by investors vary depending on the nature of their investment - whether it be ordinary shares, senior subordinated debt or contingent capital.
Evidence suggests that, even if the cost of capital did rise as a result of a shift towards more equity, the wider economic implications of banks facing a higher cost of capital are relatively minor.\(^60\)

These and other matters related to the cost of capital will be discussed in a subsequent paper to be released as part of the Capital Review.

<table>
<thead>
<tr>
<th>Type of funding</th>
<th>Indicative rate of return % per annum</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common equity</td>
<td>13.7(^\wedge)</td>
</tr>
<tr>
<td>Contingent debt capital</td>
<td>4.9(*)</td>
</tr>
<tr>
<td>Senior, unsecured debt</td>
<td>3.3(*)</td>
</tr>
</tbody>
</table>

\(^\wedge\) as indicated by the reported return on equity earned by the Australian parents of NZ banks.\(^61\) \(^62\)

* RBNZ analysis based on four contingent debt instruments issued by the big four New Zealand banks and traded on NZDX. Analysis based on data from 6 June 2017.

### Defining the group for capital measurement

An important issue for capital regulation in general is identifying the scope of activities and entities that must be reflected in the capital requirement imposed on a registered bank (i.e. defining the “banking group”). The group definition matters not just for the calculation and measurement of capital, but the definition of risk-adjusted exposures too (this “denominator” aspect of the capital regulations will be the subject of a separate Capital Review Paper).

The options for defining the “banking group” range from considering only the activities directly undertaken by the bank itself to considering the activities undertaken by the bank, entities it owns and/or controls, and entities that own and/or control the bank.

The definition of the banking group matters because instruments can only be loss absorbing if they are issued to parties that are economically independent from the bank. For example, if the bank issues contingent debt to an entity that it controls and extracts value from (a “subsidiary”), the entity will be weakened if the debt is written-

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\(^61\) Economist (2017) “Special Report - A decade after the crisis, how are the world’s banks doing? Economist Print Edition, 6 May 2017

off. Thus while the write off of the contingent debt directly boosts retained earnings for the bank, it simultaneously weakens bank retained earnings through its adverse effect on the bank’s subsidiary.

79. A similar argument can be made for a bank issuing ordinary shares to a related entity - bank losses will erode the value of the ordinary shares and thus the loss is transferred to the related entity and that, in turn, could have adverse repercussions for the bank.

80. The group definition matters for more than defining the instruments that qualify as capital. It matters for identifying aggregate risk exposures as well. The group definition will thus be further considered in future papers released as part of the Capital Review.

The Reserve Bank’s regulatory philosophy

81. An important context for New Zealand’s bank capital regulations is the regulatory philosophy applied by the Reserve Bank. This 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; the relative 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.

82. This emphasis on self and market discipline means that the framework is designed to minimise, where possible, perverse incentives (or ‘moral hazard’) that can sometimes be associated with a more intrusive approach to regulation and supervision. One implication of this approach is that New Zealand has a “non-zero failure” regime, where bank regulations are based on the expectation that individual banks will not be bailed out by tax payers.

83. Underpinning this focus on mitigating moral hazard is the absence of a deposit insurance scheme. Instead, there is a comprehensive suite of policies designed to ensure a distressed bank remains “open for business” - thus minimising contagion - while regulator-appointed managers resolve the bank’s future.

84. In New Zealand, banks are not subject to on-site inspections or other resource-intensive regulator assessments. Rather, emphasis is placed on the interplay between self-discipline, market discipline and regulatory requirements. There is no ambiguity as to who is ultimately responsible for a bank’s performance (the bank’s Board of Directors) and the regulations are supported by wide enforcement powers.

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In addition to, and in part because of, the above, the Reserve Bank seeks to be deliberately conservative in its approach to capital matters. This means that, in a situation of uncertainty about the optimal level and composition of bank capital, the Reserve Bank will err on the side of caution. The Reserve Bank has adopted a principle of being conservative in capital matters in part to counterbalance the relatively light-handed approach it takes in other supervisory areas.

The Basel Committee and global standards

International norms as to what constitutes minimum acceptable standards in the context of capital regulation are an important factor when designing capital regulations.

The 1980s Latin American debt crisis prompted the Bank for International Settlements (“BIS”) to develop global standards for bank capital regulation. This was done via the Basel Committee on Banking Supervision hosted by the BIS. The first standards were issued in 1988 (known as “Basel I). Development of a second set of standards (Basel II) began in the aftermath of the 1997 Asian financial crisis to address weaknesses in the existing framework and better deal with banks' evolving business models. The 2008/9 global financial crisis (the “GFC”), prompted the development of the third set of standards (Basel III), and these were issued in 2011.

While not a member of the Basel Committee, New Zealand is heavily dependent on international credit markets. It is therefore important that foreign lenders have confidence in the New Zealand bank regulation regime. Adopting international banking regulation standards, where they are appropriate for the New Zealand context, is often cited as an important factor in maintaining international confidence in New Zealand’s banking sector. At the broadest level this is true – it reflects a commonly understood conceptual framework – but it is worth dwelling briefly on what ‘adopting the standards’ actually means, as it is not a binary proposition that demands full and rigid compliance on the one hand, or non-adoption on the other.

The Basel standards do not constitute an all-or-nothing package; rather they provide a menu of options of varying complexity. It is therefore possible to be consistent with the Basel standards while not adopting all of the detailed standards because they are inappropriate in the local context.

There are important nuances to understand about what it means to ‘adopt’ international standards. Like all developed (and many developing countries) New Zealand has adopted the international standards over many years. But when it comes to comparing capital outcomes across countries that have ‘adopted the standards’, it quickly becomes apparent that one is not comparing like with like. This makes simple comparisons very misleading, and this situation arises for a variety of reasons. Local accounting standards, tax treatment, laws, prudential definitions and so on can all affect outcomes, even if the standards are applied in exactly the same
way. This is well understood by regulators, market participants, investors, rating agencies and so on.

91. Moreover, the standards typically allow “national discretion”, which can usually be applied to make the standards less conservative if the local regulator sees it as appropriate to do so. As the standards are “minimum” standards, not a target, applying more conservative requirements than the minimum standards is also reasonably commonplace.

92. Finally, adopting the standards does not mean that all components are necessarily appropriate for a given country. Countries can and do pick and choose to a degree, within the international standards. Perhaps the most prevalent example might be that not all countries offer internal model frameworks for calculating the denominator component of the capital ratio, and not all components of the international standards for the numerator have been applied, here or overseas.

93. As noted above, applying more conservative requirements than the international minima should deliver a lower risk banking sector for New Zealand. Where there are bespoke local requirements, it is important that the regime has a robust and clearly articulated rationale so that the confidence of foreign lenders in the regime is maintained.

94. Since the Basel Committee first announced global standards in 1988, the regulations in New Zealand have been primarily based on the Basel Committee standards, but with modifications reflecting New Zealand circumstances and the goal of having a relatively conservative regime.

95. Contingent debt, as distinct from hybrid instruments more generally, entered the New Zealand bank capital regime in 2013, as a result of New Zealand adopting most aspects of Basel III.

**The trans-Tasman context**

96. An important context for New Zealand’s bank capital regulations is the dominance of four large banks (the “big four”). Each of the big four is a locally incorporated subsidiary of an Australian-incorporated banking parent. Between them the “big four” account for almost 90% of aggregate bank assets in New Zealand.64

97. The big four banks are subject to Australian and New Zealand bank capital regulations - capital issued by the big four potentially qualifies as capital both for the New Zealand bank and for the Australian parent. This is important for a couple of reasons:

64 This calculation excludes the assets of New Zealand branches of foreign banks.
The Australian regulator’s requirements of the Australian parents can flow down into terms and conditions in the instruments issued by New Zealand banks and these may be problematic in the New Zealand context. An example would be the requirement that, in order to be recognised as capital for the Australian parent, contingent debt issued by the New Zealand subsidiary must, if it offers conversion, convert into listed ordinary shares (the New Zealand subsidiaries do not list their ordinary shares).

Banks prefer requirements to be aligned, as this reduces their costs of compliance with both regimes.

The current regime in New Zealand

98. Capital regulations applying to locally-incorporated registered banks are outlined in the Handbook of Banking Supervision, in Chapter BS2B for the big four banks, and in BS2A for banks other than the big four.

99. BS2B and BS2A continue to place emphasis upon ordinary shares as regulatory capital but, relative to former regimes operating in New Zealand, gives a larger role to contingent capital.

