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Westpac New Zealand Limited

Submission to the Reserve Bank of New Zealand on the Capital Review Paper 2: What should qualify as bank capital? Issues and Options

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1. INTRODUCTION

1.1 This submission to the Reserve Bank of New Zealand (**Reserve Bank**) is made on behalf of Westpac New Zealand Limited (**Westpac**) in respect of the *Capital Review Paper 2: What should qualify as bank capital? Issues and Options* **(Issues Paper).** Thank you for the opportunity to provide feedback. Please find our comments on the Issues Paper and specific responses to the questions raised.

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2. EXECUTIVE SUMMARY

2.1 We continue to support the review of the capital adequacy framework and acknowledge the intention of the Reserve Bank to introduce a framework built on the three pillars of "self, market and regulatory discipline".[1]

Do the Reserve Bank's proposals achieve its intended outcomes?

2.2 In our view, the Reserve Bank's current proposals for Additional Tier 1 and Tier 2 (**Proposed Framework**) do not support the Banks key objectives including the three pillars.[2]

2.3 The proposal is likely to require greater supervision from the Reserve Bank and is contrary to the principle of wanting a simpler, largely self-policing framework. This is because:

(a) Non-viability triggers are a powerful incentive for management to effectively manage a bank's risk profile and capital requirements given the consequences of these triggers being used.

(b) A framework based on Common Equity Tier One (**CET1**) incentivises a bank to increase its risk profile in order to achieve an adequate return on a greater level of common equity.

2.4 We therefore strongly encourage the Reserve Bank to consider these incentives in formulating any changes to the capital framework. Continuing to allow instruments with non-viability triggers also has the advantage of minimising unnecessary divergence from international standards.

[1] Grant Spencer: 'Banking Regulation – Where To From Here?'
[2] As set out in paragraph 167 of the Issues Paper

2.5 The areas we believe should be prioritised as part of the Reserve Bank's Capital Review are as follows:

(a) A full cost benefit analysis should be performed once the Reserve Bank has completed all aspects of its review taking into account the macroeconomic impact of the changes being considered.

(b) Consideration of the importance and benefit of point of non-viability (**PONV**) triggers in enforcing management and market discipline.

(c) Preference shares without conversion or write-off will inhibit the ability of a bank to be recapitalised.

Earlier submissions remain relevant

2.6 Per our previous consultation response, we continue to support the following principles:

(a) International harmonisation should be prioritised. Although, we recognise the Reserve Bank's view that New Zealand operates a simpler banking system, it is highly reliant on international markets for funding.

(b) Contingent instruments are loss absorbing capital. In our view, they are not legally complex or issued for the purpose of obtaining favourable tax benefits.

2.7 Our detailed submissions are set out below.

3. Current proposals do not achieve intended outcomes

Macroeconomic impact of changes must be considered

3.1 Given the significance of the changes proposed, and their potential impact to the New Zealand economy, Westpac strongly recommends that the Reserve Bank undertake a full analysis of the macroeconomic costs and benefits that changes to capital qualifying instruments and increases in the cost of capital (CET1 vs AT1) would bring, including the impact on competition and lending capacity. In Westpac's opinion:

(a) The New Zealand banking system will, for the foreseeable future, be highly reliant on offshore wholesale funding to meet its operational and regulatory capital requirements. The adoption of the Proposed Framework 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 inclusion of non-common equity capital (i.e. AT1 and Tier 2) 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. The Proposed Framework brings with it significant uncertainty and undue complexity for international investors and may impact stability of international funding for New Zealand banks.

(c) Given the scope of the Capital Review and the relative strength of the main New Zealand banks, Westpac would strongly discourage the Reserve Bank's approach to implementing changes on a 'rolling basis'. We consider that it is prudent to work through all aspects of the review before fixed policy decisions are made so the RBNZ, industry and the broader NZ economy can understand the potential impacts of what is being proposed; the potential increases in costs to both the banks and wider economy including any constraints on the availability of capital.

CET1 will increase risk and supervisory requirements

3.2 The proposed "no trigger regime" option is based on the premise that PONV triggers tend to be triggered too late and generate insufficient new equity to be of any real value. This is based on an observation of Banco Popular, a single primarily Spanish bank, with extensive long term non-performing loans, significantly in excess of provisions and capital. The point raised does not recognise the way in which PONV triggers create a powerful incentive for management to effectively manage its risk profile and capital requirements to avoid the consequential equity dilution and destruction of shareholder value. The recent speech from the Deputy Governor cites that "*giving boards and management the right incentives to act prudently is the first priority in our regulatory framework*"[3]. PONV triggers achieve this objective. Additionally under a going concern basis, we believe that an instrument that has a going concern trigger is more likely to be loss absorbing than an instrument with no trigger at all.

