NEW ZEALAND
BANKERS ASSOCIATION

Submission

to the

Reserve Bank of New Zealand

on the

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

8 September 2017

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About NZBA

1. NZBA works on behalf of the New Zealand banking industry in conjunction with its member banks. NZBA develops and promotes policy outcomes that contribute to a strong and stable banking system that benefits New Zealanders and the New Zealand economy.

2. The following sixteen registered banks in New Zealand are members of NZBA:
   - ANZ Bank New Zealand Limited
   - ASB Bank Limited
   - Bank of China (NZ) Limited
   - Bank of New Zealand
   - Bank of Tokyo-Mitsubishi, UFJ
   - Citibank, N.A.
   - The Co-operative Bank Limited
   - Heartland Bank Limited
   - The Hongkong and Shanghai Banking Corporation Limited
   - Industrial and Commercial Bank of China (New Zealand) Limited
   - JPMorgan Chase Bank, N.A.
   - Kiwibank Limited
   - Rabobank New Zealand Limited
   - SBS Bank
   - TSB Bank Limited
   - Westpac New Zealand Limited

Background

3. NZBA welcomes the opportunity to provide feedback to the Reserve Bank of New Zealand (**RBNZ**) on Capital Review Paper 2: What should qualify as bank capital? Issues and Options (**Issues Paper**) and acknowledges the work that has gone into developing the Issues Paper.

4. If you would like to discuss any aspect of the submission further, please contact:

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Introduction

5. NZBA does not consider that the Issues Paper establishes that there is good evidence supporting, or justification for, the removal of contingent debt instruments (ie Additional Tier 1 capital (**AT1**) and Tier 2 capital (**T2**), together, **contingent instruments** or **contingent debt**).

6. Rather than addressing the questions set out in the Issues Paper individually, NZBA's submission addresses and responds to RBNZ's context for reform, followed by each of the dimensions of reform.

7. NZBA notes that a group of our domestic cooperatively owned and community owned banks will be providing a separate submission addressing matters of specific relevance to them.

Comments on Part A: the context for reform

Basis for contingent instruments

8. The Issues Paper states that contingent debt instruments were accepted into the Basel III regime on the basis of theoretical arguments. This seems unlikely given the international weight of any decision to include contingent instruments as AT1. The better conclusion is that contingent instruments were accepted into the Basel III regime because there was sufficient evidence and academic consensus supporting the inclusion of contingent instruments as AT1.

9. RBNZ states that, in the absence of strong empirical evidence and academic consensus, regulators must make nuanced judgements as to the contribution contingent debt might realistically make, given local considerations.

10. NZBA considers that the same rationale should apply to any decision to depart from the Basel III standards due to local considerations. Therefore, in the absence of strong empirical evidence and academic consensus, RBNZ should not depart from the international consensus reflected in the Basel III standards. That is especially so given that departing from the Basel III standards would leave New Zealand's regulatory capital criteria inconsistent with the criteria in Australia. We note that RBNZ uses various foreign examples to support its departure from Basel III, and that limited consideration has been given to the impact of local considerations in such foreign cases.

Economic impact

11. The Issues Paper discounts the likelihood of wider economic implications in the event that the cost of capital increases on the basis that is a "private cost to banks" and may be "of secondary importance in determining the socially optimal mix of different types of capital". NZBA does not agree with that conclusion.

12. Given the significance of the changes proposed, we strongly recommend that RBNZ undertake a full analysis of the macroeconomic costs and benefits that the move towards increased common equity capital requirements would bring, including the impact on competition and lending capacity. We note, in particular, that:

    (a) The New Zealand banking system will always be highly reliant on offshore wholesale funding to meet its operational and regulatory capital requirements. The adoption of RBNZ's proposals has the potential to introduce a capital constraint to the New Zealand economy in addition to significant macroeconomic cost impacts through higher funding costs.

    (b) The increased cost in capital funding will likely be borne by New Zealand consumers and businesses to which New Zealand banks predominantly lend and / or by superannuation funds and other investors in the banking sector.

(c) The inclusion of contingent debt instruments in a bank's capital structure is consistent with the Basel III international framework and the adoption of those principles by the majority of international jurisdictions. RBNZ's proposals would bring significant uncertainty and undue complexity for international investors and may impact stability of international funding for New Zealand banks.