100. The regulations identify three different classes of bank capital. “Total capital” is the sum of all three capital types.

- “Common equity” refers to ordinary shares and qualifying accumulated reserves (reserves that are set aside for a known or expected future expense are typically excluded when calculating common equity). Shares are considered “ordinary” only if they have certain features, including voting rights.

- “Additional Tier 1” (“AT1”) consists of preference shares that write off and may convert to ordinary shares when triggered, and contingent subordinated debt that has no maturity and writes off (and may convert to ordinary shares) when the ratio of common equity to risk weighted exposures falls to 5.125%, or if the bank is deemed non-viable, whichever occurs first. “Non-viable” means a statutory manager has been appointed or the Reserve Bank has announced that the bank is non-viable. Coupon payments are made at the discretion of the issuer and, if unpaid, cannot accumulate as a debt to be paid in the future.

- “Tier 2” refers to contingent subordinated debt that has a set maturity (that cannot be less than 5 years) and writes off (and may convert to ordinary shares) when the bank is deemed non-viable. Coupon payments are made at the discretion of the issuer but can accumulate if unpaid.

101. Various regulatory capital minimums apply. For example, excluding additional capital buffers, the ratio of common equity to risk weighted exposures cannot be less than
4.5% (if the ratio is less than 7% restrictions apply to the distributions that can be paid to capital investors). Total Tier 1 must be at least 6% of risk weighted exposures (8.5% if distributions are to be unaffected) and total capital must be at least 8% of risk weighted exposures (10.5% if distributions are to be unaffected).

102. An important aspect of the regime is recognition that tax liabilities may arise for banks when contingent debt becomes loss absorbing. BS2B and BS2A require banks to accurately estimate any potential tax liabilities associated with instruments they report as capital and to deduct any potential tax liabilities from the face value when they report the value of a capital instrument (this deduction is called the regulatory “tax haircut”).

103. Given the company tax rate in New Zealand is currently 28%, the regulatory “tax haircut” is a significant consideration for issuing banks. It appears the requirement to recognise any potential tax liabilities may not always have been fully complied with in practice. This issue is discussed in more detail later in the Paper.

104. The Handbook of Banking Supervision also outlines the process for recognising AT1 and Tier 2 capital instruments (this is covered in chapter BS16). Prior to reporting an instrument as AT1 or Tier 2 capital, a bank must submit an application to the Reserve Bank for a non-objection notice. This notice is not confirmation that the instrument complies with BS2B or BS2A, but confirmation that after considering the documents supplied by the bank, and the bank’s self-assessment report, the Reserve Bank has not detected any reason to object to the instrument being reported as regulatory capital. Bank directors are responsible for ensuring compliance of the instrument with BS2B or BS2A, and an AT1 or Tier 2 capital instrument must not be reported as capital if it does not comply.

Capital structure, issuance and pricing in New Zealand

Capital structure

105. Common equity is the primary source of capital for New Zealand banks, constituting nearly 80% of total regulatory capital. Contingent debt makes up just over 80% of the remaining 20% of capital (i.e. of capital other than common equity).

106. Depending on the bank, the primary source of common equity may be ordinary shares or it may be accumulated retained earnings and reserves. On average, paid up ordinary shares constitute two thirds of the common equity of the big four banks. However this average obscures considerable variability between the big four banks - the ratio ranges from 37% to 99%.
Note: the chart above includes instruments that no longer qualify as capital and currently being phased out of regulatory capital calculations.

Issuance

107. Common equity has made the largest contribution to overall bank capital since the current regime was introduced in 2013, increasing by more than $6.0bn. The growth in common equity has been primarily due to increasing retained earnings and reserves, with paid up ordinary share capital contributing just under $2.0bn. Over the same period AT1 capital increased by $3.4bn, primarily because of the issuance of contingent debt, and Tier 2 capital increased by $0.6bn.

108. Currently some preference shares and contingent debt issued under the pre-Basel III regime continue to be included in reported capital. These instruments are subject to gradual de-recognition or phase out. Because of this, overall growth in reported Tier 2 capital since 2013 has been less than the volume of new Tier 2 capital issues.

109. Since 1 January 2013, AT1 contingent debt issuance has totalled $3.5 billion and Tier 2 issuance $2.5 billion. The four large banks have accounted for $5.7 billion or 95% of the contingent debt issuance by value. The table below reports, for the big four banks, the values of the non-common equity issues by type of instrument, category of capital, and nature of the offer. For example, the value of AT1 capital issued by the big four banks to parent entities or branches of the parent was $2.8 billion while none of the preference shares issued have been offered to retail investors. Note that the scale of the coloured bars is not proportional to the reported values.
Issues of capital instruments other than common equity since 1 January 2013

<table>
<thead>
<tr>
<th>Big Four Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total issuance $7.0 billion</td>
</tr>
<tr>
<td>Contingent debt $5.7 billion</td>
</tr>
<tr>
<td>AT1 $3.3 billion</td>
</tr>
<tr>
<td>Tier 2 $2.4 billion</td>
</tr>
<tr>
<td>AT1 $1.3 billion</td>
</tr>
<tr>
<td>To parent $2.8 bn</td>
</tr>
<tr>
<td>Retail $0.5 billion</td>
</tr>
<tr>
<td>To parent $1.0 billion</td>
</tr>
<tr>
<td>Retail $1.4 billion</td>
</tr>
<tr>
<td>to parent $1.3 billion</td>
</tr>
<tr>
<td>Conversion $5.7 billion</td>
</tr>
<tr>
<td>Conversion $1.3 billion</td>
</tr>
</tbody>
</table>

**Pricing**

110. Our understanding is that the market norm is to use the benchmark 5 year swap rate to estimate the margin paid on contingent debt issues currently accepted as AT1 or Tier 2 capital.65 This is because the first permitted optional call date for these instruments is five years after the issue date. The margin is the relevant basis for comparing the prices of different instruments. The effect of the business cycle and other risk factors like market risk premia will be reflected in the 5 year swap rate with bank-specific or instrument-specific risks reflected in the margins.

111. The big four banks are all rated AA- by Standard and Poors which suggests the market perceives the four banks as representing a similar credit risk. The essential terms of AT1 debt (and Tier 2) debt reflect the regulatory requirements. Hence one would expect the average margin set by the big four on their AT1 debt (or Tier 2 debt) to be a fair guide to the return required by investors of AT1 (or Tier 2) contingent debt issued by any of the big four banks.

112. We find the average margin set in the initial terms for AT1 debt issued by the big four is 4.50% or 450 basis points (bps) while the average for Tier 2 debt is 210 bps.66 Both these margins are lower than an average issue margin of 470 bps set in overseas markets as reported by the BIS.67

113. The average margins reported above for the big four banks obscure considerable variability in the margins set for similar types of debt. The margins range from 144 bps to 250 bps for Tier 2 issues and 350 bps to 626 bps for AT1 issues. In the case of AT1 the low margin relates to a retail issue while the high margin relates to debt issued to a parent.

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65 This rate relates to senior unsecured traded bank debt and is a widely used market benchmark.
66 This is based on a simple average based on the number of contracts issued by the big four banks, and is not a value-weighted average.
114. Four of the 8 contingent debt instruments issues by the big four are listed on the New Zealand debt exchange (NZDX). This provides additional pricing information in that trading yields relative to senior unsecured debt issued by the bank show the margin due to the fact the contingent debt is subordinate and has triggers. Only one of the listed instruments qualifies as AT1 capital. In all cases the terms include conversion to shares and a non-viability trigger.

115. Analysis reveals a margin of, on average, 133 bps above the senior unsecured fixed rate curve for the Tier 2 instruments and a margin of 251bps for the AT1 instrument (all data as at 6 June 2017)  

Dual governing jurisdictions arise from conversion

116. In practice conversion of the contingent debt issued by the big four banks would see investors receiving shares in the Australian parents, not the New Zealand banks. The conversion clauses are governed by Australian law. In contrast, other aspects of the contingent debt contract are covered by New Zealand law. Thus conversion in practice has introduced two governing jurisdictions applying to a single contract, adding complexity and arguably uncertainty to the regime.

The New Zealand experience under Basel III

General matters

Capital has increased more rapidly than risk-adjusted exposures

117. While it is not possible to know the outcome had Basel III been implemented differently in New Zealand, under BS2B and BS2A, overall, New Zealand banks have opted to increase their capital levels more rapidly than their risk adjusted exposures. Thus, on this measure, the overall quantity of capital has arguably increased under Basel III. Whether capital has increased as much as in other countries is a matter that will be further assessed in a subsequent paper issued as part of the Capital Review.

