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Ian Woolford
Manager, Financial Policy
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WELLINGTON

By email: capitalreview@rbnz.govt.nz

Dear Ian

SUBMISSION ON CAPITAL REVIEW PAPER 2:

What should qualify as bank capital? Issues and Options

We welcome the opportunity to submit on the Issues Paper referred to above (dated July 2017). Consistent with our submission on the earlier May 2017 Issues Paper, we have largely limited this submission to our views on those areas in which we believe that we have particular experience. These primarily relate to comments on several key specific features on the instruments proposed, with the objective of capitalising on market familiarity with existing securities whilst maintaining a level playing field.

In addition, we have made several broad-based observations of other aspects of the proposed reforms, and on some of the context within the Issues Paper.

As background, Forsyth Barr has been an active participant in the Additional Tier 1 and Tier 2 public market over recent years, both in relation to syndicate roles on primary offers and secondary market trading. As such, we believe that we are well positioned to provide feedback on the subjects at hand from a markets-based viewpoint.

In summary, our key points are:

- we strongly recommend that the redemption mechanism is kept for the preference share option, on the basis that the protections placed around such redemption will be sufficient to maintain the capital quality of preference shares. This will improve the feasibility of this type of instrument, and help to achieve the Reserve Bank's objective of creating a more level playing field;
- we also strongly recommend that the form of permitted Tier 2 capital be consistent with the term structure of current regime (i.e., 10 year term, with call no earlier than 5 years). Similar to the point above, this will improve the feasibility of the instrument, create a level playing field, whilst also ensuring a smooth transition from the existing regime;
- more generally, we submit that any decisions regarding the capital adequacy framework should also have regard to the role of regulatory capital in the wider market and economy;

- domestic banks have become more reliant on offshore funding, which is acknowledged as a key risk of the New Zealand financial system. Any changes to the definition of regulatory capital that contributes to this increasing reliance should be considered in this context; and
- the development of the regulatory capital market has played an important role in the local capital market. The Government has a *Building Capital Markets* work stream in its *Business Growth Agenda*, and the progress of the regulatory capital market has assisted in improving our public capital market. The proposed reforms are likely to have a material adverse effect on the public capital market.

Redemption features in preference shares

We strongly recommend that the redemption mechanism permitted under the current regime be maintained for preference shares. We do not believe that such a feature weakens the capital qualities of this class of capital for the following reasons:

- protections could be placed around the redemption similar to current call options – ie, the redemption would be subject to RBNZ approval and only permitted if the instrument is replaced with a capital instrument of the same or better quality (unless the bank can demonstrate that its capital position is sufficiently above the minimum capital requirements after repayment);
- with the above protections, such preference share funding would fundamentally be perpetual in nature, with the periodic redemptions allowing for a recycling of the underlying investors and pricing;
- we expect that issuers would incorporate a replacement issue with any RBNZ redemption application, as this is relatively common across both financial and non-financial subordinated regimes; and
- we note that whilst pre-GFC preference shares were not redeemable (as defined in the Companies Act), these issues effectively incorporated an equivalent feature via buy-out provisions within the wider banking group. We believe that having a redemption feature at the issuer level represents a superior "cleaner" alternative, avoiding additional complexity and maintaining integrity of the instrument.

Accordingly, we propose that "appropriately configured preference shares" include the ability for redemption at the option of the issuer after five years, subject to the redemption requirements of the current regime. We believe that this feature is critically important for the saleability of such instruments to the market, and its absence would have wider "level playing field" ramifications (as outlined below).

Investors are likely to be wary of perpetual securities with a fixed rate/margin, and no redemption/margin reset feature. Such securities will be vulnerable to changes in pricing levels over time, with limited liquidity events. For example, global credit markets are currently at historically low levels post-GFC, so any new issue of the above securities at this time is unlikely to be positively received by either retail or institutional investors.

Form of subordinated debt to qualify as Tier 2 capital

We note the paper's reference to "*appropriately configured long-term subordinated debt*" as qualifying as Tier 2 capital, with the specific requirements of Tier 2 instruments to be developed during a later stage of the Capital Review.

We strongly recommend that the detailed form of subordinated debt follows as closely as possible the currently permitted structures to allow for a smooth transition to the new regime and leverage off investor and market familiarity with the current instruments. In particular:

- the current “5+5” structure has been well established for many years (going back to pre-Basel 3 period) and as such is well understood by investors and the market. Accordingly, we believe that there are continuity benefits to retaining this term profile; and
- a significant departure from this structure would jeopardise the feasibility of such instruments within the NZ market, and would be inconsistent with the RBNZ’s objective of having a more level playing field between offshore-owned and domestic banks (as outlined below).

Level playing field

The Capital Review Paper states that a “more level playing field” is an objective for the reforms. We believe that the above two matters are of critical importance in achieving this objective.

The ability of domestically funded banks to access market funding will depend on being able to offer an acceptable capital instrument to the market. Based on previous issues, we believe that investors will accept perpetual preference shares if they have periodic redemption events and pricing resets, and long dated subordinated debt consistent with current Tier 2 bonds (10 year term, call at 5 years).

If the reforms result in capital instruments which are either unacceptable to investors, or only acceptable at a prohibitive price to the issuer, then this will effectively mean that offshore owned banks will continue to have access to forms of capital which are not available to all NZ registered banks.

