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## **SUBMISSION – BANK CAPITAL REVIEW**

Dear Sir,

The following is our submission which outlines First NZ Capital's ("FNZC's") views on the Capital Review Paper 2: What should qualify as bank capital?

**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?*

We are supportive of the intent of the review to simplify the capital definition in an endeavour to mitigate the risk of regulatory and/or tax arbitrage.

We disagree that the anecdotes and references to offshore jurisdictional examples (Montei dei Paschi di Siena (#33) and Banco Popular (#35)) should be used in support of the RBNZs case for change. Although we recognise there are limited case studies in which the behaviour of contingent debt when a bank has failed can be observed, making comparisons to isolated cases could be misleading due to differences in taxation rules, local laws & prudential definitions. These factors, amongst others, can all impact outcomes even if standards are applied in the same way.

We disagree with the focus placed on the banks structured as mutual societies and the potential disadvantageous position they are placed in due to an inability to issue contingent debt that includes conversion (#132). As a percentage of the market, this sector represents a very small segment and should not add weight to the argument for reform.

The references made to the pricing dynamics and possible mis-selling of existing bank capital instruments are considered outside of scope for this review (#112 & #137). This area of focus should reside with the conduct regulator (Financial Markets Authority).

We would also challenge the contention that these bank capital instruments (#181) may be mistakenly viewed by, and therefore inappropriate for, retail investors. Typically, bank capital exposures constitute a small allocation in a diversified portfolio. These instruments are offered for investment through, and by, regulated Authorised Financial Advisers (i.e. not sold via over the counter environments such as bank branches and hence, not mistakenly viewed as deposit like) and any investment decisions of retail investors are backed by comprehensive research. Further, the FMA has had significant input into the marketing and selling of these instruments, including prominent disclaimers and has deemed each of the offers as appropriate. Over time, both adviser and retail investors have developed a comprehensive understanding of these bank capital instruments that are on issue in the New Zealand market.

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

We believe a periodic review such as this is an important process in the development of the capital markets. The areas of reform that we deem necessary are:

- a. Dimension 3 (Non-viability triggers), the features of which are already encapsulated within existing OBR regulations.
- b. Dimension 5 (Recognition of tax effects). The detail specified in #206 is a possible solution as is only allowing a 72% deductibility of write down costs of any contingent debt (assuming a 28% corporate tax rate).

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

At this juncture we have no issues with increased transparency or drafting reforms – however we will reserve judgement and not provide further comment until the proposed public consultation has been published and circulated.

**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?

No

**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?

No

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

No, our preference is for Option 1 (Status Quo) with an addendum that we are comfortable that a review is conducted on the taxation rules that impact contingent debt instruments issued in New Zealand.

We also believe that the retail market is comfortable with investing in existing AT1/Tier 2 instruments. These instruments typically offer the benefit of being issued in liquid tranche sizes and are generally well understood by advisers and investors alike. It also provides issuers with a more diversified funding base. Having a range of investment options from different issuers for investors is an important element of developing and maintaining depth in New Zealand’s debt capital markets, and AT1/Tier 2 instruments are an essential part of this.

We envisage that the demand profile for preference shares would be impeded on the basis that they are non-redeemable and have more equity like features than existing AT1 products. This would be the case for both wholesale and retail investors and would likely see an increase in costs for issuers and reduced demand.

An additional consequence of the proposed changes to the regime will be the likely higher costs of capital faced by the issuing banks. Undoubtedly a portion (if not all) would be passed on to other parts of the business via transfer pricing and to external counterparties.

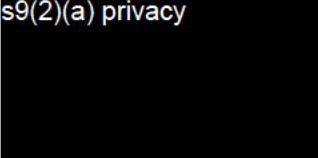
The implications of these increased charges would further dis-incentivise secondary trading books to hold inventory on balance sheet. These secondary trading books are an essential part of the debt security market, assisting in the facilitation of deal flow and liquidity, enabling investors to enter and exit positions efficiently. A further erosion of this practice to provide price support would be detrimental to the capital markets as a whole and may result in the inability complete primary issues, especially in products that have more equity like features such as non-redeemable preference shares.

Overall, we believe the changes proposed to the current regime that is well defined, has had close oversight by the market regulator and is working well for both issuers and investors, are highly likely to undermine confidence of both investors and issuers in the New Zealand capital markets. Accordingly, in the absence of any compelling evidence, we favour the Status Quo.

Thank you for the opportunity to present our submission.

Yours sincerely

s9(2)(a) privacy



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