RESERVE BANK

OF NEW ZEALAND

Response to submissions received on proposed Basel III related changes to the Banking Supervision Handbook.

December 2012

This document sets out the Reserve Bank's response to the main issues raised in submissions received on the September 2012 consultation. This document is not a consultation document.

Contents

Introduction

1. In September 2012 the Reserve Bank issued a consultation package on proposed changes to the Banking Supervision Handbook to put into effect Basel III requirements.

2. The consultation package set out draft changes to the following Banking Supervision Handbook documents:

   - Statement of Principles (BS1).
   - Capital Adequacy Framework (Standardised Approach) (BS2A).
   - Capital Adequacy Framework (Internal Models Based Approach) (BS2B).

3. Submissions on draft changes to the Banking Supervision Handbook closed on 9 October 2012. The changes proposed to the Banking Supervision Handbook have now been finalised taking into account the submissions received.

4. This document contains a summary of the main issues raised in submissions and notes the Reserve Bank's response to these issues. In this document the text of the BS1, BS2A and BS2B documents released for consultation in September 2012 (including the draft changes to existing text) is referred to as the "draft requirements".

BS1: Statement of principles

Breach of minimum capital adequacy ratio requirements

Submissions received

5. One submitter queried whether the Reserve Bank will be altering the framework outlined in BS1 that applies where a bank breaches its minimum capital ratio requirements.

Reserve Bank's response

6. The framework has now been adjusted to align with the Basel III capital adequacy regime. The key changes are:
   i. References to capital ratios are now aligned with Basel III capital ratios.
   ii. In the event of a breach of minimum capital ratio requirements, the capital plan that would already have been required when the buffer ratio of the banking group fell below 2.5 percent of risk weighted assets will need to be amended. The amendment will need to reflect the restrictions that apply in the event of a breach of minimum capital ratio requirements.
   iii. The threshold at which no increase in gross credit exposures are allowed has been changed. Previously the threshold was set at the point the banking group's Tier 1 capital ratio was less than 3 percent. One way of considering this is that 3 percent is one percentage point lower than the minimum capital ratio requirement relating to the highest form of capital recognised (i.e. the minimum 4 percent Tier 1 capital ratio). The Reserve Bank has applied this logic to the Basel III regime and set the new threshold at the point the banking group's Common Equity Tier 1 ratio is less than 3.5 percent (i.e. one percentage point lower than the minimum 4.5 percent Common Equity Tier 1 capital ratio).

Guidance on triggering non-viability

Submissions received

7. The following arguments were made regarding guidance on when a non-viability trigger event would occur:
   i. Guidance set out in the draft changes to BS1 did not go far enough to clarify how the Reserve Bank would exercise its discretion in triggering the loss absorbency mechanism, and that this lack of clarity would make pricing and marketing of capital instruments difficult.
   ii. The Reserve Bank's consideration of whether loss absorbency is required should take into account the ability of the bank to return to viability. In particular if a wind-up or liquidation is expected regardless of whether write-off occurs, then the loss absorbency provisions should not be applied as this could result in a potential wealth transfer from Tier 2 and AT1 investors to common equity providers.
   iii. The draft requirements do not provide guidance on when a partial write-off or conversion will be instigated. The requirements should explicitly state that write-

off or conversion will be required only to the extent needed to ensure the bank remains viable.

Reserve Bank's response

8. The circumstances in which the Reserve Bank would trigger the loss absorbency requirement cannot be precisely determined *ex ante*. However, the guidance in BS1 has been amended to clarify the considerations the Reserve Bank would take into account in deciding whether to trigger loss absorbency, including the relative ranking of claims and whether it is likely that other resolution or recovery mechanisms will be used.

9. The Reserve Bank accepts that greater clarity could be provided with regard to when a partial write-off or conversion will be instigated. The Reserve Bank has therefore amended subpart 2F of BS2A and BS2B to confirm that partial conversion or write-off will only be mandated if the Reserve Bank is satisfied that doing so will ensure the immediate risk that the banking group's capital will deteriorate below the minimum capital ratios is low.

10. As discussed below (in relation to subpart 2F), the Reserve Bank has also amended the non-viability trigger in subpart 2F to clarity that a non-viability event will be based on the financial circumstances of the bank.

Counter-cyclical buffer

Submission received

11. One submitter considered that the standard condition of registration "1B" and the accompanying table, as set out in BS1, should be amended so that it could apply to the counter-cyclical buffer without amendment.