118. It should also be noted that since 1 January 2013, common equity has grown more rapidly than any other capital class. Thus, the current regime has also coincided with, and has arguably contributed to, an increase in the quality of bank capital.

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68 In New Zealand the market effectively prices contingent capital as a callable bond, with the assumption that the bond is called on the first available call date, rather than a fixed term bond. The first call date is typically 5 years from the date of issue. The market pricing method has been used in the analysis.

69 Whether or not the reported growth in risk adjusted exposures is a fair reflection of actual growth is an issue that will be dealt with in a subsequent Paper, the “Denominator Paper, due to be released as part of the Capital Review.
Emerging concerns about preference shares

119. In the current regime, in order to qualify as capital, preference shares must “write off” when there is a non-viability event. This may be accompanied by conversion - i.e. the issuance of new ordinary shares by way of compensation. At present there is some uncertainty about the means to give legal effect to write off (best thought of as mandatory redemption for no consideration) of a preference share. Under the Companies Act a preference share can only be redeemed on a date specified in the terms - redemption cannot be caused by a trigger event, with the date unknown in advance, as is currently required by BS2B and BS2A.

120. Preference shares have been accepted as capital under the current regime but the wording used in the contracts to establish these shares has not yet been tested in the courts.

121. A second concern is that, as defined in the current regime, preference shares are able to be redeemed by the bank after five years. This arguably weakens the capital qualities of preference shares accepted as regulatory capital compared to the pre-Basel III regime.  

The current basis for defining the banking group may not be adequate for policy purposes

122. The historical reliance of the regime on the definition of a banking group for financial reporting purposes, when determining the banking group for capital regulatory purposes, may need to be reviewed in light of the continued evolution of accounting standards. In some cases it appears that the group consolidated for financial reporting purposes may not include entities the bank derives economic value from and controls.

123. A case in point would be Special Purpose Vehicles ("SPVs") that have the sole purpose of raising contingent capital for the bank. It would appear the current accounting standards may permit such an entity to consolidate for financial reporting purposes with an entity other than the bank, yet on economic grounds the entity is an essential part of the bank’s activities and a key risk exposure. Having the SPV outside the banking group might lead to an instrument being accepted as capital that does not effectively transfer potential losses away from the bank. The bank may be perceived by investors to be closely associated with the SPV, for example, so that the bank’s reputation is dependent on the SPV’s debts being paid.

124. If the SPV is outside the banking group, the instrument issued by the bank to the SPV will be potentially eligible as capital even though the instrument may not effectively transfer potential losses away from the bank (due to the close economic relationship between the two entities, the bank may find it necessary to support investors in the SPV). If the SPV is part of the banking group, currently it is the

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70 Under the regime applying until October 2010, to qualify as Tier 1 capital preference shares had to be “not redeemable as defined in Section 68 of the Companies Act 1993”. 

Ref #7083939 v1.6
instrument issued by the SPV to third parties that must comply with BS2B or BS2A to be counted as capital.\textsuperscript{71}

125. More generally, the big four banks are each 100\% owned by Australian corporate entities and are therefore part of an Australian-based banking group. The Australian banking groups are, in turn, owned by a diverse pool of shareholders.

126. The New Zealand capital regime does not include the Australian parent entities in the New Zealand banking group for capital regulatory purposes. A capital instrument issued by a bank to its parent is thus recognised as capital. However, given the instrument transfers a potential loss from the bank to its parent, it is possible that transferring the loss to the parent will contribute to distress in the parent that in turn harms the New Zealand bank (i.e. the loss transfer may be ineffective).

127. In New Zealand it is possible for entities to form a consolidated group for income tax purposes that differs from the group formed for financial reporting purposes. The tax group may include commercial entities that operate in non-bank sectors. Given all members of the tax group are joint and severally liable for each other’s tax, membership of a tax group has impacts for the risk exposures of the bank. To date this type of risk has not been reflected in the capital requirements of banks.

128. One of the recommendations from the IMF’s 2016 assessment of the New Zealand financial sector (conducted under the Financial Sector Assessment Programme) was that the definition of the banking group subject to supervision be more fully developed.\textsuperscript{72}

Legal uncertainty

129. As well as the Australian parents (including their branches operating in New Zealand) playing a large role as purchasers of the contingent debt and preference shares issued by the “big four” New Zealand banks, parents have been included in the retail instruments as the issuers of new shares when compensation is required for debt write off. This appears to be due to APRA’s requirements that, in order for the conversion component of contingent debt issued by a subsidiary to be recognised as capital for the Australian-domiciled parent, it must convert into ordinary shares in a listed entity (the New Zealand big four banks have no listed shares).\textsuperscript{73} This introduces complexity and some legal uncertainty.

\textsuperscript{71} BS2B and BS2A have specific provisions for instruments issued by SPVs to third parties. These provisions include, for example, a requirement that the instrument issued by the bank to the SPV (not the capital instrument) has terms that match the instrument issued by the SPV to the third party.

\textsuperscript{72} IMF (2017) FSAP Report recommendation under Principle 12.

\textsuperscript{73} APRA Banking (prudential standard) determination No. 1 of 2014, Prudential Standard APS 111 Capital Adequacy: Measurement of Capital, Attachment E, Section 8.
Drafting weaknesses in BS2B and BS2A

130. There are areas in the current regulations where the policy intent is clear but the drafting of the detailed requirements would benefit from greater clarity. The SPV provisions are an example.

131. The current policy intent is that when a bank raises capital through an arrangement using a SPV that has the sole purpose of raising capital for a bank, the instrument issued by the SPV is the eligible capital instrument and this instrument must comply with the capital requirements of BS2B and BS2A. However, the current wording in BS2B and BS2A permits a bank, under some circumstances, to report as capital an instrument issued to the SPV, meaning the most economically meaningful instrument - the instrument issued by the SPV that transfers a bank loss to third parties - may not have sufficiently capital-like qualities.  

The experience with contingent debt

All types of banks have found value in issuing contingent debt

132. As well as the big four, several small banks including one structured as a mutual society and others unable to issue ordinary shares have been able to expand their capital base using contingent debt. Banks unable to issue ordinary shares have issued debt that is triggered to write off only. In the absence of this option, growth for these banks would arguably have been constrained.

133. Despite all New Zealand banks being able to issue a version of contingent debt that qualifies as capital, it appears that, under the current capital definition, some types of banks may have access to a broader – and cheaper – range of capital opportunities than others. The current definition is thus in part responsible for a somewhat uneven playing field.

134. Banks structured as mutual societies are unable to issue ordinary shares and thus cannot offer contingent debt that includes conversion. Such banks are therefore arguably limited to relatively more expensive capital options compared to other banks. Write-off only debt is potentially less popular with retail investors than convertible debt, and thus, despite representing essentially similar risks, may face a higher required rate of return. The absence of conversion means any contingent debt will absorb losses only by writing off, which may mean a tax haircut is required, which raises the effective cost of capital to the issuing bank.

Retail investors have acquired contingent debt

135. Retail investors have purchased contingent debt and thus, presumably, value this addition to their investment options. However, the contribution of contingent debt to overall household financial investment is small. Between March 2013 and In March

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74 This instrument is not subject to regulatory oversight unless the SPV is part of the banking group.
2017 total household financial assets increased by $150 billion. In contrast, $2.0bn of contingent debt was offered to retail investors.  

136. Including contingent debt in the regime creates the potential for banks to attract new types of capital providers. Managed funds and other wholesale investors, for example, might value the opportunity to diversify beyond senior bank debt. It is not clear to what degree banks have benefitted in this way but anecdotally at least one small bank successfully issued contingent debt to an offshore wholesale investor. In contrast, contingent debt issues by the big four banks have tended to be to parent entities with the remainder, around one third, offered to retail investors.

137. In contrast to the experience overseas, there appears to be limited uptake by wholesale investors of contingent debt issued by the big four banks. If this is true, it suggests that the terms being offered on instruments issued outside the parent group are not sufficiently attractive for sophisticated investors.

138. In total, approximately one third by value ($1.8bn) of the contingent debt issued by the big four has been offered to retail investors. A further $280m has been offered by small banks to retail investors. All of the retail offers (except $32m) include conversion to shares.