3.3 There is a risk that moving to a framework which is based solely on Common Equity Tier 1 (**CET1**) (which carries a higher cost) will create a framework that incentivises a bank to increase their risk profile as management seeks to ensure an adequate return is being achieved on the higher capital banks are forced to hold.

3.4 While this outcome should be managed by increased self-discipline on the part of bank management, a secondary consequence will be to require more active regulatory supervision. This would be required to identify and contain the kinds of tail risks that the history of financial crises has demonstrated tend to be overlooked by market discipline. On this basis, the system and incentives created by an excessive reliance on common equity would, in the long run, be contrary to the Reserve Bank's regulatory philosophy of self-discipline and market-discipline.

3.5 For Australian-owned New Zealand subsidiary banks, the Proposed Framework will place greater dependency on the Australian parent to ensure adequate capitalisation of its subsidiary. This is contrary to the Reserve Bank's objective of

[3] Mr Grant Spencer, Deputy Governor, Banking regulation – where to from here?

reducing reliance on Australian parent banks (for example, BS11 and its effect on the successful implementation of OBR). Additionally, wholly-owned subsidiary banks will no longer be able to seek Tier 1 capital investment (i.e. AT1) from third party investors.

Preference shares without redemption rights

3.6 Under existing Reserve Bank rules, any redemption of preference shares is subject to approval from the Reserve Bank. The write-off mechanism within such preference shares is well understood and based on conventional legal principles. Preference shares with no rights of redemption will be significantly less attractive to investors (as there will be no certainty of exit). This will consequently narrow the regulatory capital structure of banks towards common equity even further without substantively altering the protections already in place that prevent loss of value through redemption when a bank is in financial stress. Additionally, this effectively limits New Zealand bank recapitalisation to the current Australian parent.

Importance of contingent instruments in recapitalisation

3.7 The Proposed Framework (as outlined under Option 4) does not consider the role or importance of recapitalisation. The liability under a preference share, without the elements of conversion or write off, remains outstanding. This can be an impediment to bank recapitalisation in that the benefit of a conversion feature is its ability to remove unsatisfied claims that could otherwise inhibit the recapitalisation of the bank.

3.8 In paragraph 24, the Issues Paper makes reference to the loss absorption features of pre-GFC instruments and, in particular, the unwillingness of banks and regulators to trigger suspension of coupons due to adverse signalling effects (a number of instruments on issue in Europe are not paying coupons). In our view, the issue here was, and remains, not just the adverse signal but also the fact that suspending the dividend did not actually save very much capital. So the real value of the instrument was the fact that it absorbed losses before senior creditors and depositors. The value of the instrument was undermined by the fact that the instrument could only perform this function if the bank was insolvent and what the GFC revealed was that large financial institutions could not actually become insolvent without huge collateral damage to the economy.

3.9 Westpac does not see market signalling as an issue as in the event of a stress event, a “signal” to the market will have already been made through New Zealand’s NZX continuous disclosure requirements.

4. Additional areas for further consideration

Loss absorption qualities are commensurate with common equity

4.1 The Issues Paper challenges the loss absorbing effectiveness and value of contingent instruments, stating that:

(a) Contingent instruments with a PONV trigger would, in practice, only absorb losses once a bank becomes non-viable. This ignores the fact that a PONV trigger will mean that contingent debt absorbs losses in advance of common equity.

(b) The definition of the “banking group” is important from a capital regulation perspective as instruments can only be loss absorbing if they are issued to counter parties that are economically independent of the bank. However, this conclusion is contrary to it being well accepted that common equity (at least equity issued to a parent) is loss absorbing.

(c) A number of points may be subject to legal challenge in the event of a bank failure. In the example of Banco Popular, bondholders and shareholders that incurred losses have threatened litigation in respect of the bank’s valuation (sale price to Santader of 1 euro). We note that no claim has yet been made. Insolvency events are often the subject of legal challenge by investors even outside of the banking industry (a recent example New Zealand being Feltex).