Reserve Bank's response

12. The condition as currently drafted is not intended to apply a counter-cyclical buffer. As it is likely that the counter-cyclical buffer would only apply infrequently, the Reserve Bank intends to amend banks' conditions of registration in the event the counter-cyclical buffer is applied. Such an amendment would comprise an increase in the level of the buffer ratio at which a limit on distributions begins to apply, and adjustments to the various levels of the buffer ratio at which the limit on distributions increase.

BS2A and BS2B: Part 2 – Capital definition[1]

Definition of SPV

Submissions received

13. One submitter considered that the definition of special purpose vehicle (SPV) should allow that the SPV undertake other activities incidental to raising capital.

Reserve Bank's response

14. The Reserve Bank accepts this submission and has amended the definition accordingly.

Repayment of AT1 and Tier 2 instruments

Submissions received

15. According to the draft requirements an AT1 or Tier 2 instrument cannot be repaid unless the registered bank has received prior written approval from the Reserve Bank, and the instrument is replaced with an instrument of the same or better quality. This is unless the registered bank demonstrates to the Reserve Bank's satisfaction that the banking group's capital position would be well above the minimum capital requirements after the repayment.

16. Some submitters requested that clarification be provided on what is meant by the phrase "well above", while one submission argued that this requirement could be interpreted as in effect increasing banks' minimum capital requirements.

Reserve Bank's response

17. The Reserve Bank considers it is important that it maintain discretion to determine whether an instrument being repaid should be replaced, so the particular circumstances of the registered bank can be taken into account at the time. In this context it does not make sense to pin-point *ex ante* the margin above minimum capital requirements that would be sufficient to waive the requirement to replace the instrument being repaid.

18. However, the Reserve Bank accepts the phrase "well above" could imply that a large margin over the minimum capital requirements will be required in all cases, and that this could be seen as an extension to minimum capital requirements. The Reserve Bank has therefore replaced the phrase "well above" with "sufficiently above" in order to clarify that the requirement does not set a new minimum capital requirement.

[1] This part of the document also includes some issues that relate to more than one subpart of BS2A/BS2B.

Approval for repayment of Tier 2 instruments

Submissions received

19. Some submitters considered that the requirement for banks to seek the approval of the Reserve Bank prior to repaying a Tier 2 instrument needed clarification. This was because it could be read as requiring approval to repay an instrument at maturity or at a scheduled redemption date.

Reserve Bank's response

20. Reserve Bank approval is not required to repay instruments at maturity or at a scheduled redemption date. BS2A and BS2B have been amended to make this clear. In addition the words "maturity or maturity date" and "repay" have been defined so as to avoid repetition in the drafting, and subpart 2H, setting out the approval process for repayments, has been added.

Multiple call dates

Submissions received

21. Some submitters considered that there would be value in explicitly stating that there may be multiple call dates provided in AT1 and Tier 2 instruments after five years.

Reserve Bank's response

22. Footnotes have been added to subpart 2B and subpart 2C of BS2A and BS2B to confirm that AT1 and Tier 2 instruments may contain multiple call dates after five years.

Credit sensitive dividend feature

Submissions received

23. One submission queried whether a broad index could be used as a reference rate for the calculation of distributions or payments on an instrument.

Reserve Bank's response

24. The Reserve Bank confirms that an instrument may use a broad index as a reference rate for distribution or payment calculation purposes, providing the index does not exhibit any significant correlation with the issuer's credit standing. Subpart 2B and 2C of BS2A and BS2B have been amended accordingly.

Restriction on contribution of AT1 instruments without full voting rights to total Tier 1 capital

Submissions received

25. In response to earlier Basel III consultations the Reserve Bank received some submissions that did not agree with the requirement that AT1 instruments without full voting rights may not constitute more than 25 percent of total Tier 1 capital. Further

arguments (some new) on this issue were presented in response to the September 2012 consultation. These arguments include concern that the restriction could limit the diversification of regulatory capital funding and the pricing of Tier 2 instruments. The way that pricing of Tier 2 instruments could be affected is through terms and conditions that assign Tier 2 instruments a lower priority for write-off or conversion in the event the registered bank becomes non-viable. A larger buffer of AT1 instruments could reduce the probability of Tier 2 instruments being written-off or converted and could in turn result in more favourable pricing of the Tier 2 instrument for the registered bank.