139. Despite questionable value at the point of conversion (as it seems most likely to be triggered when a bank is non-viable) anecdotal evidence suggests retail investors ascribe value to the conversion feature. It is unclear how accurately this feature is priced.

140. Moreover, the lesson from Monte dei Paschi di Siena is that the involvement of unsophisticated investors may increase the risk of a government bailout when a bank fails and contingent debt holders incur losses.

Some banks have been able to issue contingent debt tax efficiently

141. The inclusion of contingent debt in Tier 1 capital has enabled some banks to acquire relatively low cost capital. This is because contingent debt can have a lower tax impost than common equity. Debt servicing costs are a tax deductible expense to the issuing bank whereas dividends are not. If the bank is able to report the full value of the instrument as capital, it captures the full benefit of the favourable tax treatment of debt servicing costs.

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75 Some of the contingent debt offered to retail investors may have been subsequently bought on NZDX by wholesale investors.
76 Reserve Bank (2017). Key Household Financial Statistics Table C21. 30 May 2017
77 Some of the retail offers may have been purchased by wholesale investors or the underwriting entities.
78 One small bank has had success issuing contingent debt to wholesale investors.
79 If, instead, the debt incurs a tax haircut, the effective cost of the debt increases by 28%. An equity instrument would not incur a tax haircut.
A reliance on parent entities as purchasers of AT1 contingent debt

142. The main consequence of allowing non-common equity Tier 1 instruments as capital in the New Zealand context appears to have been changing the nature of parent funding, rather than creating a new class of capital providers. Almost 90% of the AT1 capital issued in New Zealand by the big four banks has been issued to parent entities (or a branch of the parent entity).

143. This apparent substitution of AT1 contingent debt issued to parent entities for common equity, and in particular, ordinary share capital, is of concern for a number of reasons:

- Ordinary share capital unambiguously absorbs losses on a going concern basis whereas contingent debt with a 5.125% CET1 trigger seems in practice likely to absorb losses only once the bank has become non-viable.
- The fiscal risk attached to common equity is arguably zero, unlike contingent debt.
- There is no uncertainty about the availability and value of ordinary share capital, unlike contingent debt which may be subject to legal challenge. The Banco Popular experience shows, for example, that debt holders may choose to challenge the conversion price used to determine the number of ordinary shares issued to debt holders.

144. One of the key planks in the theoretical case for accepting contingent debt as bank capital is the beneficial impact on bank risk taking. Where contingent debt is issued to parent entities, rather than third parties, this beneficial impact is less than it could be.\(^80\)

Economic welfare losses due to regulatory arbitrage opportunities in the context of contingent debt

145. Including conversion terms in subordinated debt gives the instrument an equity-like appearance. This potentially creates a tension between capital regulations and tax regulations. The ability to deduct interest expenses, when calculating taxable income, gives issuers an incentive to structure the instrument as debt, while the possibility of claiming the debt as capital creates an incentive to emphasise the instrument’s equity-like characteristics.

146. This tension potentially creates an opportunity for regulatory arbitrage. Banks may see value in using a contract feature for tax purposes but the feature delivers lesser quality capital (a debt that does not legally write off, for example), or the bank may seek to introduce a feature that pushes the boundary of the tax regulations but

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increases the likelihood of the instrument qualifying as capital (conversion into shares when the bank is non-viable, for example). The end result may be instruments that are less than ideal from the perspective of both the capital regulations and the tax regime.

147. The purpose of economic regulation is to correct for market inefficiencies and thus improve aggregate welfare. However, regulatory arbitrage can undermine the effectiveness of regulation, thus reducing aggregate welfare. More generally, resources used by banks trying to exploit arbitrage opportunities, and by the Reserve Bank and IRD trying to preserve their regimes, are resources that are not available to the rest of the economy.

Regulatory arbitrage opportunities may contribute to an uneven playing field

148. Not all banks may be able to take advantage of opportunities for regulatory arbitrage related to tax. Hence these opportunities may be a source of an artificial competitive advantage in the sector, benefitting only some banks.

Possible under-estimation of the tax effects of contingent debt

149. The Reserve Bank is concerned that the potential for regulatory arbitrage between tax legislation and the capital regulations may have led to some non-compliance with respect to the tax-related provisions of BS2B and BS2A.

150. There is a current requirement to acknowledge any potential tax implications arising from contingent debt and to reflect these potential "tax offsets" in the reported value of capital. Banks are required to obtain a binding ruling from IRD (or voluntarily take a tax "haircut"). A binding ruling can provide comfort that tax is fully accounted for under prudential requirements, but this will only be the case if the ruling that is sought is appropriately specified so as to capture all relevant circumstances. Whether that has always been the case in practice is not clear to us.

151. In several of the contracts used to establish contingent debt in New Zealand, and especially contingent debt issued by the big four, there are explicit conditions that give rise to no shares being issued when the contingent debt is triggered. For such contracts, tax considerations may be relevant because, in the specified circumstances, no consideration is paid to investors in exchange for writing off their debt claim.

152. Moreover, even for instruments without explicit contract terms of this nature, potential tax liabilities may arise. The context in which contingent debt absorbs losses is important for estimating potential tax effects. There are practical matters that may lead to inadequate compensation being paid to a holder when a debt writes off, even if compensation is specified. For example, if the appointment of a statutory manager is the trigger event, new shares may not be issued even if the instrument requires it.
153. Similarly if, at the time of the trigger event, the share price of the bank (or some other measure of share value) is for all intents and purposes zero, issuing shares may not be possible if agreement cannot be reached on the quantum of new shares to be issued (where the price is zero, the number of shares needed to compensate for the forfeited debt is indeterminate). Thus, even when terms envisage conversion, predictable contextual realities may mean new shares will not be issued and a potential tax liability might arise for the issuing bank.

**Difficulties have been experienced with the regulatory oversight of contingent debt**

154. When Basel III capital requirements were first introduced in New Zealand, the Reserve Bank came across a number of areas of potential non-compliance with the new requirements. To a degree, when a new regime comes into force, ‘teething problems’ can be expected until knowledge and experience develops. That said, capital adequacy is the cornerstone of any prudential regime, and as such, our tolerance for teething problems is very limited. The Reserve Bank was concerned to the point that it reluctantly introduced a ‘non-objection process’. The relevant section of the Handbook (BS16) states the objective: “The non-objection requirement is designed to provide comfort to the Reserve Bank that on the basis of the information it receives from the bank, there is no reason to object to the instrument being recognised as regulatory capital in accordance with the Reserve Bank’s capital adequacy framework.”

155. Despite the non-objection process, and industry having several years’ experience with such instruments since their introduction in 2013, the complex nature of these instruments means that problems can and do arise. In May 2017 the Reserve Bank confirmed that two instruments issued by one bank and reported as capital were not compliant with BS2A despite having received non-objection notices.

156. Overseeing instrument compliance is a resource-intensive process for any regulator. The Reserve Bank regulatory model is one that emphasises self-discipline and market discipline. Convertible instruments have proved to be an uncomfortable fit with our regulatory philosophy and approach, in a variety of ways:

- Concerns about potential non-compliance led to a non-objection process that undermines self-discipline, and arguably market discipline as well.
- They are complex and opaque, and require a disproportionate call on prudential resources.

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81 It is worth stressing that we are referring to potential, rather than actual, non-compliance. Boards were being asked to sign off as compliant instruments that would not have been compliant had they been issued.
Moreover the risk of error is high where contingent debt is concerned. This is because debt instruments with equity-like characteristics are inherently complex; the trans-Tasman context brings the prospect of two jurisdictions applying to a single instrument; and because where there are possibilities of regulatory arbitrage, banks have an incentive to introduce innovative features that increase complexity and require a policy response that can stretch the resources of the regulator.

Any risk of oversight error is problematic in this area because, while it is possible to withdraw capital status for an instrument once an oversight error is detected, the correction is potentially disruptive for markets generally.

Part B Reform Proposals

Overview

Part A of the Paper discussed the types of instruments that could potentially contribute capital to a bank and the theoretical and practical issues relevant to the use of contingent debt. Important contextual information has been described and there has been a discussion of the practical experience under Basel III - both in New Zealand and overseas. While Basel III has been viewed as broadly successful in New Zealand, issues have emerged in relation to contingent debt, preference shares, regulatory oversight and other matters.

In Part B the Reserve Bank outlines various reform options and indicates its preferred reform direction. In some cases, specific reform proposals are outlined and in others, only a general direction of reform is signalled in advance of feedback from submitters. (In such areas, further consultations on points of detail, including exposure drafts of policy where sensible, will follow.)

