A/Prof Martien Lubberink
Victoria University
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September 8, 2017

Ian Woolford
Prudential Supervision Department
Reserve Bank of New Zealand
PO Box 2498
Wellington 6140

Dear Ian,

I appreciate the opportunity to provide feedback on the second capital review paper.

Please see my accompanying comments. These should replace the ones that I sent on the first of September – I eliminated some typos.

The Reserve Bank seems to attempt to go it alone in pursuit of imaginary perfection. However, the Basel III framework offers much more solutions than the Review Paper suggests.

I am in favour of augmenting the ratio requirements. This requires minimal use of resources and maximizes effectiveness.

Please let me know if you have any questions,

Kind regards,

Martien

Kind regards,

Martien Lubberink

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

Martien Lubberink, Associate Professor, VUW

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

The contextual information presented in Part A deserves further attention:

1. **Instruments are only a subset of capital.** Paragraph 5 states that regulatory bank capital refers to financial instruments that are recognised under the policies of the regulator as bank capital. This is true, but only partially so. Regulatory bank capital includes positive elements (such as capital instruments, their associated premiums, retained earnings, accumulated other comprehensive income and other disclosed reserves, and minority interests that meet specific criteria), as well as negative items: the deductions from capital (prudential filters).

   For some banks, non-instrument items, such as retained earnings, form the dominant part of regulatory capital. Current definitions of capital in force cover the substance of paragraphs 11-15. See for example the definition of capital of Basel III, which includes retained earnings as part of CET1. Rendering these ineligible as bank capital would affect the viability of banks that rely on retained earnings.

2. **To curb unintended structuring, a definition of regulatory bank capital should be comprehensive and rigorous.** Paragraph 8 appears to take ordinary shares for granted: "The contractual features of ordinary shares are well established, as this form of corporate structure has a long history." This is a simplification. Banks will attempt to create capital instruments that qualify as equity under prudential rules, IFRS, and for credit rating agencies – and qualify as debt for tax reasons. To mitigate the risk of pseudo equity instruments entering the market, the RBNZ could learn from the European definition of capital. Articles 26-29 of the CRR use over 2,000 words to define CET1 instruments (EC, 2013b). The EC uses such an elaborate definition to prevent unwelcome structuring.

   Regulatory adjustments (prudential filters) address most of the subjectivity resulting from the accounting. Regarding paragraph 13, see BS2A Part 2 subsections 7.(3), 8.(2)(d), 9.(2)(e), and 10. Some jurisdictions even apply prudential valuations to ensure that the solvency of institutions is not presented as being better than it actually is in consideration of prudential aspects. See Articles 34 and 105 of the CRR (EC, 2013b) and the RTS on prudent valuations (EBA, 2014). There is no need to solve accounting subjectivity via the definition of capital instruments.

3. **In practice, parent banks can transfer losses on capital instruments to outside investors efficiently and effectively.** Paragraph 126 mentions that "the New Zealand capital regime does not include the Australian parent entities in the New Zealand banking group for capital regulatory purposes. A capital instrument issued by a bank to its parent is thus recognised as capital. However, given the instrument transfers a potential loss from the bank to its parent, it is possible that transferring the loss to the parent will contribute to distress in the parent that in turn harms the New Zealand bank (i.e. the loss transfer may be ineffective)." It is unclear why this is a problem or whether the problem can be solved by removing Basel III compliant non-equity instruments from the definition of regulatory capital.

   The parent bank needs to fund the instruments that it holds in its subsidiaries. Equity is costly and funding with lower quality instruments would create double gearing, which is prudentially unsound. In practice, banks solve this problem by issuing equivalent instruments back-to-back: between subsidiary and parent and parent and outside investors.

   Elimination of Basel III compliant non-equity instruments from the New Zealand definition of capital will create similar issues: the parent banks will need to recapitalise the New Zealand subsidiaries and need funding for these CET1 injections. Funding capital injections with AT1 capital or lower quality instruments is prudentially unsound. As a consequence, parent banks will need additional equity funding to address RBNZs scepticism regarding intra-group instruments.

4. **Recent European cases show that non-equity capital instruments did absorb losses.** The contextual information of Part A shows a bias against the use of Basel III compliant non-equity capital instruments. This bias is not really justifiable. For example, the Deutsche bank incident of 2016 was due to an opinion of the European Banking Authority, which re-interpreted some bank capital rules. It is unclear why this incident is relevant for New Zealand banks.

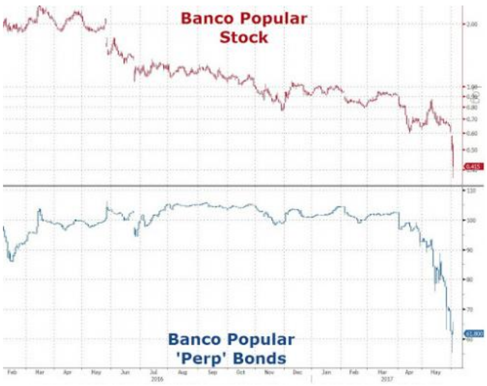
   Regarding the Mediterranean banks, none of the recent cases point to a flaw in the definition of Basel III compliant Additional Tier 1 and Tier 2 capital instruments. The Banco Popular case is not universally regarded as a failure, to the contrary. It is also unclear why the Review Paper claims that the capital instruments of Monte Dei Paschi did not absorb losses. The Monte dei Paschi case followed EU burden sharing rules: "junior bondholders and shareholders have contributed €4.3 billion, i.e. from the conversion of junior bonds into equity and the dilution of existing shareholders." (EC, 2017; Mesnard and Magnus, 2017; Sirletti, 2017)[1]

[1]The fact that retail junior bondholders who were victims of mis-selling can apply for compensation, does not imply that the instruments they held were not loss-absorbing. Loss absorption and compensation for mis-selling are two separate things. In a world where professional investors can insure themselves against the fallout of defaults, it is not unreasonable to offer retail investors a form of compensation for mis-selling.

