PO Box 35
Shortland Street
Auckland 1140, New Zealand
Telephone (09) 306 3000
Freephone 0800 803 804
CX10087 Auckland DX Sort
asb.co.nz

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Dear Grant

CAPITAL REVIEW PAPER 2: WHAT SHOULD QUALIFY AS BANK CAPITAL? ISSUES AND OPTIONS

ASB Bank Limited (ASB) welcomes the opportunity to provide feedback on the Reserve Bank's *Capital Review Paper 2 consultation* **(Review Paper)**.

ASB is aligned with the Reserve Bank's objectives of ensuring financial stability and ensuring quality capital be maintained to absorb losses in times of stress. In our response to questions included in the Review Paper we set out the extent that ASB considers reform is necessary and offer explanation where we do not. We have included alternative reform where we have been able to identify a solution that may achieve the Reserve Bank's objectives. ASB welcomes further discussion on these alternatives and other matters raised in the Review Paper and our response thereto.

We acknowledge that ASB's submission may be made publically available by way of publication on the Reserve Bank's website, and may be released in response to a request under the Official Information Act. Some aspects of this submission are commercially sensitive and we request that these are not included in any version of the submission made publicly available. We have provided a blacklined version for this purpose.

If you require any further information in relation to this submission, please do not hesitate to contact me.

Yours sincerely,

s9(2)(a) privacy [redacted]

Victoria Johnstone
Head of Regulatory Affairs
ASB Bank Limited

[redacted] s9(2)(a) privacy [redacted]

s9(2)(a) privacy [redacted]

Chandu Bhindi
General Manager Treasury
ASB Bank Limited

[redacted] s9(2)(a) privacy [redacted]

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?

Generally, ASB agrees that the contextual information presented in Part A is largely relevant for the analysis of AT1 and Tier 2 capital instruments and the role they play in absorbing losses under stressed scenarios. Some of the information presented however is incomplete, some matters have been overlooked and a number of the Reserve Bank conclusions as to the ineffectiveness of AT1 and Tier 2 capital instruments and factors motivating their issuance are inaccurate. To address this, we have provided additional information and analysis below.

Importance of multiple sources of capital funding for banks

It is critical that that New Zealand banks have access to diverse sources of AT1 and Tier 2 capital to reduce reliance on any one market or investor base. There are two main factors of the proposed reform that is likely to restrict the source of capital for Australian-owned New Zealand banks to its parent.

1. Market appetite
   The proposed reforms do not allow for issuer call dates or redemption features. There is limited domestic and offshore investor (retail and wholesale) appetite for AT1 and Tier 2 capital instruments without these features. Further, notwithstanding absence of a call or redemption feature, there is already limited domestic wholesale investor demand for perpetual preference shares as they prefer grossed up returns (without imputation credits)[1]. Offshore investor demand for these instruments is also limited as they cannot utilise the imputation credits attached to the dividend.

2. Dual recognition
   The proposed reforms disregard recognition of loss absorbing features (such as conversion and triggers). This means external AT1 and Tier 2 capital raised by an Australian-owned New Zealand bank under these reforms will not be recognised by a parent regulated under APRA. Dual capital recognition is critical in this context, as it enables Australian-owned New Zealand banks to issue external AT1 and Tier 2 capital and have this capital recognised at a parent level. Without this recognition, the parent will need to raise additional capital to cover the assets of their New Zealand operations on a consolidated basis. This would negate the need for the New Zealand bank to issue AT1 and Tier 2 to the external capital markets, as they would be able to utilise the additional capital raised by their parent.

The combination of these two factors is likely to result in Australian-owned New Zealand banks' becoming solely reliant on their parents as a source of AT1 and Tier 2 capital. This will significantly increase these banks and the broader New Zealand economy to the economic risk profile and investment decisions of their parents.

In addition, this outcome is contrary to the Reserve Bank's broader principle of ensuring banks in New Zealand remain self-reliant, including access to external sources of capital and funding particularly in stressed scenarios. It is important that banks retain the option to raise AT1 and Tier 2 capital instruments from external investors to strengthen their capital structure above CET1, and provide additional buffers to cushion losses.

[1] This is because their performance management is measured on a pre-tax basis.

Taxation

There are three aspects of the tax discussion in Part A that warrant further analysis.