Fiscal risk is commensurate with common equity

4.2 The Issues Paper makes reference to “mum and dad” investors, noting that politicians may not wish to see losses imposed on them and that these losses may instead be borne by taxpayers. Any fiscal risk relating to contingent instruments is not materially higher than that for common equity. In particular, we note that:

(a) The New Zealand Government has made it clear that it would not bail out a bank in the event of failure. In New Zealand, the RBNZ has an OBR policy in place which aims to allow a distressed bank to be kept open for business, while placing the cost of a bank failure primarily on the bank’s shareholders and creditors (referred to as a “bail-in”), rather than the taxpayer (i.e. a “bail-out”).

(b) The disclosure regime for financial products is well regulated by Financial Markets Conduct Act 2013 and the Financial Markets Authority. In Italy the miss-selling of contingent instruments to retail investors that is being investigated is unlikely to 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.

Contingent instruments enable boards to retain value under stress

4.3 The Issues Paper does not give sufficient weight to the similarities between the contingent instruments and common equity in terms of a Board’s ability to retain value within a bank under financial stress. A Board has discretion to pay or not pay distributions, subject to requirements of the Companies Act 1993. The Issues Paper notes that a preference share entitles the holder to “fixed stream of income”[4]. However, that income is a distribution and is, therefore, subject to the same board discretions and Companies Act 1993 requirements. Similarly, under Basel III, the

[4] See paragraph 17 of the Issues Paper.

Board has absolute discretion to withhold the payment of income payable on contingent debt. Additionally, the Reserve Bank also controls discretionary distributions under the Capital Conservation Buffer (**CCB**) provisions. The CCB states that where a bank fails to maintain a common equity buffer ratio of 2.5% above regulatory minima, restrictions are imposed on the level of distributions it can make.

Contingent debt tax treatment

4.4 Westpac does not agree that AT1 and Tier 2 instruments are designed to give rise to more favourable tax treatment. They are designed to meet the relevant capital adequacy criteria, as efficiently as possible. Similarly, Westpac does not agree with any suggestion that issuing AT1 or Tier 2 convertible instruments to Australian residents provides a tax advantage / regulatory arbitrage to New Zealand banks (this point has been formally agreed with the New Zealand IRD). The tax treatment of the instruments is an important consideration for the pricing of the coupon attached to the instrument with the ability to obtain a tax deduction for the cost of AT1 and Tier 2 instruments being an output of the relevant tax legislation.

4.5 Based on discussions between Reserve Bank and the NZBA, we understand that the Reserve Bank'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 the Reserves Bank's purpose. This could easily be dealt with by simply detailing all items that must be covered by the IRD ruling.

New Zealand Banks are currently well capitalised when compared to global peer banks

4.6 In Westpac's view, New Zealand banks are already well capitalised when CET1 ratios are compared to global peers on an internationally harmonised basis. The New Zealand Bankers Association commissioned PWC to undertake an international comparability study of capital ratios for the key industry participants (ANZ, ASB, BNZ and Westpac) in order to formulate a view of New Zealand bank capitalisation on an internationally harmonised basis. PWC concluded that the NZ Banking sector capitalisation levels (based on Basel III) compare very favourably with Banks globally (for example, average New Zealand bank CET1 under the RBNZ regime is circa 100-150 bps higher than that of Australia on a harmonised basis).

Resourcing

4.7 One of the concerns that the Reserve Bank has highlighted is the issue of resourcing in respect of instrument compliance which, in its view, has led to a non-objection process that undermines self-discipline.

4.8 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.

4.9 The Issues Paper does not propose the adoption of this recommendation as a means of addressing its concerns. The cost / benefit analysis of increased resourcing for supervision of regulatory capital should be encapsulated as part of this capital review. It would be preferable for Reserve Bank resourcing constraints to be addressed rather than them being a factor unduly influencing the capital review's outcome.

4.10 In Westpac's view a possible solution to the issue of sufficient resourcing could be addressed through engagement with external specialists at the expense of the issuing bank.

5. RESPONSE TO CONSULTATION QUESTIONS

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?

No, refer to our comments in section 2 through 4.

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

No, refer to our comments in sections 2 through 4.

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

No, refer to our comments in sections 2 through 4.

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, refer to our comments in sections 2 through 4.

Question 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, refer to our comments in sections 2 through 4.

Question 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?

We are strongly opposed to option 4 as the way forward. Refer to our comments in sections 2 through 4.