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

DeutscheCRAIGS

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Introductory comments

Deutsche Craigs Limited (**Deutsche Craigs**) is the investment banking division of Craigs Investment Partners Limited (**Craigs**). Craigs is one of the largest NZX Advisory firms in New Zealand, with over 110 advisers located in 17 branches throughout New Zealand. Craigs has over 50,000 clients having over $13 billion held under management in custodial operations, plus another several billion dollars where the assets are held by the clients directly. As you note in your paper New Zealand retail investors through NZX firms and private bank networks have been the largest investors in bank capital instruments.

In this context we provide our insights on the Capital Review Paper 2 (**Paper**) and potential impacts on both the structuring of capital instruments and investor demand.

Key views

We agree with the RBNZ that it is critically important for New Zealand to have a sound and efficient financial sector with well capitalised banks. We note the soundness of the banking sector is also reflected in the credit ratings, which importantly provide both a domestic and an international benchmark for both issuer and individual issue funding.

The RBNZ states it has adopted a principle of being conservative in capital matters to counter-balance the relatively light-handed approach in other supervisory areas. We agree ordinary equity is the most critical component and believe this can be reflected in more conservative settings above the international minimum standard while still permitting some incremental capital instruments that are consistent with Australian banks in particular and broadly aligned to other global banking systems. The volume of bank capital instruments issued in the domestic market suggests a need by both issuers and investors and we doubt issue sizes of $400m could be delivered unless the security was widely accepted. We think the success of these issues is also a vote of confidence by investors in the strength of the banking sector in New Zealand (as does the credit rating of those issuers).

Our key views are that:

1. If the RBNZ chooses to adopt a more conservative stance on what constitutes a capital instrument it should not set criteria which would see the instruments that met that criteria disqualified from Basel III recognition. At a minimum the non-viability triggers should be retained to maintain compatibility.

2. The RBNZ should permit debt instruments to continue to qualify for capital recognition so long as they meet the specified criteria, acknowledging that this criteria may be more restrictive than it is now. This comment applies to both Tier 1 and Tier 2 instruments.

3. The existing ability for issuers to include an issuer redemption right in preference shares should be retained.

4. The RBNZ appears concerned that the existing instruments may not work as anticipated because of perceived risks around mis-selling. This would be contrary to all the work undertaken by the FMA and the financial advisers drawing attention to the specific risks applying to these instruments.

Ultimately we do not believe there is a substantive case to move away from the global capital standards, other than to remedy some areas around tax and SPV definitions.

Questions re Part A:

Do you agree that the contextual information presented in Part A is relevant for the capital definition?

Types of capital

Paragraph 9 notes that "ordinary shares remain on issue until the company is wound up." We think it worthwhile to note that while this may generally be true, companies, if they are solvent, can buy-back and cancel shares on issue any time they wish. We believe this is important observation as it provides context for some comments we make on perpetual preferences shares later in this paper.

Most particularly a contention by the RBNZ that a preference share with an explicit redemption mechanism provides less permanent capital than ordinary shares. We argue that ordinary share capital can be less permanent than preference shares. This is because preference shares typically have a 5 year non-call period whereas a company could redeem ordinary equity from the day after it was issued, i.e. there is no five year stand-down period.

Paragraph 16 discusses the features of preference shares. We note that preference shares are not a common instrument in the New Zealand market and not as easily understood as debt instruments. We do not believe that introducing another form of equity with the suggested features will be attractive to equity investors and as a preference share it will be excluded from some debt investor mandates. Relaying solely on preference shares on this basis seems to us to move away from the simplification goal of the RBNZ.

Paragraph 28 contends that in New Zealand the majority of debt has included conversion because parent entities dominate as purchasers of the debt. In our view the two key reasons for the prevalence of conversion in New Zealand are:

1. Initial approaches by the banks to NZX Firms and other investors revealed a very strong preference for conversion. This is understandable given conversion would deliver an outcome no worse than write-off and could lead to a better outcome. In offshore jurisdictions there was we understand a preference for write-off in part because not having any prospect of being converted to equity meant these instruments were able to be included in debt mandates.