1. <u>Potential tax liability haircut</u>
   According to the Review Paper, the regulatory haircut for potential tax liabilities arising from AT1 and Tier 2 capital instruments is potentially under-estimated and applied inconsistently. Further, it states the binding rulings obtained by banks as to potential tax implications for these instruments may be too narrow and fail to capture all relevant outcomes. In practice, the rulings cannot capture anything other than the contractually intended loss absorption mechanism (e.g. conversion) and therefore cannot address the consequences of this mechanism failing. The consequences of a conversion failure however are clear, that is, the instrument is written-off and a potential tax liability may arise as a result.

   The potential tax outcome on write-off cannot be analysed in isolation without broader commercial consideration of the factors that contribute to write-off. It is reasonable to assume that in such a scenario the bank will be distressed and have substantial tax losses to offset (and remove) any potential tax liability. s9(2)(b)(ii) commercially sensitive [redacted]

   Regulators in other jurisdictions[2] acknowledge that conversion is the primary loss absorption mechanism and that it is envisaged that write-off would occur only in very limited circumstances. Furthermore, regulators have also acknowledged the role of tax losses in absorbing tax liabilities in the event of a conversion failure.

   It is also worth highlighting that following recent tax changes, a potential tax liability on write-off will only arise on issuances to external investors and not on those issued to a Australian-owned New Zealand bank's parent. This tax treatment has the potential to exacerbate reliance on parent-funded capital (see *Importance of multiple sources of capital funding for banks* above) and it is therefore it is important that these different tax outcomes on write-off are neutralised by the regulatory regime.

2. <u>Bank capital structures</u>
   The Review Paper infers that tax outcomes are primary considerations for banks when determining their capital structure. s9(2)(b)(ii) commercially sensitive [redacted]

[2] PWC's *NZBA AT1/T2 Capital: Global comparison of tax and regulatory treatment.*

3. Tax neutrality
   We also note that there is no evidence to suggest that contingent debt instruments deliver an unfavourable outcome for the tax regime, or the economy as:
   - Deductible coupons paid to New Zealand residents are symmetric (i.e. deductible to issuer and assessable to investors). Previous asymmetry in respect of instruments issued offshore is expected to be closed by 1 July 2018; and
   - Thin capitalisation and transfer pricing rules protect against over leveraging and off market pricing.

International experience – contingent debt

ASB agrees with the Reserve Bank that contingent debt reduces the risk of bank failure by providing added loss absorbing capacity. Contingent debt instruments supplement but do not substitute CET1. However, the Reserve Bank argues that in practice, contingent debt instruments cannot be relied on for recapitalisation of a bank as a going concern, citing the Monte dei Paschi di Sienna (MPS) and Banco Popular failures as supporting evidence. These AT1 and Tier 2 instruments ultimately did absorb losses, and it is indisputable that losses were borne by the holders of these instruments. In addition, there have been a number of examples of issuers making prudent decisions to defer or cancel coupons on bank capital instruments in periods of stress (refer Attachment 1). This demonstrates the important and market accepted role that these instruments play in absorbing losses and augmenting the capital structure.

Complexity

ASB is concerned that the Reserve Bank's objective to "reduce complexity for the capital regime" appears to be motivated by the Reserve Bank's desire to simplify its oversight responsibilities. The definition of capital should not be determined by the Reserve Bank's resourcing considerations. To assist the Reserve Bank in its BS16 non-objections process, issuers provide the Reserve Bank with legal and tax opinions and accompanying Director attestations. As such, overall we do not consider the level of bank capital issuance is unnecessarily onerous. In addition, the Reserve Bank could consider resourcing the oversight of these issuances on a user-pays basis. We also note any issues with respect to complexity needs to be balanced against the importance of New Zealand banks maintaining access to a diverse AT1 and Tier 2 investor base.

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

See **Questions re proposed reforms** below.

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

We consider the current disclosure provides adequate transparency for public scrutiny however, ASB does not object to public disclosure of BS16 assessments and Director attestations. We note that legal opinions are prepared for the benefit of the addressee only and therefore cannot be publicly disclosed without author consent.

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?

ASB has not identified any other aspects of the capital definition that require reform. It is difficult however to opine on the quality of capital without understanding the quantum of capital required (which we understand is subject to a future consultation). This is particularly relevant if capital sources are limited to solely the parent, as it means the parent would need to also provide capital to meet requirements between CET1 and total capital.

Questions re proposed reforms: Do you agree that the proposed reform for each 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?

ASB supports clarification of requirements and the reform to the extent it is aligned to APRA and does not restrict ASB's ability to issue capital to external investors. We set out below where we do not agree with the proposed reform and offer alternative options to achieve the Reserve Bank's objectives where appropriate. We strongly encourage the Reserve Bank to review the relative merit these alternatives.