In general terms, the Reserve Bank’s preference is for a capital regime that is easy for banks to comply with and simple to administer. This reflects the regulatory philosophy outlined in Part A. Only if there are clear regulatory benefits from having a complex definition of capital, will complexity be acceptable.

The Reserve Bank’s view can be summarised in broad terms as identifying little regulatory value in “going concern” triggers and conversion and acknowledging that these aspects of the current regime introduce considerable complexity. The “going concern” trigger appears, in effect, to be no different to a non-viability trigger. Moreover, non-viability triggers appear to have little value given subordinated debt will be captured in the resolution of a non-viable bank.

Given the expectation that AT1 contingent debt will only absorb losses in the context of a non-viable bank entering resolution, the argument that conversion provides valuable incentive benefits during the life of the instrument falls away. Thus, as a general direction, the Reserve Bank prefers to move towards a regime that accepts
subordinated debt without triggers as capital, but not contingent debt, and, moreover, accepts such debt as lower tier regulatory capital, not Tier 1.

164. Other indirect considerations, including the fiscal risk that may accompany capital issues to retail investors, the potential for risk mispricing, and the economic and welfare costs of regulatory arbitrage, support arguments for a simpler capital regime, which omits contingent debt, being the most suitable for New Zealand.

165. In addition to considering the relative benefits and costs of complexity in the context of bank capital regulations, it is important to acknowledge a wider regulatory context. The government regulates financial market conduct and administers an income tax regime. Accepting contingent debt as bank capital arguably introduces complexity into these other regulatory regimes. This may be acceptable from a welfare perspective if the added complexity is required for a sound and efficient financial sector – but a convincing case to this effect has proved elusive to date.

166. The purpose of Part B of the paper is to outline and explain various reform proposals including the Reserve Bank’s preferred reform option, Option 4. In particular, the purpose of Part B is to:

- identify those aspects of the definition of capital where there is a case for reform;
- identify what could be done to improve the definition of capital in those areas where improvement is needed;
- combine the proposed reforms in varying ways to create distinct reform bundles (“Options 1 to 5” where Option 1 is the status quo);
- identify the Reserve Bank’s preferred option; and
- seek submissions on Options 1 to 5 and other matters addressed in the paper.

167. Options 1 to 5 are designed in such a way that movement from Option 1 to Option 5 delivers:

- greater certainty as to the loss-absorbing quality of capital;
- reduced uncertainty about loss-absorbing value of capital given tax considerations;
- A regime that is easier to comply with and easier to oversee;
- reduced fiscal risk;
- a reduced potential for the mispricing of risk.
168. An important difference between Options 1 to 5 is the status of the key contractual terms that give rise to contingent debt, namely: the inclusion of triggers, contractual write-off and contractual conversion to shares.

169. The Reserve Bank’s preferred option is Option 4 which defines Tier 1 capital as common equity plus appropriately configured preference shares while appropriately configured long-term subordinated debt, without triggers, would qualify as Tier 2 capital.

170. Subordinated debt with triggers, write off and/or conversion would not qualify as regulatory capital under Option 4 and regulatory recognition of existing instruments with these features would be gradually phased out (i.e. with “grandfathering”).

The dimensions of reform

171. A capital definition is made up of parts - required contract terms, definitions of key words and phrases, references to other legislation and so on. The Reserve Bank’s preliminary view is that, based on information currently available, not all of the components of the current capital definition require reform. In particular, at this time, requirements related to common equity do not appear to be in need of reform.\textsuperscript{83}

172. The table below lists the core components of any capital definition and identifies the components that the Reserve Bank is currently proposing to reform. The remaining components will continue to be closely monitored and may be assessed, at a subsequent date, as part of the Capital Review.

173. There are clearly conditions identified in the theoretical literature where preference shares and contingent debt have loss absorbing qualities. However in practice, in New Zealand (and arguably elsewhere) the potential of these alternatives to common equity could be argued to have been undermined by the legally uncertain requirements and difficulties inherent in applying theoretical constructs in real-world settings (in the case of contingent debt).

174. Part A of the Paper outlined the theoretical case for and against contingent debt and noted key features of the instruments delivered in practice by the market here and overseas. Part A also described a number of issues that have emerged in New Zealand in relation to capital instruments under Basel III.

175. From the discussion in Part A it is possible to identify several important aspects of the current capital definition that appear to warrant reform (the 6 “dimensions of reform”). The issues arising in each area are summarised below (for more details see \textsuperscript{83}Aspects of the capital definition such as the accounting treatment of various balance sheet equity items will be monitored closely and if warranted will be reviewed in the future. Accounting treatment receives detailed coverage in APRA’s standard APS 111, for example, and several submissions to the Basel Committee in 2009 addressed accounting matters. This suggests accounting aspects might be an important, but currently overlooked, part of the capital definition in New Zealand.)
Part A). The changes that could be made to address these issues are also outlined, alongside specific reform proposals in some cases (in others a general direction of reform is indicated). The reform proposals are variously bundled to form reform Options 1 to 5.

176. In addition, the Reserve Bank is of the view that certain changes should be made in relation to transparency and, in a more general sense, to aspects of the current drafting of the regulations. These proposed changes are included in each of the Options 1 to 5.
Core components in the definition of capital.
(red/italicised items are subject to review in this Paper).

**Definition of group**
- Legal ownership
- Accounting consolidation
- Special purpose entities
- Tax groups
- Managed funds, insurance and other related business
- Other related entities

Accepted terms for ordinary shares:
- Voting rights (if any)
- Maturity (if any)
- Ranked access to dividends (if any)
- Participation in liquidation proceeds

Accepted terms for preference shares:
- Voting rights (if any)
- Maturity (if any)
- Ranked access to dividends (if any)
- Participation in liquidation proceeds
- Triggers
- Mandatory redemption
- Conversion to ordinary shares

Treatment of retained earnings and reserves:
- Accounting treatment for balance sheet equity items
- Status of different types of reserves
- Deductions from shareholder equity (e.g. the value of goodwill)

Accepted terms for subordinated debt:
- Presence of a “going concern” trigger (and the definition of the trigger)
- Presence of a non-viability trigger (and the definition of the trigger)
- Write off provisions
- Conversion (i.e. compensation for write off)
- Maturity
- Seniority, security and guarantees

Measurement and aggregation:
- Deductions
- Capital held in subsidiaries
- Capital issued by special purpose entities
- Tax offsets
Dimension 1 - Preference shares

The issues

177. Preference shares are potentially valuable capital but, as currently allowed in the capital framework, raise a number of issues. For example, the means to give effect to write off (best thought of as mandatory redemption for no consideration and currently required under BS2B and BS2A) may be legally uncertain in that the terms used to give effect to write off are untested in the courts.

178. Moreover, we question the regulatory value in requiring mandatory redemption of preference shares. Preference shares are subordinated to all debt instruments and thus have equity qualities and are accounted for as such when banks report their financial position. Hence “writing off” a preference share has no loss-absorbing effect on a bank’s balance sheet.

179. The only purpose mandatory write-off appears to serve is to enable preference shares to be replaced by new ordinary shares, and this threat of conversion theoretically incentivises existing shareholders to take fewer risks. However, in reality, the triggers used have been low (set at the floor established in the regulations) and so conversion can realistically be expected only once the bank has become non-viable. As such, the incentive benefits from including triggers in a preference share seem likely to be negligible.

180. As defined in the current regime, preference shares are able to be redeemed by the bank after five years and periodically thereafter. This arguably weakens the capital qualities of this class of capital compared to the pre-Basel III regime. Under the earlier regime preference shares recognised as capital were “perpetual” which meant they were not redeemable as defined in section 68 of the Companies Act 1993 and were not repayable or redeemable at the option of the holder. 84

181. Distributions paid on preference shares may be fixed, relative to a benchmark interest rate. If, in addition, preference shares have a fixed-term retail investors may mistakenly view these instruments as deposit-like and thus under-estimate the risks of such investments. This would appear to have the potential to increase fiscal risk.

182. The term “preference share” is used for a wide range of contractual terms. In order to ensure the instrument has suitable loss-absorbing qualities, it would seem desirable for the requirements to clearly articulate what is considered to be a “preference share” that has loss-absorbing properties.

183. Under the current regime, regulatory requirements with respect to preference shares are not particularly detailed. Detailed requirements such as contractual terms and so on, which that reduce ambiguity, can be helpful for industry.

