

# Submission

to the

## Reserve Bank of New Zealand

on the

## Issues Paper – Review of the Capital Adequacy Framework for locally incorporated banks

9 June 2017

## 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 the Issues Paper – Review of the Capital Adequacy Framework for locally incorporated banks (**Issues Paper**) and commends the work that has gone into developing the Issues Paper and additional material.
4. If you would like to discuss any aspect of the submission further, please contact:

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## General

5. Given the limited time available to consider the Issues Paper, NZBA's comments on the scope of the Review are high-level at this stage, however, there is supporting detail that will be available during the consultation stage.
6. NZBA wishes to engage closely with RBNZ throughout the Capital Adequacy Framework review process (**Review**). Given the significance of the initiative, early and on-going engagement is critical to facilitate a successful and thorough Review, mutual understanding with the industry, and a smooth transition to any new/revised

policies. Early engagement will also allow any concerns or significant information to be considered before the formal consultation occurs later in 2017.

7. NZBA has concerns over the timing of the Review in two respects; first, the target completion date of Q1 2018 is considered ambitious. NZBA suggests RBNZ considers an extension of that timeframe to allow for robust consultation and feedback. Given the relative strength of the New Zealand banking system, NZBA considers that RBNZ should adopt a process that allows time for international development and empirical evidence to be taken into account. At a minimum, NZBA requests that RBNZ provides the industry with a detailed timetable through to completion of the Review, which builds in time for capital planning, including transitional provisions.
8. Secondly, NZBA is concerned that the Review is being conducted before the Australian Prudential Regulation Authority (**APRA**) and Basel Committee on Banking Supervision (**BCBS**) reviews are finalised (consultation is expected to occur over the course of 2017 at the earliest). In particular, NZBA is concerned that the BCBS review will not be taken into account given the importance RBNZ places on the ability to effectively assess New Zealand banks' capital positions in relation to the global context. NZBA considers that a framework that is largely consistent with international standards would create efficiencies for both market participants and regulators. Furthermore, the international framework is well understood and provides clarity for global investors and customers, this is particularly important given that New Zealand competes for funding on both a domestic and international stage.
9. Additionally, NZBA does not consider the Issues Paper affords adequate recognition of the relationships between and among various other tools already available to RBNZ for financial stability purposes; an additional suite of measures would result in unnecessary conservatism and NZBA considers that there are other ways of addressing RBNZ's concerns. For example, if capital deteriorates, the current framework includes the additional countercyclical buffer tool which assists in the protection of financial system stability and decreases the risk of a bank failing.
10. NZBA notes one further issue that will be the subject of a separate submission; some member banks are unable to issue Tier 2 (**T2**) capital as a convertible instrument as their ownership structure restricts conversion. Those members are therefore interested to engage with RBNZ on proposed alternative accessibility to eligible T2 capital.

## Numerator (definition of eligible capital)

11. RBNZ's view, as expressed in the Issues Paper, is that Common Equity Tier 1 (**CET1**) capital is the highest quality capital available to banks, and is therefore preferable to Additional Tier 1 (**AT1**) or T2 capital (together, **convertible instruments**). NZBA considers that relying on CET1 as the sole source of capital would in fact create unnecessary costs for the real economy and market participants and that there is value in allowing the diversification of capital structures by way of convertible instruments; they are attractive to a range of investors and allow banks to maintain access to cost efficient capital and thereby generate greater organic capital growth. Additionally, raising CET1 capital is not a straightforward exercise for some banks, therefore it is critical that other capital-raising options are available to those organisations.
12. It appears that RBNZ's preference for CET1 capital is borne from concerns regarding the effectiveness of convertible instruments, however, NZBA considers that

convertible instruments are an important and effective source of loss absorbing capital. Additionally, convertible instruments are held on terms that are consistent with RBNZ's requirements for permanent and unrestricted access to funds and the ability for such instruments to absorb losses without triggering a default, and their inclusion in the capital structure is consistent with the Basel III international framework (those principles having been adopted by the majority of international jurisdictions).