Wider financial stability considerations

In a more general sense, the proposed elimination of non-viability represents a significant departure from the globally accepted form of capital instruments. As highlighted in the Issues Paper, the majority of our banking system has Australian-based parents, and these banks prefer the two countries’ requirements to be aligned. We expect that the elimination of non-viability will likely result in no capital issuance from NZ subsidiaries. Our understanding is that the Australian parent will have little to no interest in the subsidiary issuing a capital security that provides no capital recognition at the group level.

This will reduce the standalone nature of the NZ subsidiaries, as all this capital will come from the wider group, making the subsidiaries more dependent on parental support. We suggest that this is a negative development for the robustness of our banking system.

Further, this is also likely to further increase the dependence of our banking system on offshore funding sources (via the parents). The Reserve Bank identified bank funding pressures as being one of the three key risks to New Zealand’s financial system in its most recent Financial Stability Report. It noted that banks have become more reliant on offshore funding, and that this has exposed them to international risks that could significantly increase the cost of funding or reduce its availability.

In addition, credit rating agencies highlight the risks associated with New Zealand banks’ reliance on offshore funding markets, and note this as being a weakness of our financial system. Greater reliance on offshore funding could reduce the credit ratings of domestic banks and, in turn, increase their funding costs. Any changes to the capital market framework which could result in lower domestic/higher offshore capital funding flows would further contribute to the current negative trend.

We note that it appears that the big 4 banks can still issue directly out of the parent under APRA supervision, consistent with a group funding strategy. However, such raisings are likely to be completely separate from the NZ subsidiary, with no guarantee that the funds would even flow back into domestic investments.

Accordingly, whilst we acknowledge the rationale for the proposed reforms, such decisions should be made in full recognition of their significant flow-on affects on the wider banking system and its stability, particularly given our banks' dependence on offshore funding and the NZ market's relative size in the global market.

Stand alone considerations for local banks

It is generally accepted that New Zealand's financial system is less diversified relative to peer countries. We have a concentration of a few large institutions, all with Australian parents. As the Reserve Bank has indicated, whilst the implicit support of the parent banks is valuable for the New Zealand banking or financial system, it is also a vulnerability, and it is important that our banks be seen as strong on a stand alone basis in order to maintain their international standing.

The proposed reforms are likely to reduce the ability for our banks to raise regulatory capital in their own right and will increase the dependence on their parents, and accordingly reduce their stand alone international standing.

Accordingly, the review should also consider the wider impact on the funding of our local banks, their competitiveness relative to offshore owned entities, and their standing in the international markets.

Importance of bank regulatory capital to the local capital market

We disagree with the assertion in the Issues Paper regarding the contribution of bank instruments to local investors. Whilst the NZ$3 billion of AT1 and Tier 2 Capital securities issued in the past 3 years is relatively small in relation to bank deposits, we submit that a more meaningful benchmark is the listed capital market. 2014–16 represented a period of high volumes of new debt issues on the NZX Debt Market, with an overall total of ~NZ$10 billion. Bank instruments have represented around 30% of this total, and accordingly have formed an important part of the local capital market.

These instruments have allowed domestic investors to gain a quasi-equity exposure to the banking sector, with the commensurate risk and return profile. This exposure has been valuable to local investors, particularly given the general shortage of listed equity opportunities in locally incorporated banks.

Further, these types of instruments have provided retail investors with a broader range of quality investment products. Note that lack of such variety was considered to be one of the key weaknesses by the Capital Market Development Taskforce in its study of New Zealand's capital markets.

As evidenced by the *Building Capital Markets* work stream within the Government's *Business Growth Agenda*, well functioning capital markets are considered to be essential for strong economic growth. They are vital for ensuring that New Zealand businesses can respond to opportunities and grow the economy.

In addition, regulatory capital issues have allowed locally incorporated banks to maintain a more efficient capital structure. This is likely to have flowed through to a lower cost of capital, for both lenders and borrowers alike. A bank funded solely by Common Equity Tier 1 capital will have a much less efficient balance sheet and higher cost of capital, and this is likely to adversely affect borrowers and the wider economy.

The market and its participants have also invested significantly in understanding these instruments, which have principally been sold via advised channels. Due to Customer Due Diligence considerations, all of the major capital transactions have been sold via intermediaries through firm allocations with no public pool. Financial advisors with AFA qualifications under regulatory guidance from the Financial Market Authority ("FMA") have performed a significant role in the distribution of these securities.

This process has been assisted by the consistency in structure and terms demonstrated across these deals since the GFC. In addition, the FMA has also been active in overseeing the market, including the production of guidance notes to further assist understanding. We believe that a significant change to these terms will be negative for the local capital market, and the significant work to date by both market participants and regulators in further understanding of this segment will be lost.

Offshore examples

The Issues Paper describes in significant detail recent developments regarding two banks in the European banking sector (being Monte dei Paschi di Siena and Banco Popular). Given significant differences in jurisdictions and markets, we submit that care must be taken in relation to applying these offshore events to the NZ market.

In particular, we note above that the selling of these securities in NZ has been monitored by the FMA, whilst the standard offer structure employed in the NZ market has meant that offers have generally lacked a public pool. Accordingly, we believe that the Monte dei Paschi di Siena example may be of limited relevance to NZ.

In addition, the view that the ability of contingent debt to absorb losses may be compromised by government bailout is arguably even more pronounced in the event of implementation of an OBR process. We note that a capital issue will typically involve a few thousand mostly advised investors, whereas a wider OBR process for a large bank will likely involve several hundred thousand depositors, many of whom will not have received any advice.

If you have any questions regarding the feedback provided in this letter, please feel free to contact either of the undersigned.

Yours sincerely
Forsyth Barr Limited

s9(2)(a) privacy [redacted]

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