84 BS2A which was in effect from 15 October 2010 until 31 December 2012
184. Given the legally untested nature of mandatory redemption for no consideration, and, in our view, the absence of a strong theoretical case for including “write off” contractual terms, we see benefits in removing the requirement for preference shares to “write off”.

Reform proposal relating to preference shares

- Include a clear definition of “preference share” in the regulations and have specific regulatory requirements for preference shares.
- Recognise only non-contingent preference shares as capital (i.e. do not accept as capital preference shares that are triggered to write off and/or covert to ordinary shares).
- Recognise only non-redeemable preference shares as capital.
- Detailed proposals for the definition of, and the contractual requirements of, preference shares will be developed and released for consultation, during a later stage of the Capital Review.

Dimension 2 - “Going concern” triggers (currently included in AT1 capital)

The issues

185. Based on what has emerged in the debt market here and overseas, and the findings in the international literature, the potential for contingent debt to absorb losses on a going-concern basis (i.e. when a bank remains viable) appears limited. The recent experience of Spanish bank Banco Popular highlights this concern. Despite having issued going-concern contingent instruments (some with 7% triggers) none of the instruments became loss absorbing prior to the bank being deemed non-viable.

186. In other words there appears to be little regulatory value from including instruments triggered other than by non-viability events. However, currently debt instruments with going-concern triggers can be accepted as high quality (i.e. Tier 1) capital.

187. The position that going-concern triggers add little regulatory value reflects certain realities. For example, theoretical and practical considerations mean that going-concern triggers are defined by accounting-based, and thus backward looking, measures of financial strength, not forward-looking market-based measures.

188. Given the dominance of parent entities as purchasers of Tier 1 contingent debt issued by the big four banks, contingent debt appears to have been used as a substitute for ordinary shares. The loss absorbing quality of ordinary shares is far greater than that provided by contingent debt, thus the quality of capital in the regime has arguably been harmed by as a result of accepting contingent debt as Tier 1 capital.
189. One possible response is to change the type of going-concern trigger that is required of contingent instruments, moving away from accounting-based measures. However, the theoretical case for market-based triggers remains contentious and, as yet, such triggers have been elusive globally. In any event, the prospect of market-based triggers being introduced in New Zealand in the near term seems limited.

190. Rather than requiring market-based triggers, the regime could retain the current type of going-concern trigger, but specify a higher trigger level for subordinated debt qualifying as Tier 1 capital. The Swiss Authorities, for example, have required globally systemic Swiss banks to issue some of their contingent debt with a trigger defined as common equity less than 7% of risk weighted exposures.

191. However, high triggers do not appear to have been popular among issuers. For example, of the 529 contingent debt instruments rated by Moody’s, only 19 have “high” triggers, and none have a trigger defined above the Swiss minimum of 7%. Globally this sort of trigger is a novelty and there appears to be a limited bank appetite to issue this sort of instrument.\(^85\)

192. Further, raising the trigger level does not eliminate the fundamental concern with accounting-based going-concern triggers - namely, the trigger itself remains accounting-based and thus a poor indicator of bank strength. Again, this is a lesson from Banco Popular’s failure.

193. A second possible response is to exclude contingent debt with going-concern triggers from the definition of capital. In practice, this would mean defining Tier 1 capital as consisting only of shareholder capital (whether common equity or preference shares). Going-concern triggers could still be included in debt issued by the banks, but such debt would not have regulatory capital status. This reform would align the regulatory classification of contingent debt with the reality that it is likely only to be loss absorbing when the bank has become non-viable, i.e. a gone-concern.

Reform proposal relating to going-concern triggers

- Limit Tier 1 capital to common equity and appropriately configured preference shares.
- Detailed reform proposals in relation to preference shares will be developed and released for consultation at a later stage of the Capital Review.

\(^85\) Of the 19 “high trigger” contingent debt instruments rated by Moody’s, 12 do not include conversion, just write off. This is consistent with banks having an aversion to issuing instruments which genuinely threaten existing shareholders with a loss of control.
Dimension 3 - Non-viability triggers (currently included in AT1 and Tier 2 capital).

The issues

194. Including a non-viability trigger in a subordinated debt instrument seems unnecessary given the automatic inclusion of such instruments in bank resolution. The impact of bank non-viability on such instruments (i.e. the transfer of loss to holders of subordinated debt) is well signalled without a specific non-viability trigger.

195. The prevailing international definition of “non-viability event”, which is mirrored in New Zealand, involves action by the bank regulator. This likelihood of regulator action is not something that can be accurately priced, and thus the presence of this contract term introduces uncertainty into debt pricing, potentially adding to the cost.

196. The current acceptance of non-viability triggers means investors in contingent debt potentially incur losses ahead of shareholders. To the extent there is any value remaining in the bank at the point of non-viability, investors in contingent debt, in effect, will rank behind shareholders. This may have perverse incentive effects compared to simple (non-contingent) subordinated debt being subject to resolution.

197. On the other hand, there may be some value in requiring write-off triggered by a non-viability event to be specified in a subordinated debt contract accepted as capital. This might improve the efficiency of the debt market and/or reduce the fiscal risk associated with bank failure - for example, if there is a lack of awareness of the resolution regime or an expectation that, in the absence of contract terms specifying write-off, a creditor may be bailed out by the government.

198. Once the limits of contingent debt are recognised, the importance of other aspects of the regulatory framework, including bank resolution and disclosure, become clearer. Ensuring these aspects of the regulatory framework are well-designed and implemented reduces the need for non-viability triggers.

Reform proposal relating to non-viability triggers

- Only accept non-contingent subordinated debt as Tier 2 capital.

- Detailed proposals relating to the specific contractual requirements of Tier 2 instruments would be developed, and released for consultation, during a later stage of the Capital Review.

Dimension 4 - Conversion

The issues

199. The inclusion of conversion introduces complexity for no obvious regulatory gain. For example, including conversion in contingent debt issued to Australian parents introduces two governing jurisdictions over the contracts, which adds not only complexity but potentially legal uncertainty.
200. Depending on the nature of the issue, and the parties involved, conversion can also introduce uncertainty about the loss-absorbing value of the instrument (because of the potential for a tax liability to arise). While the tax implications of debt write-off are relatively straightforward, the inclusion of conversion in debt instruments adds complexity and room for regulatory arbitrage. Opportunities for regulatory arbitrage are arguably detrimental for economic welfare and potentially create an uneven playing field.

201. While conversion to shares brings no added loss absorbing benefits *per se* (the removal of debt being both necessary and sufficient to achieve loss absorption), in theory the inclusion of conversion incentivises management to adopt a lower risk appetite during the life of the contingent debt instrument. However, conversion terms do not offer such a benefit if the contingent debt is likely to only ever be loss-absorbing when a bank has already become non-viable.\(^86\)

202. While the creation of new shareholders once a bank has been deemed non-viable might appear to be of potential benefit in the context of bank resolution, in New Zealand a statutory manager has the powers to establish a new shareholder base (i.e. there is no need for subordinated debt to create new shareholders via contract).

*Reform proposal relating to conversion*

- If no contingent debt is accepted in the regime the issue of the conversion of debt into ordinary shares does not arise.

- If subordinated debt with a non-viability trigger is accepted as Tier 2 capital in the regime (and it is the Reserve Bank’s preference that only non-contingent debt is accepted) it must, at most, be triggered to write off, not convert into ordinary shares. This would achieve the goal of delivering Tier 2 capital with the desired capital qualities while avoiding unnecessary regime complexity.

- Detailed proposals relating to the specific contractual requirements of Tier 2 instruments will be developed, and released for consultation, during a later stage of the Capital Review.

**Dimension 5 - Recognition of tax effects**

*The issue*

203. It is important that the capital values reported by banks are accurate. If a capital instrument is likely to impose a tax liability on the issuing bank, at the time the instrument absorbs losses, the value available to absorb losses will be reduced. Hence, any potential IRD claims on the bank of this nature should be taken into account when reporting capital values.

\(^{86}\) Under the present regime, in order to be accepted as capital preference shares also must also write off or convert to ordinary shares. The rationale is again the perceived incentive benefits
204. The current regime requires banks to accurately estimate and deduct any potential tax liabilities arising at the point a capital instrument absorbs bank losses. If banks wish to report the full value of a contingent debt instrument, currently they must acquire a binding tax ruling from the IRD.

205. Some banks have raised matters of interpretation of the requirements, arguing that a less conservative interpretation than the stated policy intent is possible. Perhaps for this reason, some banks may have requested less than comprehensive rulings, and have thus potentially overlooked relevant tax effects.