13. In relation to RBNZ's specific concerns regarding convertible instruments:
  - Convertible instruments are neither legally complex nor opaque; their loss absorption mechanisms are transparent (set out in the contractual terms of the instrument) and there is legal certainty that conversion or write-off of convertible instruments would occur as intended.
  - The government would not be required to compensate holders of convertible instruments as the OBR regime provides for the bail-in of creditors, including AT1 and T2 instrument holders of a failing bank.
  - Conversion would be unlikely to create a contagion effect as the conversion or write-off of convertible instruments is expected to occur in scenarios of extreme stress when a bank is close to or at the point of non-viability, therefore adverse signalling effects are less relevant. In addition, any concerns about the viability of a bank would have likely played-out through mandatory distribution restrictions and mandatory continuous disclosure requirements (ie prior to any trigger event of capital instruments).
  - There is a low risk of market manipulation of triggers as conversion triggers are not market-based, rather, they are at the discretion of RBNZ.
  - There is also a low risk of conversion occurring too late as the current regulatory capital framework and continuous disclosure requirements applying to banks make it highly unlikely that a deterioration in a bank's financial condition would not be recognised.
14. Additionally, NZBA does not consider the tax aspects of convertible instruments to be uncertain or overly complex. The tax outcomes of such instruments are well understood and, through receipt of binding rulings from the Inland Revenue Department (**IRD**), are unambiguous. NZBA also notes that Chapman Tripp, on behalf of NZBA, has tendered a further submission addressing the tax issues arising from the Issues Paper.
15. Uncertainty regarding convertible instruments effectively results in banks being unable to continue to issue convertible instruments as a source of capital. NZBA therefore requests that, in the interim, the industry is provided with certainty that capital instruments currently on issue still meet RBNZ's requirements. Additionally, NZBA requests that, in the event there is a change in the definition of eligible capital stemming from the Review, that those changes are applied prospectively.

## Ratios (minimum requirements and capital buffers)

16. At the outset, NZBA notes, and is keen to explore with RBNZ, the apparent disconnect between RBNZ's desire for more capital to be held by banks, as against its aversion to capital instruments other than CET1 capital instruments.
17. NZBA has views on RBNZ's commentary around global comparisons, in particular with respect to where New Zealand bank capital ratios are positioned, that it would like to explore further. In particular, NZBA encourages RBNZ to consider the

macroeconomic costs of higher capital. NZBA also notes that the industry has commissioned its own report on global comparisons to assist RBNZ in its Review. The results of that report will be provided as soon as they are available.

18. NZBA considers that, when making international comparisons, a fair evaluation should consider any differences in product or asset class distributions, as well as differences in lending practices and the macroprudential tools that may be in use.
19. NZBA considers the current capital framework is adequately conservative, and sufficiently strong, and notes that the perception of conservatism can differ depending on the context. RBNZ calibrates its capital requirements conservatively when compared with other international banking regulators, and banks' stress testing results under extreme scenarios demonstrates that New Zealand banks are well capitalised. However, more facts are needed to have confidence in exactly where New Zealand banks sit in the global context.

## Conclusion

20. NZBA understands that RBNZ's Review needs to be comprehensive, but has concerns over the implications of potential alteration to all components of the capital adequacy calculations (numerator, denominator and ratios). In particular, NZBA is concerned that the Review could result in increasing the amount of capital held by New Zealand banks more than what was contemplated.
21. It is important that RBNZ provides a clearer idea of its ultimate intent; be it reviewing all three components to determine which will deliver the best outcome, or applying additional conservatism to all three components. NZBA notes that, in its opinion, the latter would result in an unnecessarily complex, and overly conservative framework and that a conclusion on conservativeness of current risk weights in New Zealand should be in the context of prudential changes (eg Loan to Value Ratio restrictions).

## Responses to questions in the Issues Paper

**For each of the three sections (numerator, denominator, ratio), are there any important topics relating to capital adequacy that we have left out entirely?**

22. The Issues Paper has not taken other macro-prudential tools and other policy developments (eg OBR) sufficiently into account in its various rationales nor has it adequately incorporated stress testing into its supporting arguments.

**Do you have any information (eg empirical data) that is relevant to the issues discussed in the paper?**

23. Due to the short time frame available to consider the Issues Paper and the numerous reference sources, NZBA is not yet in a position to determine what empirical data should be the immediate focus. However, NZBA considers that the empirical information presented in the Issues Paper needs to be more comprehensive and viewed in a more objective way.

## Are there particular areas of the review that should be prioritised?

24. Clarity regarding the status of existing convertible instruments should be prioritised.
25. NZBA also suggests that domestic benchmarking exercises are de-prioritised while this Review is being conducted.