2. The tax haircut on capital for issues that have write-off as their primary mechanism provides issuers with a very strong economic incentive to pursue conversion. We estimate that for Tier 2 debt the haircut increases the effective cost of the capital raised by circa 0.40%. For Tier1 debt instruments the increase is much greater, at around 1.00%.

To this end the objectives of issuers and investors were aligned in a preference for conversion. It is noteworthy that the only issuers of instruments with write-off have been those that legally could not offer conversion, for example SBS Bank Limited, The Co-operative Bank Limited and Kiwibank Limited (before the development of the Kiwi Capital Funding Limited structure). To this end these parties are at significant disadvantage because of the increase in the cost of the capital raised after accounting for the capital haircut compared to those able to issue convertible instruments.

Paragraph 33 (and 140) appears to bring to the fore an underlying concern that these instruments might not work as expected in a stress environment, and particularly when retail investors are involved. Firstly, it is important to acknowledge that the FMA has done considerable work in this area, as have the various retail distributors, with significant warning statements included on all marketing material. We believe it would be difficult in the New Zealand environment for investors to be able to argue they were mis-sold the securities given the prevalence and magnitude of these warning statements.

Paragraph 30 states it is important that the instrument can realistically contribute to losses. We believe the ability of banks to defer or cancel interest and the pyramid tables showing capital structure make the loss absorption of the current instruments very clear. While a commonly used phrase, 'mum and dad investors' (paragraph 61), this seems rather naive given the vast majority of retail investors would have obtained their securities under advice from NZX Firms and banks (none of the listed capital products have had public pools and so an investor has to go through a financial intermediary) furthermore and these are likely to form part of a portfolio of securities rather than a single investment sold over-the counter and sitting alongside term deposits.

Paragraph 43 notes the importance of allowing for mutual societies when designing capital regulations. These entities are a small part of our domestic market and while of relevance should not drive the policy.

A focus on contingent debt

In respect of paragraph 66 we note that for completeness AT1 securities, no matter their legal form, are denied tax deductibility in Australia because the tax system categorises them as equity instruments. The key attribute driving this categorisation being their perpetual nature (regardless of issuer call / redemption rights).

The trans-Tasman context

It is unclear from the context of paragraph 97 whether the RBNZ believes the requirement that upon a trigger event that the Notes must convert into shares in the Australian listed parent is problematic. From a New Zealand investor perspective we see this as a preferable outcome because the possibility of receiving shares in a listed company is a far superior result in terms of potential liquidity post the conversion event and also having a listed share makes the decision on the conversion price much more transparent.

Ultimately this outcome is a function of tax haircut, which means that from the perspective of the bank shareholders, conversion is a requirement in order to achieve the most cost-effective outcome. In the case of the Australian owned banks, putting aside APRA requirements, the bank and investor preference would be for conversion to be into the listed Australian parent over being issued shares in the unlisted New Zealand bank given the lack of pricing transparency and liquidity.

These same comments apply to paragraph 129.

Capital structure, issuance and pricing in New Zealand

On a number of occasions (for example paragraph 106) we observe a distinction being made between paid in capital and retained earnings. In our mind any such distinction is artificial. For example two banks can be identical but have a different split between capital and reserves. This would happen if one bank chose to retain all its earnings and not pay any dividends, and the other chose to pay out all its earnings but then required those shareholders to reinvest those dividends by subscribing to newly issued shares. The total equity of both banks is the same but its composition is different. We don't consider that these two banks should be treated differently from a regulatory perspective.

Paragraph 109 notes that there has not been an issue of preference shares to retail since 2013. Again this is directly attributable to debt instruments being preferred over preference shares, even though economically the risks in respect of loss absorption (and hence delivering the same loss absorption outcome) are identical. Reasons for this include:

1. Not all investors can use imputation credits. For example charitable trusts do not invest in preference shares for this reason. Another important investor group that cannot attribute full value is overseas investors. This would be a disappointing outcome as there are signs that offshore investors have more recently increased their interest and participation in capital issues which are large and liquid, with the issuance from the Australian owned banks particularly relevant here. It would be disappointing if this emergent trend was extinguished. We note that this is why the Australian banks have almost exclusively used the domestic market for their AT1 instruments because only domestic investors can value the franking credits that form part of the return.