European examples

13. The Issues Paper points to two recent bank collapses in Italy and Spain as providing useful lessons on the performance of contingent debt instruments when banks suffer big losses.

14. However, the Issues Paper does not provide substantive discussion on the economic, political and legal context in which these failures took place so that any meaningful comparisons can be made against the New Zealand context:

(a) **Monte dei Paschi di Siena**: The Issues Paper does not explain why the authorities in Italy decided to bail out retail investors nor does it consider whether such intervention is likely in the New Zealand regulatory environment. For example:

(i) Did the disclosure documents for Monte dei Paschi di Siena include prescribed warning statements (of the type required in New Zealand)?

(ii) What was the method of distribution in Italy?

(iii) Were there other social or political factors at play that led to government intervention that are not present in New Zealand (in New Zealand the government has repeatedly said that it would not bail out a bank that was failing)?

(b) **Banco Popular**: The Issues Paper does not explain why the common equity trigger failed. For example, were the directors of the bank subject to continuous disclosure obligations of the type required in New Zealand? Additionally, the possible legal challenge referred to in the Issues Paper appears to relate to a valuation carried out by independent experts, rather than to the contingent debt issued by the bank. We also note that no claim has yet been made in the courts.

15. In addition, NZBA wishes to note that those banks failed at the tail-end of the Global Financial Crisis; they had been weak for several years as a result of poor economic growth, assistance had already been provided at various points prior to their collapse, and, ultimately, the losses were greater than could be offset by the conversion of the contingent instruments.

Effectiveness of trigger levels

16. The Issues Paper states that if a going-concern trigger for conversion or write off is set too low, contingent debt adds little value compared to simple subordinated debt and "has no prospect of restoring the bank to health". However, this argument overlooks a critical attribute of contingent debt: the ability to remove, through write off or conversion, a class of creditors that would otherwise need to be dealt with in a bank resolution. The removal of a class of subordinated creditors may be beneficial

during a resolution process (eg in a creditors' compromise) and recapitalisation is potentially easier as a result of the removal of equal or higher ranking subordinated liabilities.

Mum and dad investors

17. Citing the collapse of Monte dei Pachi di Siena as an example, the Issues Paper argues that contingent debt in New Zealand "may not absorb losses", because it will "be at least partly 'bailed out' by tax payers" because of the unwillingness of politicians to see losses borne by retail "mum and dad" investors. However, a bailout is significantly less likely in New Zealand than may be the case in the Italian context.

18. In particular, we note that:

    (a) OBR clearly provides that, in the event of a bank failure, creditors will be bailed-in, which would include holders of AT1 and T2 instruments of a failing bank.

    (b) The New Zealand government has made it clear that it would not bail out a bank in the event of failure, and has proven that it takes a robust approach to retail investor bail out (letting 43 out of 47 finance companies fail, with substantial loss to retail investors).

    (c) The disclosure regime for financial products is well regulated by Financial Markets Conduct Act 2013 (**FMCA**) and the Financial Markets Authority (**FMA**). In the Monte dei Paschi di Siena example, a key issue (and seemingly a key driver for the bail out) was the mis-selling of contingent instruments to retail investors. This should not be an issue under the New Zealand regime. If it were an issue, this should be addressed by the FMA, rather than as a by-product of prudential capital review.

19. The Issues Paper comments that, in contrast to offshore experience, wholesale investors have not tended to invest in contingent debt products issued by New Zealand banks. This is not entirely correct; participation by wholesale investors has occurred over time.

Signalling effect

20. The Issues Paper states that a contingent debt trigger event could signal distress to the market, and references a possible cessation of coupon payments by Deutsche Bank as an example.

21. NZBA considers that signalling is a positive as it encourages greater transparency (eg through NZX or ASX continuous disclosure) and makes it more likely that the relevant trigger would operate at the intended time.

Appeal of contingent debt

22. The Issues Paper states that it is generally accepted that the primary appeal of contingent debt is its attractive tax treatment relative to equity.

23. NZBA considers that is a generalisation. Banks prefer to issue different types of capital instruments for a variety of reasons, including relative cost and appeal to investors. Additionally, contingent debt has been an effective means of deepening

capital pools and providing additional market disciplines through secondary market pricing.

24. We understand that RBNZ's concern is not with the tax outcome per se but rather with how it perceives that tax ruling process (administered by the Inland Revenue (**IRD**)) has evolved over time. The primary concern appears to be whether all of the salient matters regarding the tax consequences of the relevant AT1 or Tier 2 instrument are adequately captured in the ruling issued by IRD for RBNZ's purpose. This could be dealt with by simply detailing all items that must be covered by the IRD ruling.

