

20 October 2020

To: Bank CEO's
cc: Bank Treasurers

Dear Chief Executive

The Reserve Bank is responding to enquiries from banks regarding the implementation of Capital Review decisions announced in December 2019. This letter provides an overview of the near-term work being undertaken to implement the Capital Review decisions, particularly regarding the process for the change in definition of Additional Tier 1 (AT1) and Tier 2 capital instruments. We recognise that banks would like certainty and clarity on this aspect of implementation in order to plan their future funding and lending strategies.

The Reserve Bank intends to release detailed consultation materials on the implementation of the Capital Review via an exposure draft of the revised Banking Supervision Handbook in late November 2020. This will include revised definitions of Additional Tier 1 and Tier 2 capital instruments (reflecting the 2019 Capital Review decisions).

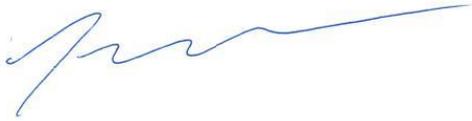
Before the new rules are in effect, the Reserve Bank is still accepting applications under BS16 for recognition of AT1 and Tier 2 capital instruments that would comply with our existing rules, as outlined in BS2A and BS2B of the Banking Supervision Handbook. We note, however, that instruments that are compliant under the old rules, but are deemed non-compliant under the new rules, will be subject to a de-recognition period once the new rules are implemented, as signalled in the December 2019 decisions. The de-recognition period will be included in the November consultation material.

We have received questions from banks about the likely shape of Tier 2 instruments under the new rules. Detailed information will be included in the material released in late November. However, at this stage, we are in a position to release some general guidance on what we envisage the new Tier 2 instruments to look like prior to the November consultation. This guidance is attached as an Annex to this letter. Please note that this guidance is not final and is subject to the outcomes of the exposure draft consultation.

We are not providing any additional guidance in this letter regarding AT1 instruments. The December 2019 decisions included a number of significant changes to AT1 instruments in the prudential framework. The November consultation material will include a detailed description of our proposed eligibility requirements for AT1 instruments for feedback from industry and the public.

Providing clarity and certainty to banks on the future capital framework is a high priority for us. At the moment, we expect the consultation on the revised framework to run from November until the end of March 2021, with the rules finalised before 1 July 2021.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Geoff Bascand', with a long horizontal flourish extending to the right.

Geoff Bascand
Deputy Governor / General Manager Financial Stability

Annex: Guidance on Tier 2 capital under the new rules

As noted in the main text to this letter, the Reserve Bank intends to open consultation on the details of the implementation of the December 2019 Capital Review decisions in November 2020. This will include consultation about the new requirements for instruments to qualify as Tier 2 capital, as well as the approvals process that will be put in place for capital instruments.

The Reserve Bank is aware that there may be interest in issuing new Tier 2 capital instruments before the Capital Review changes are in place. We are also aware that banks may want any new Tier 2 capital instruments to continue to fully qualify as Tier 2 capital under the new rules, even if issued before those rules are finalised and published.

It is important that clear and transparent processes are followed for implementing the Capital Review decisions, including finalising the new Tier 2 rules. We need to undertake a full, transparent and detailed public consultation before the new rules can be finalised by July 2021. While we can, and will, be clear on what we are proposing, and see no reason at this time to deviate from our proposals, we cannot be certain about consultation feedback and consequently the final decisions. So, at this time, the Reserve Bank is unable to provide definitive guidance or assurance on the content of the new Tier 2 rules.

If a bank issues a new Tier 2 instrument before the new Tier 2 rules are finalised, it will face some risk that the new instrument may not qualify as Tier 2 capital, once the new rules are implemented. Any such non-compliant instruments would be eligible for gradual de-recognition during the transition period, as signalled in the December 2019 Capital Review decisions.

To assist banks in dealing with this risk, this letter sets out guidance to banks that are contemplating issuing a new Tier 2 capital instrument before the Tier 2 rules are finalised. Further information on the Reserve Bank's current thinking on the content for the new Tier 2 rules will be contained in the consultation material set to be released in November.

The Reserve Bank is open to the prospect of banks issuing Tier 2 instruments in advance of the final decisions, but reserves the right to assess these as non-compliant, once the final rules are in place in 2021.

The notes below cover process considerations, as well as the guiding principles that the Reserve Bank is applying in its current thinking on the content of the new Tier 2 rules.

Process considerations for issuing Tier 2 capital instruments

Banks should pay regard to the following points for issuing Tier 2 capital instruments:

- Banks should follow the existing non-objection process set out in BS16 in respect of the instruments' compliance with current rules. The Reserve Bank will apply its usual processes for this consideration.
- The Reserve Bank will not provide any formal or informal assurances to banks about the future compliance (or non-compliance) of any new instrument with the new Tier 2 rules.
- The Reserve Bank will confirm the status under the new Tier 2 rules of any Tier 2 instruments issued after this letter, once the new rules are in place in July 2021 (or earlier if the rules are finalised before then). This may include requiring the issuing bank to carry out additional steps to confirm the compliance of the instrument with the revised Tier 2 rules.

Guiding principles for new Tier 2 capital instruments in the revised capital framework

The main change to Tier 2 capital instruments, as announced in December 2019, is that Tier 2 instruments must not include any contractual features that give rise to conversion or write-off mechanisms at the point of non-viability.

Full details of the Reserve Bank's approach to Tier 2 instruments will be published as part of consultation material for Capital Review implementation. Based on the Reserve Bank's current working proposals for the new Tier 2 capital instruments (which remain subject to consultation), a bank wanting to issue a new Tier 2 instrument should consider the following points:

- The governing law for Tier 2 instruments must be New Zealand law.
- The Tier 2 instrument should be subordinated in the liquidation of the Issuer to the claims of depositors and unsubordinated creditors of the Issuer.
- A current market practice for Tier 2 terms sheets is to include a general "Status" section for the instrument. It is expected that the new Tier 2 rules will ask Issuers to step-out the various components of the status section in the terms sheets. For example, rather than including one general "Status" paragraph, there will be a separate line item in the terms sheets for "Form", "Ranking", "Set-off and Offsetting Rights" and "Rights in Liquidation of Issuer". This style change is being contemplated by the Reserve Bank for the purposes of standardisation, transparency and simplicity.
- It is expected that the new Tier 2 rules will ask Issuers to include certain standard terms in Tier 2 term sheets, also for the purposes of standardisation, transparency and simplicity. Considering current market practices for Tier 2 terms sheets, we expect these terms are likely to be regarded as non-contentious (as opposed to material departures from the current market norms). For example:
 - Legal Form: Debt
 - Regulatory Treatment (issuer): Tier 2 Capital
 - Accounting Treatment (Issuer): Liability
 - Not deposit liabilities: the notes are not deposit liabilities of the Issuer
 - No restrictions on other securities: The terms of the Notes will not limit, or otherwise restrict, the Issuer from issuing (or otherwise dealing with) equal, junior or senior securities in its absolute discretion (or similar)
 - Variation of rights: No amendment to the terms of the Notes will be permitted if such amendment would impact (or potentially impact) the capital treatment of the Notes under the Reserve Bank's prudential standards at the relevant time (or similar)
 - No participation in issues of securities: The Notes confer no rights on a Holder to subscribe for new securities of the Issuer or to otherwise participate in the profits of property of the Issuer, except by receiving payments as set out in the Notes (or similar)
 - Conversion or exchange: not applicable
 - Documents: [List key issue documents]