   A variation on this theme is that many institutional investors are measured on their portfolio performance on a pre-tax basis. Imputation credits are typically not included in these performance calculations. This means investing in preference shares disadvantages the manager from a reported performance perspective and so reduces their demand for preference shares.

2. Some mandates are defined by the legal form of the instrument. As such, despite there been no economic difference between the preference share and an equivalent debt instrument, some investors cannot for mandate reasons invest in "debt" instruments that are legally shares. This is important as it limits the volume the domestic capital market can absorb. The debt instruments on issue now have a wider investor appeal to an investor group that does not fully overlap.

3. Resident Withholding Tax is deducted at 28% irrespective of the investor's tax-rate, whereas debt instruments are taxed at the investor's marginal tax rate. As such for those investors that pay less than a tax rate of 28% must wait until they file their tax return to achieve their full return.

The above factors also weigh against institutional participation, as such the desire by the RBNZ to simplify the capital structure will likely result in increasing the proportionate amount of the capital issues that are owned by retail investors and restrict the development of the market.

In simple terms an imputation credit is not as valuable as cash. The table below compares the pricing of preference shares that have been issued historically compared to an estimated price if the same instrument had been structured in debt form. The CBA instrument is very pertinent because this was a Tier 2 instrument structured as a debt instrument, so directly comparable to Tier 2 debt issues that were been done at the same time by the Australian owned New Zealand banks.

Issuer	CBA	Fairfax	Works	BNZ
Date	Apr 05	Apr 05	Mar 07	Feb 08
Rating	A+	BBB	-	A+
Preference share margin	75	100	205	220
Estimated bond margin	40	60	180	200
Implied margin premium	**+35**	**+40**	**+25**	**+20**
Implied "market" value of the Imputation Credits	**87%**	**85%**	**92%**	**93%**

Source: Deutsche Craigs

The evidence indicates that an imputation credit is worth between 85% and 92% of its face value, which translates to preference shares being priced between 0.25% and 0.50% higher than an equivalent instrument structured in debt form. This incremental cost, combined with preference shares having a smaller demand pool, means both the potential investors and issuers prefer capital instruments to be structured in debt form.

The market does use the relevant swap rate to the interest rate reset date for pricing as in Paragraph 110 but it is worthy of noting this is acknowledged typically as a measure of interest rate risk rather than necessarily an expectation that the security will be redeemed on this date.

The New Zealand experience under Basel III

As noted elsewhere it is not correct in our view to say that the inclusion of a redemption right weakens the qualities of preference shares.

Basel II preference shares were not permitted to have a redemption right but ultimately this was able to be easily structured around by granted another entity (typically one associated with the bank) the right to call that instrument from investors. Once the preference share was called it was a simple matter, upon receiving RBNZ approval, to have the bank buy-back or cancel those preference shares. The ASBPA and ABSPB securities currently listed on the NZX are examples of this, albeit CBA chose not to exercise its call right.

In our view the Basel III reforms of allowing an explicit redemption right in preference shares simply recognised that reality and made it much more transparent. We do not see how the inclusion of a redemption right weakens the capital position given the bank is unable to redeem the preference shares without the consent of the RBNZ. We expect that if the RBNZ chooses to disallow a redemption right then say a bank owned by an Australian entity will simply issue a preference share that has a call right embedded in favour of another entity within the wider Australian bank. This would be a backward step.

