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BANK CAPITAL REVIEW– SUBMISSION

1. This is the submission of Russell McVeagh on the "Capital Review Paper 2: What should qualify as bank capital? Issues and options".

2. Russell McVeagh has advised on all of the convertible instruments issued by New Zealand banks since the introduction of the Basel III standards. We also advise insurers on capital issuance.

3. Please contact Guy Lethbridge or Deemple Budhia if you have any questions regarding our submission.

Yours faithfully
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SCHEDULE

1. QUESTIONS RE PART A

1.1 We agree that contextual information is relevant for a definition of capital. However, we do not consider that the contextual information presented in Part A contains all of the information that should be considered for the purposes of this review. Our comments on the contextual information presented in Part A are set out below.

1.2 *European examples*: Contingent debt instruments are a relatively new form of capital and there are very few examples of these instruments being relied upon when a bank fails. Care needs to be taken before conclusions regarding the effectiveness of contingent debt instruments in New Zealand are made based on these limited offshore examples. For example, there may be significant legal, social, economic or political reasons which make comparisons between those offshore examples and New Zealand less meaningful.

1.3 *Impact on mutuals*: We agree that the impact of the capital definition on mutual societies is an important consideration. However, we do not think this consideration should be a prime reason for reform generally. Corporate structure is a choice for a bank and its owners; different structures carry different benefits and disadvantages. We suggest that consideration is given to developing a separate capital definition that applies to mutual societies, as has occurred in Australia (mutual equity interests) and the UK (core capital deferred shares).

1.4 *Effectiveness of trigger level*: The paper overlooks a key benefit 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. We think a recapitalisation of a failing bank is likely to be more successful if subordinated creditors have been removed, because:

(a) those creditors no longer have an ability to make demands or vote (eg in a compromise); and

(b) the bank's balance sheet is more attractive as a result of the extinguishment of the liabilities represented by the subordinated debt.

OBR is not able to achieve the same outcome with regard to subordinated debt as explicit loss absorption through write-off or conversion.

1.5 *Retail investors*: It is important that the capital review takes into account the regulatory settings that apply to the offer of contingent debt instruments to retail investors in New Zealand. In our view these settings reduce the likelihood that retail investors will expect to be bailed out by the Government if a bank fails. The paper does not recognise the disclosure requirements under the Financial Markets Conduct Act 2013 that apply to bank hybrid products. An offer document for contingent debt instruments to retail investors must include prescribed information explaining the nature of the instrument and the related risks. The offer documents must also include prominent warning statements. The distribution of bank hybrid products has also been tightly controlled by bank issuers: there has been no public pool and distribution has occurred via NZX firms and other approved intermediaries only. It has not been possible for instance, for retail investors to acquire convertible capital instruments at a branch of a bank.

1.6 *Signalling effect*: The paper does not recognise the positive signalling effect of continuous disclosure. An issuer of debt instruments that are quoted on NZX is subject to the continuous disclosure obligations of the NZX Listing Rules. Contingent debt instruments are more price sensitive than senior bonds, and so issuers of these instruments effectively are subject to enhanced disclosure obligations. A failure to comply with these continuous disclosure obligations can result in liability for the issuer and its directors. This is likely to lead to a more informed market if a bank is experiencing financial difficulty, and may increase the likelihood of a going concern trigger being effective.

1.7 *Appeal of contingent debt*: The paper does not recognise the existing tax settings that limit the overall level of interest deductions that a business can claim, such as thin capitalisation and transfer pricing rules. In our view, limitations on the deductibility of financing costs are a matter to be addressed by tax legislation taking into account the Government's desired policy settings, and should not be a factor driving the definition of regulatory capital.

1.8 *Definition of banking group*: Care needs to be taken about including all SPVs within the banking group. SPVs are formed for different purposes. For instance, an SPV that is formed by a bank's owners to assist it to raise funds to contribute as capital to a bank may not necessarily need to be included in the banking group. The effect the SPV has on the quality of capital should be assessed on a case by case basis.

1.9 *Complexity and uncertainty*: The paper states that for capital issued by the four big banks, conversion has introduced 2 governing jurisdictions applying to a single contract, adding complexity and arguably uncertainty to the regime (paragraphs 116 and 129). In our experience, it is not particularly unusual for different provisions of a contract to be governed by the laws of different jurisdictions, and such provisions typically do not result in complexity or uncertainty. In the contracts governing the capital issuance by the four big banks, it is very clear which law governs the loss absorbing provisions. Legal opinions are obtained by the Reserve Bank from Australia and New Zealand counsel regarding the effectiveness of the contracts, which can address the Reserve Bank's concerns.

1.10 *Preference shares:* The paper 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. We do not agree with the statement that redemption cannot be caused by a trigger event. Our view is that 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.

1.11 The paper states that preference shares are able to be redeemed after 5 years. The paper does not mention that the RBNZ capital rules require any redemption to be subject to the approval of the Reserve Bank. 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.