Preference shares

The Reserve Bank's objectives with respect preference shares can still be achieved if the definition of preference shares contain trigger features and allows for redemption at issuers call (subject to regulatory approval). Trigger features do not diminish the loss absorption capability of instruments and in fact, when combined with the OBR regime, provide supplementary support. The trigger mechanisms are based on conventional legal principles and can be expected to operate as intended. Redemption features do not weaken capital quality as redemption would be subject to the bank's own and the Reserve Bank's assessment of ensuring prudent levels of capital are maintained.

Triggers

The Reserve Bank argues that triggers are irrelevant in the New Zealand context because capital instruments are automatically bailed in if OBR is invoked, and become available to absorb losses. Therefore, the Reserve Bank concludes that their inclusion adds nothing other than unnecessary complexity. Trigger features however are not detrimental to the loss absorbency of AT1 and Tier 2 instruments in an OBR regime, and are critical in the context of dual recognition (see above). The Reserve Bank should therefore allow a concession for trigger features in order to ensure dual recognition of capital instruments for Australian-owned New Zealand banks.

Note that ASB favours the retention of a going concern trigger, and potentially increasing it consistent with the trend in Europe. The appropriate AT1 trigger point should be determined as part of the overall capital review, but we maintain triggers should not be set any higher than the top third of the buffer ratio. This would provide for financial recovery via coupon suspension before conversion or loss of principal occurs.

Conversion

ASB does not support the removal of contingent debt from the regulatory regime.

We understand the Reserve Bank has concerns around the legal certainty conversion into shares issued by a bank in a foreign jurisdiction. Shared contracts across jurisdictions is not uncommon within capital markets however, and the terms of instruments issued by Australian-owned New Zealand banks are clear as to which jurisdiction governs loss absorption.

Furthermore, the Reserve Bank states that conversion adds no further loss absorbency benefits as, in the context of a resolution, a statutory manager already has powers to establish new shareholders. This view however, overlooks the benefits of removing via conversion a class of creditors ahead of a statutory manager being appointed. These creditors would otherwise need to be dealt with in resolution and could potentially impede recapitalisation.

Recognition of tax effects

We have discussed our position in respect of the value of loss absorbing capital in detail in our response to **Questions re Part A**. The tax consequences of conversion are clear, as are the tax outcomes on write-off. ASB recommends that the Reserve Bank adopt the approach of other regulators, and respect that the primary loss absorption mechanism is conversion on which a tax liability does not arise. The Reserve Bank should recognise that in the unlikely scenario that conversion fails and write-off is required, a bank can be expected to have substantial tax losses to offset the liability. Here, the regulatory haircut for potential tax liabilities could follow accounting convention and not apply until such a time that it became more than likely that a tax liability will materialise.

Definition of banking group

ASB agrees that the accounting definition of the banking group may not be appropriate for the purposes of prudential regulation. In developing its position, ASB encourages the Reserve Bank to recognise that often these entities are formed by owners of the bank for commercially valid reasons including preservation of existing ownership rights. We understand that the Reserve Bank will consult on the group definition at a later stage of the capital review.

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 reforms? Which Option do you prefer and why? Do you have any other comments regarding Options 1 to 5? Do you agree with the Reserve Bank that Option 4 provides the best way forward?

ASB accepts that some reform may be required to strengthen loss-absorbing features, however we do not support any significant deviation from Basel III requirements. As such, ASB favours an option that at a minimum provides for the inclusion of redemption and trigger features. ASB therefore favours Option 1 as only Option 1 provides for the inclusion of these features, and limits the potential macro impacts highlighted in **Questions re Part A**.

ASB does not agree that Option 4 provides the best way forward and recommends that Reserve Bank reassess the basis on which it has concluded that reform is required. To the extent reform remains necessary, ASB encourages the Reserve Bank to engage with banks to develop a solution that meets Reserve Bank requirements while providing banks with options to manage and diversify its sources of capital to provide the requisite loss absorption in times of stress.

ATTACHMENT 1: Examples of coupon suspension

Examples of Post Basel III coupon Suspension		
Issuer	**Announcement Date**	**Instrument**
CajaSur	December 2012 and March 2013	Preference Shares Junior Subordinated Debt
Erste	December 2014	Tier 1 Upper Tier 2
Banca Carige	November 2015	Tier 1
Veneto Banca	December 2015	Tier 1
BremerLB	June 2017	Additional Tier 1