We also consider that the concerns expressed around SPVs in paragraph 123 are overstated. In our view so long as the terms of the instrument issued by the SPV mirrors the terms of the instrument issued by the bank to the SPV there is no risk from a regulatory perspective. The reputational risks and economic risks are identical irrespective of whether the instrument issued to investors by the bank itself or an SPV. It appears to that the concerns expressed here (and also in paragraph 131) could be resolved by requiring either the SPV to be included in the financial group (for example it must be a wholly owned subsidiary of the bank), or requiring the issuer to confirm that in its view (perhaps backed up by a legal opinion) that the instrument issued by the SPV would be counted as capital if the same instrument was issued by the bank directly. This appears not dissimilar to the existing Basel III requirements that capital cannot be upgraded between the issuer and the bank, i.e. the capital treatment at the bank level (no matter the character of the instrument issued by the bank to the SPV) is determined by the characteristics of the SPV issued instrument.

The tax group issues noted in paragraph 127 are worthy of debate as we agree these do appear to at least notionally increase risk, although quantifying those risks given the remoteness of an adverse outcome seems problematic. We also note that being within a consolidated tax group may bring financial benefits to the financial group such as lower tax and therefore higher retained earnings.

With respect to paragraph 138, for completeness, we note that Kiwibank's first issue of a Basel III instrument in December 2012 was a $150m tier 2 instrument that did not feature conversion. The inefficiency of the instrument (in particular the 28% tax haircut) drove the development of the KCFL structure. It is noticeable that the only banks to issue instruments with write-off are those banks that have a legal or ownership structure that makes offering conversion difficult. In this sense the additional costs incurred from the 28% haircut associated with write-off instrument put these institutions at a competitive disadvantage.

Are there other contextual matters that have been overlooked in Part A?

One other contextual matter is the signalling effect that the pricing performance of listed securities can provide to the market, and also regulators. We are confident that the pricing of capital instruments will portend deterioration in financial performance much more quickly than the publicly released disclosure statements and in this sense can be a useful tool for regulators. The historical performance of the capital instruments issued by the likes of Credit Agricole and South Canterbury Finance provide evidence of this.

We see a material risk that if the RBNZ implements these proposals, and specifically removing conversion so that capital instruments will attract a tax hair-cut, or removing trigger events such that it would no longer be both for both the New Zealand subsidiary and the Australian parent to recognise capital, but only one or the other, then we will not see any capital issuance from the major New Zealand banks. At best we will see the Australian banks issue direct into the New Zealand market, as Westpac did in 2016. In our view this would be a significant detrimental change forced on the capital markets resulting in not only a restriction of the investment opportunities available to New Zealand investors but, importantly for the RBNZ, the removal of signalling provided from secondary market pricing of these securities. It also means that whilst the Australian banks may be able to raise capital efficiently from the New Zealand market the same will not be able to be said for a domestic bank given any capital it raises will be more expensive by virtue of the hair-cut or more unattractive terms from an investor perspective (increasing the headline rate).

Do you have any other comments in relation to Part A?

We have no other comments on Part A.

Question re Dimensions of Reform:

Do you agree that the 6 "dimensions of reform" in fact require reform?

We are not convinced that other than in respect of recognition of tax effects and the definition of the banking group that reform is required. We see considerable merits in retaining a system which aligns with global norms and importantly is reasonably consistent with the approach in Australia.

Whilst we recognise that the RBNZ has historically, and wishes in the future to maintain a conservative stance, it would not be an optimal outcome if the RBNZ was to adopt a stance that meant any capital instrument recognised by the RBNZ would be ineligible for recognition in Australia and other markets. RBNZs approach under Basel II was a better model whereby the set of available capital instruments was much more conservative than available offshore but still met the global capital definitions.

As such, much as for Basel II, if the RBNZ determined that a conservative position was appropriate, it would be better for simplicity if the required minimum CET1 was increased whilst still permitting the banks to issue capital instruments that were a conservative subset of the eligible instruments available in offshore markets. As such they would still be able to be recognised in all jurisdictions rather than under the RBNZ's proposed approach which would mean no instrument issued in New Zealand would meet the Basel III criteria.

Dimension 1 – Preference shares

We disagree with the contention in paragraph 181 that investors could confuse preference shares with term deposits. Their perpetual nature (irrespective of whether an issuer has redemption rights) and non-cumulating distributions are very strong indicators of a differentiation from term deposits. If the RBNZ still remained concerned with the risk of confusion the non-viability trigger should be retained given its inclusion strongly reinforces the notion that these securities bear no resemblance to term deposits.