25. NZBA does not agree with RBNZ's perspectives on the tax treatment of capital instruments, as explained in the submission prepared by Chapman Tripp (on behalf of NZBA) in response to the Issues Paper – Review of the Capital Adequacy Framework for Locally Incorporated Banks (**Appendix One** to this submission).

26. Additionally, NZBA commissioned PwC to undertake an international comparison of New Zealand's tax treatment of contingent instruments against Australia, Canada, Hong Kong, Japan, Singapore, UK and US (**Appendix Two** to this submission). The report concluded that New Zealand's tax position is not out of step with those jurisdictions in relation to contingent instruments. Notably, PwC also concluded that banking regulators in other participating jurisdictions do not appear to have raised concerns regarding the potential tax consequences of conversion or write off upon a trigger event.

27. NZBA wishes to note that it supports neutrality regarding application of a tax haircut for capital instruments for all New Zealand banks. Not all banks in New Zealand are able to issue convertible instruments, and so issuing write off only instruments is the only option to source external capital for those banks (at 72% recognition only). While NZBA recognises that this would represent a change in approach, allowing 100% capital recognition for write off instruments would allow this to occur.

Issuance of convertible instruments

28. The Issues Paper states that Australia and New Zealand are the dominant countries issuing contingent debt that includes conversion.

29. NZBA notes that contingent debt is also widely issued in the United Kingdom and Europe (according to Moody's 2016 CoCo Monitor there are over 300 AT1 instruments on issue), and that the Issues Paper does not consider the particular legal, tax and/or regulatory consequences in other countries of issuing write off only contingent debt instruments which may explain differences in approach.

Regulatory arbitrage

30. The Issues Paper also refers to the possibility of regulatory arbitrage on the basis that an instrument can be treated as debt for tax purposes but as capital for regulatory purposes. In fact, there is no such tension. New Zealand's tax laws contain a broad definition of debt (generally treating as debt any instrument that is debt according to general law) rather than the more nuanced functional definition used in the regulatory capital context. Additionally, the tax rules around debt and capital are long-standing, well understood, and have a high degree of certainty.

31. New Zealand's tax laws also contain measures to prevent the deduction of excessive amounts of interest expenditure. It is therefore neither necessary nor appropriate for bank capital requirements to be driven by tax policy considerations that are already addressed under the tax laws. For the bank capital requirements to, in effect, cut across those measures in the tax laws would create harmful economic distortions.

RBNZ's approach to capital matters

32. The Issues Paper states that overseeing instrument compliance is a resource-intensive process for any regulator, and that the complex and opaque nature of convertible instruments has required a disproportionate call on prudential resources. That is particularly so given RBNZ's deliberately conservative approach to capital matters.

33. In early May 2017, the International Monetary Fund released its findings from its Financial Sector Assessment Programme which was undertaken in 2016. One of the key recommendations put forward was increased resources specifically for the supervision and regulation of banks, insurance companies and financial market infrastructures.

34. We note that the Issues Paper does not propose the adoption of this recommendation as a means of addressing its concerns. We would be concerned if the cost / benefit analysis of increased resourcing for supervision of regulatory capital was not encapsulated as part of this capital review or if RBNZ resourcing constraints were unduly influencing the capital review's outcome. If RBNZ feels itself under-resourced to analyse these instruments, one option would be to take a similar approach to the IRD binding rulings process.

Trans-Tasman context

35. Any inconsistency between tax jurisdictions is an issue for each country's taxation authority. These inconsistencies do not impact on the quality of contingent instruments.

Recognition of tax liabilities

36. The Issues Paper states that it appears the requirement to recognise potential tax liabilities may not always have been fully complied with in practice.

37. NZBA does not agree. The RBNZ capital rules expressly state that the potential tax liabilities should be based on the contractually intended loss-absorption mechanism, rather than the potential write off required if conversion did not occur as expected. Potential tax liabilities have been calculated on this basis, as required by the RBNZ capital rules.

