TO: THE RESERVE BANK OF NEW ZEALAND

ON: ISSUES PAPER: REVIEW OF CAPITAL ADEQUACY FRAMEWORK FOR LOCALLY INCORPORATED BANKS

9 JUNE 2017
INTRODUCTION 1  This submission is from Chapman Tripp, PO Box 993, Wellington 6140.

2  We would be happy to meet with the Reserve Bank to discuss our submission. Our contact is:

ABOUT CHAPMAN TRIPP 3  Chapman Tripp is a leading law firm with a strong practice in banking and finance law. We have advised a range of banks and other stakeholders on issues in connection with the Reserve Bank’s Capital Adequacy Framework.

The matters covered in the Reserve Bank’s Issues Paper: Review of Capital Adequacy Framework for Locally Incorporated Banks (the Issues Paper) are of direct interest to us as legal practitioners and to our clients.

SUBMISSION STRUCTURE 4  This submission focuses on one aspect of the Issues Paper. This relates to the fact that the Reserve Bank has raised concerns about how Additional Tier 1 (AT1) and Tier 2 instruments work in practice and their complexity.

GENERAL COMMENTS 5  As a general comment we welcome the opportunity to respond to the Issues Paper.

Given the significance of the review, and the impact that it will have on banks, it is important that the review is thorough and complete.

With this in mind, we consider that the review process should be broad ranging and transparent. It is critical that the correct issues are identified for consideration, and that assumptions around particular outcomes are not made too early in the process. In light of this, we support the Reserve Bank’s approach of requesting the market for its input on the issues that should be considered as part of the review.

SUMMARY 6  In a number of places in the Issues Paper the Reserve Bank states that it has concerns about the complexity of AT1 and Tier 2 Instruments. However, it is not clear to us what is causing the Reserve Bank to have these concerns.

This issue impacts directly on one of the key principles that the Reserve Bank will have regard to as part of the review, namely do such instruments create “unnecessary complexity”. Given this, we consider that, as part of the next
stage of the consultation, the Reserve Bank should clearly explain the background to its concerns.

The consultation paper should also provide a balanced assessment of these concerns against the impact of not having such instruments available to the market. There are clear benefits in having a broader range of capital instruments available to investors, given the consequential effect of having a broader range of investors in such instruments.

The consultation paper should also assess these concerns in the context of the relationship with foreign-owned banks home country regulators. Global consistency is an important factor. Particularly relevant is the fact that, so far as we are aware, APRA has not expressed any concerns about AT1 or Tier 2 Instruments being unnecessarily complex.

A transparent discussion of these issues is needed as part of the next stage of the capital adequacy review process. There needs to be a robust debate as to whether AT1 and Tier 2 instruments do, in fact, create unnecessary complexity and compliance costs, and whether having these types of instruments actually conflicts with the Reserve Bank’s high-level principles. In order for this to occur, banks and other stakeholders need to have a complete understanding of the Reserve Bank’s concerns and a proper opportunity to respond to them.
Issues Paper Questions

7 In various places in the Issues Paper the Reserve Bank indicates that it has a number of concerns regarding the nature of AT1 and Tier 2 Instruments. These include concerns in respect of the complexity of such instruments and that they are opaque, uncertainty about whether they will work in practice and difficulties with administering such instruments.¹

8 These comments seem to indicate that, in the context of the six high-level principles that the Reserve Bank proposes to have regard to in carrying out the review, especially the fifth principle, the Reserve Bank has a preference for banks to issue more “straight forward” capital instruments only, namely common equity Tier 1 (CET1) instruments, especially shares.

9 This is also reflected in the statement at the end of the Summary to the Issues Paper where the Reserve Bank refers to seeking to ensure a “balanced outcome”, with the benefits of capital being realised in practice, but at the same time the capital requirements being appropriately conservative and relatively simple. (emphasis added).

10 These comments are of concern to us. Not only is it unclear to us as to what the Reserve Bank is basing its concerns on, but the Issues Paper gives the impression that the Reserve Bank has “pre-determined” its view on the issue.

11 We accept that, given the structure of convertible instruments, they will inevitably have some degree of complexity, as compared with other types of debt instruments.

12 However, we do not think that the convertible instruments issued by New Zealand banks are “unnecessarily” complicated. The key feature, namely the ability to absorb loss in the event of the occurrence of a non-viability trigger event, is, to our mind, dealt with in a relatively straightforward way. Such conversion mechanisms are no more opaque than the conversion mechanisms used in other types of debt or equity structures (for example mandatory convertible

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¹ See, for example, the comment in paragraph 7 in the Summary of the Issues Paper, and the comments in paragraphs 34, 35, 38 and 40 of the Issues Paper.

² The fifth principle is stated as 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.
notes).

13 A degree of complexity is introduced through needing to have a fall-back mechanism if conversion cannot be achieved. But this feature cannot be avoided, given it is one of the key features prescribed by the Basel Committee on Banking Supervision’s Basel III global regulatory framework.

14 In this context we do not believe that the implementation of the Basel Committee’s framework in the G20 and other countries has led to concerns by overseas regulators that the contractual terms of convertible instruments are “too complex”.

15 On the question of whether the instruments are too opaque, and are not capable of being clearly understood, we acknowledge that there are aspects of how the convertible instruments operate which need to be properly disclosed in the relevant offering documents for the instruments.

16 However, we consider that these matters can be, and have been, satisfactorily dealt with through appropriate risk disclosures which meet the requirements of New Zealand’s financial markets conduct legislation. Relevantly, we are not aware that the Financial Markets Authority has raised any particular concerns with the disclosures that have been made in respect of the various convertible instruments that have been offered to the public under the FMCA regime (for example ASB Bank, Co-operative Bank, and, in a slightly different context, Westpac Banking Corporation).

17 The Reserve Bank has a concern as to whether the convertible instruments will work in practice given that they are untested in the New Zealand environment.

18 As part of the BS16 approval process, banks are required to provide robust legal opinions with regard to the legal effectiveness of the instruments, including that there are no legal impediments to the conversion mechanics operating in the circumstances intended.

19 Accordingly, from a legal perspective, we question the Reserve Bank’s concerns as to the ability of the convertible instruments to operate in practice. If the Reserve Bank does have any residual concerns, then we suggest that, rather than removing the ability to use such instruments on the basis of being too complex, a better approach would be to clarify any
legal principles which may be in doubt so as to ensure legal certainty.

20 The Reserve Bank also raises a concern as to whether AT1 debt and Tier 2 instruments will actually absorb losses when a bank gets into difficulty. The concern, in part, appears to relate to the risk that where a bank is failing, there will be too much political pressure on governments to bail-out holders of such instruments, thereby undermining their effectiveness. A reference is made to recent events surrounding the Monte dei Paschi bank in Italy.

21 However, we note that just a few days ago the failure of Banco Popular in Spain was successfully resolved with such instruments operating as they were intended. They were converted to equity for effectively no value and the bank was sold to Banco Santander for the nominal price of €1. Moreover, it appears that Banco Popular’s deposit holders and other senior debt holders were unaffected by the resolution process. The process was completed very quickly and efficiently over the course of several days only.

22 This serves as a good example of convertible instruments performing as they are supposed to. It also reminds us that we should not make generalised assumptions about the potential ineffectiveness of convertible instruments, just because there may be an example where they appear to have been found wanting.