As noted elsewhere we do not believe that having an issuer redemption right harms the benefits of perpetual preference shares from a capital perspective. As noted previously the lack of an explicit issuer redemption clause in the preference shares can be addressed as it was under the old rules to make the instrument more marketable, albeit this is most likely limited to those entities in which the registered bank sits under a holding company structure and an entity higher up the corporate chain holds the call rights. In our view the regulations should recognise this and allow redemption rights (subject to the approval of the RBNZ). This is little different to ordinary shares which the issuer can redeem at any time it likes (again subject to RBNZ approval).

We concur with the RBNZ's view that preference shares can be structured in a variety of ways, including achieving AT1 treatment, Tier 2 treatment and also a conventional debt instrument. As such we agree that it will be important to specify the terms of the preference shares. This is the same for debt instruments, as they can also take a variety of forms, and so rightly the current regulations are very prescriptive in describing the specific characteristics that must be met for a debt instrument to achieve capital recognition.

Reform proposal	Comment
Include a clear definition of "preference share" in the regulations and have specific regulatory requirements for preference shares.	Agree.
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).	Disagree; we believe it important to maintain compatibility with international definitions. It is also noteworthy that the inclusion of triggers specifically highlights to investors that there is greater risk in these types of instruments.
Recognise only non-redeemable preference shares as capital.	Disagree. We believe issuer redemption rights should be permitted so long as any such redemption requires the approval of the RBNZ. Investors would have no right of redemption.

Dimension 2 – Going concern trigger (currently included in AT1 capital)

In the context that AT1 instruments only require a going concern trigger if they are treated as debt for accounting purposes the Dimension 1 outcome will in part dictate whether this discussion is redundant. We do acknowledge that the RBNZ is not alone in expressing scepticism about the value of going concern triggers. For example Standard & Poor's treat any trigger below 7% as a gone-concern trigger when evaluating capital instruments, and hence reduces the equity credit they assign to the instrument.

One point worth making though is that it is possible to structure a perpetual subordinated debt instrument that would be classified as equity for accounting purposes (non-cumulative interest payments and no maturity date) and so would not under Basel III require the going concern trigger. In our view the ability under Basel III to issue subordinated debt that by virtue of its terms gave similar capital outcomes to preference shares was a significant benefit to banks and investors. Our strong preference is that AT1 instruments can continue to be issued in debt form so long as they meet the relevant capital requirements.

In respect of paragraph 193 the wording is unclear to us. If it is contemplating that a bank could issue contingent debt with going-concern triggers, we consider this to be a highly unlikely occurrence if such an instrument would be ineligible for capital treatment from the RBNZ's perspective by virtue of the trigger.

Reform proposal	Comment
Limit Tier 1 capital to common equity and appropriately configured preference shares.	We believe that allowing appropriately structured debt instruments (i.e. would be recognised as equity for accounting purposes) to meet the Tier 1 definition would benefit issuers and investors at no cost to the RBNZ.

Dimension 3 – Non-viability triggers (currently included in AT1 and Tier 2 capital)

We disagree that this area requires reform for these reasons.

1. From an Issuer perspective the inclusion of conversion avoids the tax hair-cut associated with write-off instruments, and therefore gives a more cost-effective outcome.

2. From an investor perspective conversion offers a potentially better outcome, albeit the likelihood of a non-viability event is small and the value realised upon conversion may not be significant. We note that a key feature of the New Zealand market, the major banks being owned by listed Australian companies, means there is a scenario in which New Zealand investors gain a significant benefit from conversion if the New Zealand entity becomes non-viable but the Australian bank does not. In essence the loss would have transferred from the investors to the Australian owner.

3. There are significant benefits in having rules that follow global norms. Removing the non-viability trigger will mean this is no longer the case.

