HEARTLAND
BANK

9 June 2017

Ian Woolford
Manager, Financial Policy
Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
Wellington

By email: capitalreview@rbnz.govt.nz

Dear Ian

Issues Paper: Review of the Capital Adequacy Framework for locally incorporated banks – Heartland Bank Limited submission

1. We refer to the Reserve Bank's May 2017 publication entitled "Issues Paper: Review of the Capital Adequacy Framework for locally incorporated banks" (the **Issues Paper**).

2. We are a member of the New Zealand Bankers Association (**NZBA**) and have reviewed its submission in response to the Issues Paper. We generally concur with the comments made in that submission.

Specific questions

3. We also comment as follows:

Question 1: For each of the three sections (numerator, denominator, ratio), are there any important topics relating to capital adequacy that we have left out entirely?

4. In our view, subject to the observations made by NZBA in their submission, the scope of the review is comprehensive and there are no obvious omissions. However, the review is at its outset and other important topics may arise during the consultation process.

Question 2: For each of the three sections (numerator, denominator, ratio), have any important and relevant issues been omitted from the topics that have been discussed?

5. In our view, no important and relevant issues have been omitted from the scope of the review. Again though, the review is at its outset and other important issues may arise during the consultation process.

Question 3: Do you have any information (e.g. empirical data) that is relevant to the issues discussed in the paper?

6. No.

Question 4: Are there particular areas of the review that should be prioritised?

7. An issue of significant importance to us, and to the industry more generally, is the capital treatment of existing and future AT1 and Tier 2 instruments.

8. Banks need to continue monitoring their regulatory capital positions during the course of the review and may wish to issue regulatory capital before the review is concluded. At this time, pending the outcome of the review, the existing banking standards *should* prevail and banks *should* have the optionality to issue CET1, AT1 or Tier 2 regulatory capital – however the treatment of our recent BS16 application and the review more generally has created some uncertainty. Given the long lead-in times for any issue of AT1 or Tier 2 instruments, this creates real problems for banks wishing to issue those instruments in the short or medium term.

9. We agree with the NZBA's submissions that the relevant banking standards provide that the primary loss absorption mechanism is paramount for determining tax haircuts, that the conversion and write-off features of AT1 and Tier 2 instruments are simple and effective, and that there therefore does not need to be any significant focus on the tax outcomes of AT1 and Tier 2 instruments (which, in our view, are currently clear). However, we don't necessarily agree that prioritisation of this matter is desirable. Rather, we think that it may be difficult to consider any element of the review in isolation from the other elements, and that addressing the capital treatment of existing and future AT1 and Tier 2 instruments in isolation to the other matters could create unintended consequences.

10. The preferable approach, which the Reserve Bank has separately confirmed is currently the case, is for the Reserve Bank to continue to review BS16 applications during the capital review consultation period (although this would be reassessed once the Reserve Bank's positions start to firm up), to consider those applications in light of the existing banking standards, and to provide that any notices of non-objection would remain valid for a three month period.

11. We think that is sensible. We also request that the Reserve Bank provides as much notice as possible to banks of the firming up of any of its positions – and that the Reserve Bank grandfathers any AT1 and/or Tier 2 regulatory capital issues which have not occurred at that point in time but which have been substantially progressed.

Other comments

12. Comprehensive consultation will occur in relation to each of those sections (i.e. numerator, denominator, ratio), during which time industry will be able to engage with the subject matter in detail. However, at this stage, we wish to take the opportunity to make some initial observations regarding matters of importance to Heartland.

Extent to which reserves etc should be recognised

13. The Reserve Bank is considering the extent to which amount other than paid up share capital, such as reserves, should be recognised in regulatory capital, or alternatively should be excluded

or deducted. As set out above, of particular interest to Heartland is the deduction from the face value of any Tier 2 instrument of any potential tax liability on write-off of that instrument.

14. We assume that this will be consulted on in detail during the review. As an interim comment though, and as submitted by NZBA, the tax treatment of these instruments under the current rules is clear. To the extent that consideration of the tax outcome of write-off needs to be considered, the occurrence of a non-viability trigger event would coincide with significant losses, and consequent tax credits, which would be very likely to far exceed the amount of any remission tax liability caused by the write-off of the relevant instruments.

Benefits of AT1 and Tier 2 instruments?

15. There appears to be an assumption that a key benefit, from a bank's perspective, of AT1 and Tier 2 instruments is the tax advantage of those instruments as compared to CET1 equity.

16. As a locally-incorporated bank without a foreign parent, we don't experience those tax benefits. However, AT1 and Tier 2 instruments give us optionality around the type of regulatory capital that we raise, and offer the following real benefits:

    (a) Tier 2 capital and CET1 equity are very different financial products and have different markets. Simply put, the ability to issue Tier 2 capital gives us more options for raising regulatory capital. At some times in the economic cycle, there may be more demand for Tier 2 instruments than CET1, and vice versa.

    (b) We have greater flexibility when issuing Tier 2 instruments than we do when issuing CET1 equity. For example, we privately placed A$20m of Tier 2 instruments recently but would find it very difficult to manage investor expectations if we conducted a CET1 equity raise of less than approximately $75m.

On-going recognition of AT1 or Tier 2 instruments

17. There is also concern about how AT1 or Tier 2 instruments would actually operate in practice, given that they have never been tested.

18. In our view, the lack of testing should not necessarily count against the on-going viability of AT1 or Tier 2 instruments. The terms of regulatory capital instruments very clearly set out the trigger for loss-absorption (i.e. the objectively ascertainable non-viability trigger events), and what happens on occurrence of a non-viability trigger event (i.e. conversion and/or write off). Legal opinions are obtained that those terms will be legally effective.

19. Any concern that Government may wish to bail out holders and interfere with the intended operation of the instruments requires supposition. However what we do know is that the terms are required to be – and are – very clear as regards whether any third party (including Government) guarantees the issuer's obligations under the instruments.

20. Lastly, the value that will be derived from AT1 and Tier 2 instruments on the occurrence of a non-viability trigger event seems clear to us – the face value of the instrument will cease to be a liability on the bank's balance sheet.

Solo ratios

21. Finally, the review will consider whether the existing requirement to disclose a "solo" ratio should be retained or strengthened. As a general observation, consolidation should mean that solo ratios are redundant.

22. Also, as a registered bank with an Australian subsidiary, having a solo capital ratio requirement may have different implications for Heartland than it would for other banks. Likewise, the extent of banks' different funding structures will affect solo capital ratios, so that would need to be taken into account in the calibration of those solo capital ratios.

Regards

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David Mackrell
HEARTLAND BANK | CHIEF FINANCIAL OFFICER
s9(2)(a) privacy [redacted]
W www.heartland.co.nz **P** PO Box 9919, Newmarket, Auckland 1149