206. An alternative to requiring comprehensive rulings would be to impose a mandatory regulatory tax haircut on all debt accepted as capital. This would be a conservative response to the potential for tax liabilities to arise but may lead to instances of an inappropriate tax haircut for some instruments.

Reform proposal relating to the recognition of tax effects

- The policy intent, that potential tax is accounted for, should be put beyond doubt.
- Not accepting debt with conversion terms would simplify the issue of potential tax liabilities. This is because the only tax consequences that would have to be considered relate to debt write off.
- Clarify the current tax ruling requirement, namely require a comprehensive tax ruling for any instrument that is eligible as capital and is either contingent debt or part of a wider arrangement that includes a contingent debt instrument.

Dimension 6 - Defining the banking group

The issue

207. The group definition is important for determining what instruments qualify as regulatory capital. However it is also important for identifying risk weighted exposures. The discussion of the group definition in this Paper reflects capital definition considerations and further reforms to the group definition, prompted by the need to aggregate risk weighted exposures, may be proposed in subsequent consultation papers issued as part of the Review.

208. At present accounting standards are relied upon to define the banking group for regulatory capital purposes. Accounting standards require judgement to be applied, making the group definition subject to interpretation. Accounts are prepared for the purpose of providing meaningful information for shareholders, which has a different purpose to prudential regulation. Hence there is the potential for the group defined for accounting purposes to be inappropriate for capital regulatory purposes.
209. One area of potential concern relates to special purpose vehicles (SPVs). When capital is raised by a SPV for a bank it makes sense from a regulatory perspective to have the SPV inside the banking group yet this may not be required by accounting standards.

210. How capital in a subsidiary is to be recognised is a complex issue and the current requirements are difficult to interpret and apply.

211. More generally, the big four banks are each 100% owned by Australian corporate entities and are therefore part of an Australian-based banking group. The Australian banking groups are, in turn, owned by a diverse pool of shareholders.

212. The New Zealand capital regime does not include the Australian parent entities in the New Zealand banking group for capital regulatory purposes. A capital instrument issued by a bank to its parent is thus recognised as capital. However, given the instrument transfers a potential loss from the bank to its parent, it is possible that transferring the loss to the parent will cause distress in the parent that in turn harms the New Zealand bank (i.e. the loss transfer may be ineffective).

213. In New Zealand it is possible for entities to form a consolidated group for income tax purposes that differs from the group formed for financial reporting purposes. The tax group may include commercial entities that operate in non-bank sectors. Given all members of the tax group are joint and severally liable for each other’s tax, membership of a tax group has impacts for the risk exposures of the bank. To date this type of risk has not been reflected in the capital requirements of banks.

214. One of the recommendations from the IMF’s recent FSAP review was to review the basis for defining the banking group for regulatory capital purposes.

Reform proposal relating to the definition of the group

- Augment the current accounting group definition so that, if an SPV is included in the structure used to raise capital for the bank, the SPV is included in the banking group for regulatory capital purposes.

- Detailed proposals relating to the group definition will be developed, and released for consultation, during a later stage of the Capital Review. These will reflect issues raised in the context of aggregating risk exposures as well as issues arising in the context of the definition of capital.

Enhanced Transparency

215. A key aspect of the regulatory philosophy adopted by the Reserve Bank relates to transparency, and more use could be made of this tool. Public scrutiny has the potential to increase regulatory compliance. Currently only the contracts underpinning capital instruments offered publicly are open to public scrutiny.
216. If relevant documents need to establish capital instruments - including issues to parents - were held in a public depository the scrutiny of the terms would be enhanced. At a minimum enhanced transparency would need to apply to the Deeds, the banks' compliance self-assessment, a legal opinion as to the legal effectiveness of the terms and Directors' Attestations. All four documents are currently required as part of the non-objection process (BS16). This enhanced transparency would usefully complement oversight by the Reserve Bank.

217. It is proposed that Deeds, bank self-assessments of the instrument's compliance with BS2A or BS2B and any supporting legal opinions are to be made available online to the general public (as is the case under the current covered bond policy) irrespective of what other reforms are implemented.

218. Detailed proposals relating to transparency will be developed, and released for consultation, during a later stage of the Capital Review.

219. More generally, the options outlined in the paper address the issue of complexity (whereas the suite of options available to increase scrutiny will be addressed as part of the post-FSAP evaluation of the Reserve Bank's supervisory model).

Drafting reforms

220. In addition to the above reforms, changes will be made to ensure the policy intent (which transpires as a result of the Capital Review) will be accurately and comprehensively reflected in the text of BS2B (and BS2A). This may mean changes to the drafting of BS2B (and BS2A) will occur in addition to those needed to give effect to the proposed reforms indicated above.

221. Detailed drafting changes to BS2B and BS2A will be subject to public consultation at a later date.

A changing tax landscape

222. Tax considerations appear likely to feature prominently as a part of the decision by some banks to issue contingent debt. The proposals covered in this paper would exclude contingent debt from Tier 1 capital and, limit Tier 2 capital to subordinated debt that has, at most, only write off triggered by a non-viability event.

223. While a reasonably significant change to the current regime, it should be noted that such instruments have not had a very long history in the New Zealand framework, and, to varying degrees, are valued by banks through a tax lens, which will change from time to time.

224. An example of the potential for the tax environment to change in such a way that it may affect the incentives for contingent debt issuance is the subject of a discussion.
Ref #7083939

paper published by the IRD in September 2016. The IRD and the Australian Tax Office are considering aligned reforms that will see contingent debt interest expenses taxed in one regime or the other.

**Reform Options 1 to 5**

225. The proposed reforms identified above can be variously bundled to produce a set of distinct options, Options 1 to 5. The options proposed are bundled in such a way that as one moves from Option 1 to Option 5, there is:

- Reduced complexity for the capital regime;
- Greater certainty as to the loss-absorbing quality of regulatory capital;
- A more level playing field; and,
- A reduced risk of regulatory arbitrage.

The proposal to improve transparency by making the Deeds and related material publicly available is considered a useful reform irrespective of whether the definition of bank capital changes or not. Similarly, ensuring the drafting of the requirements delivers the policy intent is sensible. These reforms are therefore implicit in each of the options except the *status quo* option.

<table>
<thead>
<tr>
<th>Reform is made with respect to:</th>
<th>Option 1: “status quo”</th>
<th>Option 2: “status quo plus”</th>
<th>Option 3: “Limited trigger regime”</th>
<th>Option 4: “No trigger regime”</th>
<th>Option 5: “Equity only regime”</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Preference shares</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>2. Going concern triggers</td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>Not applicable</td>
<td></td>
</tr>
<tr>
<td>3. Non-viability triggers</td>
<td></td>
<td></td>
<td>✓</td>
<td>Not applicable</td>
<td></td>
</tr>
<tr>
<td>4. Conversion</td>
<td></td>
<td>✓</td>
<td>✓</td>
<td>Not applicable</td>
<td></td>
</tr>
<tr>
<td>5. Tax recognition</td>
<td>✓</td>
<td>✓</td>
<td>Not applicable</td>
<td>Not applicable</td>
<td></td>
</tr>
<tr>
<td>6. Group definition</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

✓ means the option includes the proposed reform.


Under Options 4 and 5, given the capital instruments permitted under these Options, tax effects are not expected. However, if the capital instrument is part of a wider financial arrangement tax effects may need to be considered.
226. Option 4 is the Reserve Bank’s preferred option. In Option 4 only common equity and preference shares are accepted as Tier 1 capital and long term subordinated unsecured debt - without triggers - is accepted as Tier 2 capital (there are also reforms to preference shares, tax recognition and the group definition). Banks can continue to offer contingent debt instruments to parents and others under Option 4 - and would do so to the extent the bank values them as a form of funding - but these instruments would no longer qualify as regulatory capital. The implications of Option 4 are discussed in more detail below.

227. Detailed proposals relating to each of the reform directions indicated above will be developed, and released for consultation, during a later stage of the Capital Review.

228. Option 3 is similar to Option 4 with the exception that in Option 3 contingent debt with a non-viability trigger leading to write off (not conversion) is accepted as Tier 2 capital.

229. Option 2 continues to allow preference shares and contingent debt with going concern triggers as AT1 capital, and continues to allow conversion to ordinary shares, but has reforms to preference shares, tax recognition and the group definition.