Additional evidence that puts the recent European cases in a more positive perspective are Dombret (2017); Sandbu (2017); Worstall (2017), with a cautious remark from Danièle Nouy “I would say that we have passed the test.” (Nouy, 2017a).

Q1. Are there other contextual matters that have been overlooked in Part A?

Shareholders do lose out when a bank approaches non-viability. The idea of a “debt-induced bank collapse” (§54), seems a tad far-fetched, especially when approaching non-viability. See for example Barth et al. (2008), who show that for companies that suffer from a weakened credit standing, the gains on lower valued debt are more than offset by the losses on assets. The graph of Banco Popular below shows that shareholders lost out indeed:



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

The Basel III rules text and associated documents offer sufficient flexibility to address the problems that the Review Paper signals. The primary objective of regulatory capital is to absorb losses. Ensuring a national and international level playing field is important for a country that hosts foreign banks, joint stock banks, and non-joint stock banks. Other dimensions are of secondary order.

Regarding the problems regarding loss absorption in going concern (§185 – §193), see this comment of Danièle Nouy: “we have experienced significant supervisory issues with Additional Tier 1 instruments, more fit for gone concern purposes” (Nouy, 2017b). The Banco Popular case then illustrates what this entails: AT1 absorbs losses, but not necessarily in going concern. So what! Given that AT1 and Tier 2 instruments have demonstrated their ability to absorb losses in recent cases (whereas this was not common under pre-Basel III rules), this is insufficient to justify a major rewrite of the definition of capital.

The reforms with respect to the group definition and tax are practical problems that are not insurmountable.

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

My suggestion would be to redraft where necessary and regarding transparency adhere to the applicable Basel disclosure requirements (BCBS, 2012, 2017).

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?

Adhering to Basel III enables the RBNZ to achieve its prudential objectives, while at the same time establishing a national and international level playing field.

Having contributed to the Basel III definition of capital and several different definitions of capital for European banks and conglomerates (CEBS, 2009, 2010; EC, 2013b,a, 2014), I would be swayed by a more compelling case against the use of Basel III compliant capital instruments. Agreed, AT1 has disadvantages. However, investors, issuers, and regulators are learning to use them. According to Moody's 2016 CoCo Monitor there are over 300 AT1 instruments in issue. There are also dedicated indices that track prices and terms of listed capital instruments. A recent Reuters article shows that banks do not any longer take the first call of an AT1 instrument for granted (Gledhill, 2017).

There are benefits to sticking closely to Basel III. First, it solves many, if not all, of the problems identified by the Review Paper. See the main associated documents:

1. the rules text, with the main definitions of the three capital Tiers for joint stock banks and non-joint stock banks. Note that criterion 5 of the Basel III definition of AT1 protects permanence and loss-absorption: banks can only call an AT1 instrument when it is prudent to do so.

2. the non-viability press-release, which regulates the conversion and write-down at the point of non-viability,

3. the Basel III FAQs, which set the non-viability trigger at a pragmatic low level of 5 1/8% – thus rendering going concern triggers largely ineffective. The Banco Popular case then demonstrates that AT1 becomes loss absorbing in gone concern, which the Reserve Bank seems to want.

4. the disclosure requirements. These protect the use of terms such as 'CET1', 'AT1', 'Tier 2': "To enable market participants to compare the capital adequacy of banks across jurisdictions it is essential that banks disclose the full list of regulatory capital items and regulatory adjustments. In addition, to improve consistency and ease of use of disclosures relating to the composition of regulatory capital, and to mitigate the risk of inconsistent formats undermining the objective of enhanced disclosure, the Basel Committee

has agreed that internationally-active banks across Basel member jurisdictions will be required to publish their capital positions according to common templates."

The aforementioned Basel III documents set minimum requirements regarding the items that constitute regulatory capital and thus secure a level playing field.

An additional advantage of sticking closely to Basel III is that AT1 offers coupon cancelability. This enables a bank to absorb some losses in going concern.

Lastly, listed AT1 and Tier 2 instruments offer investors additional information about the performance of a bank, which is a clever solution if a bank has no shares listed – and dovetails with RBNZ's third supervision pillar on regulatory discipline (See the figure on page 3).

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

I encourage the Reserve Bank to abstain from developing its own definitions of capital, especially given that the Basel III definitions and implementations thereof are well-supported. See for example, the EBA single rulebook and aforementioned Basel FAQs. Moreover, it took the Basel committee with a team of specialists pooled from multiple countries from 2008 to 2012 to define capital. The Reserve Bank may spread its wings too thin by assuming that a resource-constrained supervisor can achieve a lasting outcome on its own.

Attempting to go it alone in pursuit of imaginary perfection is naive – it makes the Reserve Bank vulnerable to structuring efforts and unintended consequences, just what the Reserve Bank wants to avoid.

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?

I see no compelling case for reforms of the definition of capital. With an acceptable and internationally accepted definition of capital, a resource-constrained RBNZ should perhaps focus on increasing the quantity of capital.

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