We also consider that inclusion of the non-viability trigger language and the requisite warnings the FMA require on the offer documents offers significant benefits in terms of making sure that investors are aware that this type of instrument has additional risks and complexity. Removing the trigger would we believe be a retrograde step in that it creates a greater risk of investors seeing the resulting vanilla subordinated debt instrument as more akin to a term deposit, a risk that the RBNZ is rightly focused on.

Reform proposal	Comment
Only accept non-contingent subordinated debt as Tier 2 capital.	Disagree as we believe the inclusion of a non-viability trigger does not inhibit the achievement of RBNZ's desired policy outcomes.

Dimension 4 - Conversion

We agree that conversion does add complexity, particularly in the New Zealand context where there is only one bank that has listed equity meaning conversion can occur in a relatively transparent manner. In our view there have been and continue to be two key drivers for inclusion of conversion:

1. Issuer led as the inclusion of conversion avoids the tax hair-cut associated with write-off instruments.

2. Investor led because conversion does offer a potentially better outcome, albeit the likelihood of on a non-viability event is small and the value realised upon conversion may not be significant. We note that a key feature of the New Zealand market, the major banks being owned by listed Australian banks, means there is a scenario in which New Zealand investors gain a significant benefit from conversion.

   This occurs if the New Zealand bank was to become non-viable but the Australian bank parent remains viable. In this case the investors would hold a worthless investment in the New Zealand bank but they would be able to exchange it for potentially valuable shares in the Australian parent.

Reform proposal	Comment
If no contingent debt is accepted in the regime the issue of the conversion of debt into ordinary shares does not arise.	Agree.
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.	In our view it is unfortunate that write-off suffers a tax hair-cut but conversion does not. This creates a strong incentive to issue convertible instruments. We are concerned that if RBNZ disallows conversion that issuance of capital instruments in New Zealand will be severely restricted other than by those issuers who have little choice to issue. In addition it disadvantages investors with the risk of their Tier 2 investments being written off while equity is still whole.

Dimension 5 – Recognition of tax effects

We only have an incidental comment to make here. Elsewhere the RBNZ is indicating that it wishes to remove triggers and rely on the OBR regime. Does the RBNZ have a view on whether any such subordinated debt (i.e. without non-viability triggers) issued should attract a tax haircut? This is because one option, amongst others available through the OBR or Statutory Supervisor regime, is that the debt could be written off even if such a right was not contractually included in the terms of the instrument. That write-off would generate taxable income and hence in theory the same tax hair-cut could apply.

Reform proposal	Comment
The policy intent, that potential tax is accounted for, should be put beyond doubt.	Agree.
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.	Agree.
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.	Agree.

Dimension 6 – Defining the banking group.

We agree with the proposed reform to capture any SPV's used for issuance within the banking group.

Reform proposal	Comment
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.	Agree.

Question re transparency and drafting changes:

Do you agree that these areas in fact require reform?

We have no comments to make here.

Question re Dimensions of Reform:

Are there other aspects of the capital definition that also require reform?

We do not have any other aspects we wish to comment on.

Do you have any other comments relating to the proposed areas of reform?

We have no other comments.

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?

We have no further comment to make beyond those made above.

Do you have any other comments with respect to the proposed reforms?

We have no further comment to make beyond those made above.

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?

We consider there is another option, which we will call 1A. Under this option the existing regime is retained for compatibility reasons but shortcomings in "Tax recognition" and "Group definition" are addressed.

Which Option do you prefer and why?

Our order of preference would be 1a (see comment above), 2 and 3. This is because all these options allow contingent debt instruments. In respect of option 4 we do not believe that this option will see any issuance from the banks owned by offshore parties because the debt issued will not satisfy the Basel III capital definition, and as such those banks will in effect default to Option 5. There may be some issuance from the domestic owned banks under Option 4 because they do not have to consider compliance with Basel III, and as such the flexibility provided to those banks creates a strong preference for Option 4 over Option 5.

Do you have other comments regarding Options 1 to 5?

No further comments.

Do you agree with the Reserve Bank that Option 4 provides the best way forward?

No. See answer to the first question in this section.