Complexity and uncertainty

38. The Issues Paper states that, for capital issued by the Australian owned banks, conversion has introduced two governing jurisdictions applying to a single contract, adding complexity and arguably uncertainty to the regime. In fact, it is not unusual for different provisions of a contract to be governed by the laws of different jurisdictions and such provisions do not result in complexity or uncertainty. In contracts governing capital issuance it is very clear which law governs the loss

absorbing provisions. Legal opinions are obtained by RBNZ from Australia and New Zealand counsel regarding the effectiveness of the contracts which should mitigate RBNZ's concerns.

Preference shares

39. The Issues Paper outlines RBNZ's concerns regarding preference shares. It states that there is uncertainty about the means to give effect to a legal write off of a preference share and that the write off mechanism has not been tested in the courts. While the write off mechanism (mandatory redemption for no or nominal consideration) has not been tested in the courts, it is based on conventional legal principles. NZBA does not agree with RBNZ's statement that redemption cannot be caused by a trigger event; the specified date can be the date on which the non-viability trigger event occurs. In any case, it is possible to include a secondary write off mechanism to remove any residual uncertainty. That secondary write off mechanism would operate in the manner contemplated by the existing RBNZ capital rules, with the shares remaining on issue but all rights of the preference shares (other than the right to receive a nominal amount in a liquidation) effectively terminated.

40. Additionally, the Issues Paper states that preference shares are able to be redeemed after five years. However, it does not mention that the RBNZ capital rules require any redemption to be subject to the approval of RBNZ. This approval requirement means the possibility of early redemption does not weaken the capital qualities of preference shares. In fact, early redemption can have positive effects, if a capital instrument is able to be replaced with another instrument on more favourable terms.

Issuance of contingent debt to parent entities

41. The Issues Paper states that the apparent substitution of AT1 contingent debt issued to parent entities for common equity is of concern for a number of reasons. First, the Issues Paper states that contingent debt with a 5.125% CET1 trigger "seems in practice likely" to absorb losses only once the bank has become non-viable. This assertion is based apparently on one example (Banco Popular, discussed above at [14(b)]). However, even if a bank has become non-viable, the conversion or write off of subordinated debt and preference shares would improve the likelihood of recapitalising the bank.

42. Secondly, the Issues Paper states that the availability and value of contingent debt may be subject to legal challenge. The risk of a legal challenge arising if an entity (bank or corporate) fails is always going to be high. If people lose money (whether equity, debt or another claim) they will be interested in pursuing all remedies to get it back. The recent Feltex litigation (where holders of ordinary shares have taken legal action following the insolvency of the company) shows that this risk can arise for common equity.

Comments on Part B: reform proposals

Overview

43. NZBA considers that RBNZ should continue to allow AT1/T2 capital instruments that satisfy both RBNZ and APRA criteria. Under the RBNZ's proposals, New Zealand subsidiaries of Australian banks are highly unlikely to issue AT1/T2 capital

instruments externally as these instruments would not meet both APRA and RBNZ criteria. This removes a valuable source of regulatory capital. For example, Australian owned banks would become solely reliant on their parents for capital, which NZBA sees as counter to recent Trans-Tasman funding arrangements imposed by APRA and contravenes RBNZ's principle that banks are self-reliant. In addition, and perhaps more critically, New Zealand banks will become more exposed to the decisions of the parent bank which could potentially have broad consequences for New Zealand.

44. Alternatively, if RBNZ pursues Option 4, NZBA considers that it should continue to recognise existing AT1/T2 instruments until their first call date (at which point they would no longer qualify as capital). NZBA considers that approach is preferable (compared to the RBNZ proposal of a five-year phase-out) as the existing AT1/T2 instruments have been issued in good faith and at considerable cost under Basel III rules that are still relatively new. Additionally, the existing AT1/T2 instruments continue to provide strong loss absorbency and we see no reason to disqualify these instruments prior to their first call date.

45. NZBA considers that banks should be able to rely on regulations being effective throughout the expected life of each transaction, unless there are exceptional reasons to change. In our view, no such exceptional reasons exist here.

46. Finally, NZBA queries whether RBNZ has sought comment from the major rating agencies on the potential implications of Option 4 on ratings of New Zealand banks. We understand that each rating agency has its own method of determining capital adequacy and the change proposed by RBNZ could have significant impacts on those calculations, and therefore on the New Zealand banking industry's reputation internationally.

Dimension one: preference shares

47. NZBA considers that redeemable preference shares should continue to be treated as capital. Redemption would continue to be subject to RBNZ's approval and the bank having an appropriately strong level of capital. NZBA considers that the market would recognise that preference shares are a potentially permanent form of capital and having a redeemable option would not diminish this perception. Perpetual preference shares would not be marketable.