230. Option 5 limits regulatory capital to ordinary shares, retained earnings and preference shares. In this regime banks structured as mutual societies would be constrained to grow at the rate of their retained earnings as any subordinated debt they issued would not qualify as capital.

231. Another way to look at the options is in terms of the permitted features of the various classes of capital (see table below).
<table>
<thead>
<tr>
<th>Features of instruments permitted as capital</th>
<th>Option 1 – status quo</th>
<th>Option 2 – status quo</th>
<th>Option 3 – limited trigger regime</th>
<th>Option 4 – no trigger regime</th>
<th>Option 5 – equity-only regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Ordinary shares and reserves</td>
<td>as per BS2B/BS2A</td>
<td>as per BS2B/BS2A</td>
<td>as per BS2B/BS2A</td>
<td>as per BS2B/BS2A</td>
<td>as per BS2B/BS2A</td>
</tr>
<tr>
<td>Preference shares:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>● classed as AT1?</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
</tr>
<tr>
<td>● redeemable?</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>● required to write-off or convert to shares?</td>
<td>yes</td>
<td>no</td>
<td>no</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>Subordinated debt:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>● CET1 at 5.125% as trigger</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>no</td>
</tr>
<tr>
<td>● non-viability trigger</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
</tr>
<tr>
<td>● conversion option available to banks</td>
<td>yes</td>
<td>yes</td>
<td>yes</td>
<td>no</td>
<td>not applicable</td>
</tr>
<tr>
<td>● tax treatment</td>
<td>status quo</td>
<td>full tax recognition</td>
<td>full tax recognition</td>
<td>Tier 2 only</td>
<td>Tier 2 only</td>
</tr>
<tr>
<td>● available class for sub debt</td>
<td>AT1 and Tier 2</td>
<td>AT1 and Tier 2</td>
<td>AT1 and Tier 2</td>
<td>Tier 2 only</td>
<td>Tier 2 only</td>
</tr>
</tbody>
</table>

Ref #7083939 v1.6
Focus on Option 4

232. Under Options 3, 4 and 5 there are fewer types of instruments and fewer permitted contract features, which means the regime is easier to comply with and easier to oversee. This not only means costs are lower to both banks and regulator, but the risks of errors being made - that might lead to some instruments being derecognised when the error is discovered - are reduced.

233. Options 3, 4 and 5 deliver a capital definition which gives increased certainty as to the loss absorbing quality of bank capital. In these Options, ordinary shares and preference shares play a larger role than at present. Ordinary shares (and, to a lesser degree, preference shares) provide the highest quality capital available as they absorb losses whatever the financial health of the bank at the time, the magnitude of the loss that can be absorbed is clear, the potential for legal challenge is less than for contingent debt and the fiscal risks associated with these instruments (particularly ordinary shares) appears less than in the case of contingent debt.

234. An important outcome of adopting Option 3, 4 or 5 is that the capital definition would no longer give some banks an artificial competitive advantage over others.

235. The current rules give the big four banks a route to capital that appears to be cheaper than the options that are available to all NZ banks. This is particularly relevant for Tier 1 capital. Historically, the conventional options for Tier 1 capital have always been: issuing ordinary shares, retaining earnings and issuing non-voting preference shares. Currently the regime gives an added option for the big four, and that is to directly or indirectly issue contingent debt that converts into ordinary shares in the bank’s parent. This option arguably offers tax and other benefits for the issuing bank and/or its parent that allows the instrument to be attractively priced relative to what the other banks can offer.

236. Tier 1 capital is particularly important. Under Options 3, 4 and 5, the capital raising options available for all banks to increase Tier 1 capital would be the same: raise new ordinary share capital from existing shareholders, retain more earnings or issue non-voting vanilla preference shares to existing shareholders or third parties. Under these Options all banks, irrespective of their constitutions and corporate structure, would have to compete for Tier 1 capital other than common equity in the same market (i.e. the market for preference shares).

237. Under Options 3, 4 and 5, Tier 1 capital will typically constitute equity under the Income Tax Act which would simplify the tax situation and create less opportunity for regulatory arbitrage.

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89 All of the big four banks are 100% owned ultimately by an Australian banking group. It is not envisaged that the big four NZ banks will be permitted to issue ordinary shares to other parties in the foreseeable future.
238. Under Options 3, 4 and 5, banks’ Tier 1 capital-raising would be via well-understood, conventional means (common equity or preference shares).

239. However, there is an important difference between Options 3 and 4 in respect of Tier 2 capital. Given the presence of the resolution regime, a requirement to have a non-viability trigger leading to write-off is arguably redundant and including it thus adds unnecessarily to the complexity of the regime.

240. Hence Option 4, which only accepts non-contingent subordinated debt as Tier 2 capital, is preferred over Option 3 which accepts contingent debt with a non-viability trigger.

241. The Basel standards continue to be reflected in Option 4 in that common equity remains the most important type of capital and the definition of common equity in Option 4 is based on the Basel standards. There are differences in the way subordinated debt is treated, but the differences are arguably in form, rather than substance. Subordinated, unsecured debt continues to be loss absorbing in the context of a failed bank.

242. Banks can continue to issue contingent debt under Options 4 and 5, and this would potentially be recognised by APRA as capital for their parent group (providing it met APRA’s requirements). However, such debt would not qualify as regulatory capital in New Zealand.

243. Under all Options except Option 1, the New Zealand requirements of preference shares would differ from those indicated in the Basel standards. However, the Basel standards requirement that preference shares “write off” is potentially problematic in New Zealand and arguably unnecessary (preference shares have loss absorbing properties irrespective of the financial health of the bank, and thus don’t require a trigger to be loss absorbing).

**Implementation**

244. The expected timeframe for completion of the Capital Review is 2018. As well, time has to be allowed for drafting the new regulations.

245. There will be a 5 year transition period for existing instruments which will no longer qualify as capital under the revised BS2A and BS2B.

**Seeking your views**

The Reserve Bank invites submissions on the issues discussed in this document. In particular, we seek your views on the following questions.
Questions re Part A: Do you agree that the contextual information presented in Part A is relevant for the capital definition? Are there other contextual matters that have been overlooked in Part A? Do you have any other comments in relation to Part A?

Question re Dimensions of Reform: Do you agree that the 6 “dimensions of reform” in fact require reform?

Question re transparency and drafting changes: Do you agree that these areas in fact require reform?

Question re Dimensions of Reform: Are there other aspects of the capital definition that also require reform? Do you have any other comments relating to the proposed areas of reform?

Questions re proposed reforms: Do you agree that the proposed reform for each of aspect of the capital definition is the most appropriate reform and, if not, why not? Do you have any other comments with respect to the proposed reforms?

Questions re Options 1 to 5: Do you agree that bundling the reform proposals together to form Options 1 to 5 is the best way to combine the reforms? Which Option do you prefer and why? Do you have other comments regarding Options 1 to 5? Do you agree with the Reserve Bank that Option 4 provides the best way forward?
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 by the first quarter of 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.
Appendix 2: History of capital regulations in New Zealand

Capital regulations have been imposed on New Zealand banks, via bank conditions of registration, since the bank registration regime was introduced by the Reserve Bank Act in 1989. Since 1989 the approach has been to consider only the bank and entities it owns and/or controls when defining minimum capital requirements. Entities that have shareholdings in the bank are not considered when defining the group. The group that consolidates for financial reporting purposes has generally been accepted as the relevant group for capital regulatory purposes.

Prior to 1 January 2013 the capital definition was relatively simple. Ordinary shares, qualifying accumulated reserves and non-redeemable non-cumulative preference shares were accepted as Tier 1 capital. Other types of preference shares, long-term subordinated debt and debt that converted into ordinary shares (“mandatory convertible notes”) were accepted as Tier 2 capital. The period that had to elapse before mandatory conversion took place was not standardised in the regulations.

Effective from October 2010 to December 2012 there were two classes of Tier 2 capital - “upper Tier 2” capital (if the instrument had no fixed maturity and was non-redeemable, among other features) and “lower Tier 2” capital (with a fixed term of no less than five years).

The current definition draws heavily on the Basel III standards, published in 2011 by the Basel Committee, and took effect from 1 January 2013.

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92 There have been exceptions to this. TSB is required to hold capital against an entity it does not consolidate with for reporting purposes for example and an entity Rabobank includes in its financial reporting group is excluded from consideration when the bank calculates regulatory capital requirements.
93 Refer the version of BS2A applying from 2010 until Dec 2012

Ref #7083939 v1.6