1.12 *Issuance of contingent debt to parent entities:* The paper states that the fiscal risk attached to common equity is arguably zero, unlike contingent debt. We query whether this statement is accurate. We think the fiscal risk (ie, of a government bailout) of contingent debt issued to a parent entity would be low, and that there is no reason to think the risk is higher in the case of contingent debt than in the case of common equity.

1.13 The 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 will always exist. 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. However, we think the risk of a legal challenge arising out of an issue to a parent entity is likely to be low.

2. QUESTIONS RE DIMENSIONS OF REFORM

2.1 We do not agree that the 6 "dimensions of reform" all in fact require reform.

Dimension 1 – Preference Shares

2.2 We have the following observations on the issues raised in paragraphs 177-184:

(a) Although the write-off mechanism is untested by the courts the mechanism is based on conventional legal principles. Many legal structures are untested by the courts but this does not mean those structures do not work. 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 in paragraph 1.10.

(b) 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. See our comments in paragraph 1.4.

(c) We think the fiscal risk that could arise from retail investors mistakenly viewing preference shares as deposit-like is low. 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.

Dimension 2 – "Going concern" triggers

2.3 We have the following observations on the issues raised in paragraphs 185-193:

(a) The conclusion that the potential for contingent debt to absorb losses appears limited is based on only one example. It is important to carefully consider how applicable that example is to New Zealand.

(b) Even if there were 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.

(c) We agree that a market-based trigger is not desirable. As the Reserve Bank notes, there is the risk of market prices being manipulated. In addition, it is unclear where the "market-based" information would be found as most registered banks in New Zealand do not have their equity quoted on a public exchange.

Dimension 3 – Non-viability triggers

2.4 Our observations on the issues raised in paragraphs 194-198 are as follows:

(a) 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 in paragraph 1.4.

(b) 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

2.5 Our observations on the issues raised in paragraphs 199-202 are as follows:

(a) We think it is important that the implications of departing from the Basel III standards are fully tested before a decision to do so is made. This is particularly important given the dominance in New Zealand's banking market of Australian owned banks. See our comments in paragraph 1.9.

(b) We query whether the concerns about an "uneven playing field" are a justification for removing convertible capital instruments. See our comments in paragraph 1.3.

Dimension 5 – Recognition of tax effects

2.6 Our observations on the issues raised in paragraphs 203-206 are as follows:

(a) 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. We do not think it is 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

2.7 Our observations on the issues raised in paragraphs 207-214 are as follows:

(a) We agree with the statement that accounts are prepared for the purpose of providing meaningful information for shareholders, which has a different purpose to prudential regulation.

(b) We do not agree that it "always makes sense" to have an SPV that raises capital for a bank inside the banking group. See our comments in paragraph 1.8.

3. QUESTION RE TRANSPARENCY AND DRAFTING CHANGES

3.1 We do not agree that these areas all in fact require reform.

3.2 For a retail offer of capital instruments, the legal documents under which the instruments are constituted are required to be publicly available on the Disclose register. For a wholesale offer (eg an issue to a parent entity), we query what benefit public disclosure would achieve. We do not think this disclosure would have any impact, for example, on fiscal risk or the risk of legal challenge. We query whether, in the context of capital instruments, public scrutiny would lead to increased regulatory compliance.

3.3 It is not correct that supporting legal opinions are currently publicly available under the covered bond policy. Nor do we think this would be helpful information for investors. To the extent legal risks exist, those risks should be disclosed to potential investors in the relevant offer documents (eg a PDS). A legal opinion addressing the requirements of BS16 is not likely to be in a form that is suitable for potential investors.

3.4 We do support drafting changes to the RBNZ capital rules so that they can be applied with certainty. See our comments in paragraph 4.1 below.

4. QUESTION RE DIMENSIONS OF REFORM

4.1 For the Reserve Bank's preferred "hands-off" approach to be successful, there must be certainty and predictability regarding the legal rules that apply to the interpretation of the RBNZ capital rules. This is not the case at present. We think it would be very helpful if the status of the RBNZ capital rules could be expressly stated (ie as subordinate legislation) so that there is then a clear understanding (by both the Reserve Bank and banks) as to how these rules are to be interpreted and applied.

5. QUESTION RE PROPOSED REFORMS

5.1 We do not agree that the proposed reform for each aspect of the capital definition is the most appropriate reform, for the reasons contained in this submission.

5.2 The paper states that the cost of capital will be discussed in a subsequent paper (paragraph 75). We think it would be preferable for the cost of capital is considered at the same time as the definition of capital instruments is being reviewed, not subsequent to decisions (or preferred approaches) on capital instruments being taken.

6. QUESTIONS RE OPTIONS 1 TO 5

6.1 We do not see any major flaws with the status quo and therefore consider Option 1 to be the best way forward.