48. The removal of contingent preference shares would mean that domestic banks would struggle to grow and access capital. That is because there is a limited market for perpetual preference shares; the inability to redeem would lessen competition and therefore limit access to capital, which in turn affects economic growth.

49. Although the write off mechanism is untested by the courts the mechanism is based on conventional legal principles. In any case it is possible to include a secondary write off mechanism that effectively terminates preferential rights rather than redeeming the shares. See our comments at [39].

50. A potential benefit of contingent preference shares is that a class of preferential claimants is able to be removed (by either conversion or write off) and so do not need to be dealt with in a resolution.

51. NZBA considers that there is an extremely low risk of retail investors mistakenly viewing preference shares as deposit-like. New Zealand's securities laws require prescribed warning statements to be included in offer documents, including the

warning "This investment is riskier than a bank deposit" on the front cover. NZBA notes the extensive engagements banks have had with the FMA in ensuring this message is clearly articulated in all offer documentation and intermediary and investor engagements. This recognises that the FMCA regime has sought to address such concerns.

Dimension 2: "going concern" triggers

52. NZBA does not support the removal of going concern triggers on the basis that they are not detrimental to loss absorption. Even if there was doubt as to whether contingent debt with a going concern trigger would be effective in all cases to absorb losses on a going concern basis (prior to the point of non-viability) an instrument with such a trigger would be more likely to do so than an instrument with no trigger at all. And an instrument with no such trigger may present a barrier to recapitalising the bank if new investors were concerned by the liabilities or claims represented by the AT1 and T2 instruments remaining outstanding.

53. The conclusion that “the potential for contingent debt to absorb losses on a going-concern basis (ie when a bank remains viable) appears limited” is based on one example only. It does not necessarily follow that the same thing would happen in New Zealand, noting the strength of NZ bank balance sheets represented by sound asset quality, strong funding liquidity and capital position of NZ banks.

Dimension 3: non-viability triggers

54. As above, NZBA does not support the removal of non-viability triggers on the basis that they are not detrimental to loss absorption. In addition, a potential benefit of contingent subordinated debt is that a class of creditors is able to be removed and so does not need to be dealt with in a resolution. See our comments at [16].

55. Investors in contingent subordinated debt will rank behind shareholders only if the loss-absorption occurs via a write off. If loss-absorption occurs via conversion, then investors will rank equally with shareholders.

Dimension 4: conversion

56. NZBA does not support the removal of contingent debt from the regulatory regime and we query whether a balanced view of the apparent complexity and uncertainty of conversion has been presented, given that RBNZ’s preferred approach would bring its own complexities and uncertainties and involve a significant departure from the international norms reflected in the Basel III standards. See our comments at [38].

57. Additionally, the (perceived) complexity of conversion must be balanced against the need to access a diverse pool of investors, and the potential risks of not being able to do so.

Dimension 5: recognition of tax effects

58. The RBNZ capital rules are quite clear in that only the tax consequences of the contractually intended method of loss-absorption need to be taken into account. It is not accurate to state that banks have argued "that a less conservative interpretation than the stated policy intent is possible".

Dimension 6: defining the banking group

59. The Issues Paper states that instruments can only be loss absorbing if they are issued to parties that are economically independent from the bank. However, it does not recognise that SPVs may be formed by a bank's owners rather than by the bank itself and that it is possible for an SPV to be economically independent from the bank.

60. Additionally, NZBA does not understand RBNZ's concerns with shareholders suffering the loss (through a capital instrument) if a bank incurs losses.

Transparency

61. NZBA does not support the proposals at [215]-[219] of the Issues Paper. NZBA does not consider that this information would be useful to potential investors as it is highly technical. AT1/T2 offer documents include, among other things, warning statements, 'plain English' explanations of the structure, and summaries of the Terms of the Notes, as required by the FMCA and NZX and FMA requirements.

62. Additionally, legal opinions form part of the suite of documents underpinning each transaction. They are provided to the banks' directors, regulators and joint lead managers regarding the validity and enforceability of the Deed Poll, and on the legislative and regulatory compliance of the disclosure documents. These opinions are for the benefit of the parties to whom they are addressed and cannot be relied upon by any other party. Including such legal opinions in a public depository may mislead investors.