Reserve Bank's response

26. The Reserve Bank's rationale for the restriction was to limit the extent to which a bank that only just meets the minimum common equity requirement can report a strong Tier 1 capital ratio. The Reserve Bank still considers this is a valid argument in favour of the restriction. However, taking into account the various points raised against the restriction, it has now decided, on balance, not to include it in our requirements.

BS2A and BS2B: Subpart 2A – criteria for classification as ordinary shares

Distributions

Submissions received

27. One submitter noted the draft requirements allow distributions to be paid out of "retained earnings" only, rather than out of "distributable items" as permitted by APRA. It was noted that, as drafted, the requirement may unduly restrict payments from capital items that are permitted under the Companies Act 1993. It was requested that the Reserve Bank align with APRA on this matter.

28. Also, one submitter considered the words "due and payable" should be inserted into the criteria for ordinary shares set out in section 2.28(i) of BS2B as follows:

    Distributions are paid by the registered bank only after all legal and contractual obligations have been met and payments <u>due and payable</u> on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as Common Equity Tier 1 capital.

Reserve Bank's response

29. The Reserve Bank accepts that distributions should be able to be paid out of any distributable items, not just retained earnings, and has amended subpart 2A accordingly. This change has also been made to subpart 2B.

30. The Reserve Bank agrees that including the words "due and payable" as described above would be consistent with the intent of section 2.28(i) (and the equivalent section in BS2A). However, the Reserve Bank does not consider it necessary to add these words for the following reasons: the meaning of the criterion is already clear in our view; the issue was raised by just one submitter; and including the additional words would be a departure from the Basel III standard and from other regulators including APRA.

Purchase of instruments by related parties

Submissions received

31. Three submissions were received on the requirement that capital instruments may not be purchased by either the registered bank or a related party over which the registered bank exercises control. One submitter considered that the meaning of "control" needed clarification and submitted that the definition from the Companies Act 1993 should be used. Another considered that the requirement could prevent a registered bank from issuing capital instruments to its parent, or a subsidiary thereof. A third submitter considered this requirement may restrict the provision of full recourse lending, where the borrower is purchasing a well-diversified portfolio including the capital instrument. This submitter argued these services should be explicitly excluded from the requirement.

Reserve Bank's response

32. The definition of "control" that is to be used in interpreting this requirement is the definition of "control and significant influence" provided in the definition section of BS2A and BS2B. The standard has been amended to make this clearer. This definition sets a lower threshold than the Companies Act 1993. In response to submissions a minor amendment has been made to this definition in relation to requirement (ii), such that a party will only have control or significant influence if it can *influence* the financial and operating policy decisions of another entity, rather than merely participate in such decisions.

33. The Reserve Bank accepts that capital instruments should be able to be purchased by the ultimate parent, or wholly-owned subsidiaries thereof, of the registered bank and has included wording to this effect. The Reserve Bank considers that full recourse lending to borrowers intending to purchase a fully diversified portfolio should not be prohibited and has hence included wording similar to APRA on this issue.

34. These changes also flow through to subpart 2B and subpart 2C.

Prohibition on preferential distributions

Submissions received

35. Some submitters considered that the wording in requirement (i) of subpart 2A of the draft standards, which prohibits preferential distributions on CET1, is unclear in that preferential distribution "*in respect of other elements classified as CET1"* are prohibited.

Reserve Bank's response

36. The Reserve Bank considers that the words "*in respect of other elements classified as CET1"* add little to the requirement and has therefore amended the provision to clarify that the prohibition is on ordinary shares not having any preferential or predetermined rights to distributions of capital or income.

BS2A and BS2B: Subpart 2B – criteria for classification as Additional Tier 1 capital

Requirement that the instrument is perpetual

Submission received

37. One submitter sought the Reserve Bank's view on having a Long-Stop Date for conversion or redemption, (for example, whether the instrument could convert to ordinary shares or be redeemed after say 50 years).

Reserve Bank's response

38. The Reserve Bank plans to adopt the Basel III standard that the principal amount of an AT1 instrument must be perpetual (i.e. there is no maturity date). This is also consistent with the approach taken by APRA. The Reserve Bank is unaware of any New Zealand specific reason for departing from the Basel III standard and does not intend to do so on the basis of one submission. However, the Reserve Bank would recognise as AT1 capital an instrument that was consistent with our requirements for AT1 instruments and also converted to ordinary shares at some future date.

BS2A and BS2B: Subpart 2D – recognition of minority interests and other capital issued out of fully consolidated subsidiaries that is held by third parties

Treatment of retained earnings

Submissions received

39. One submitter noted that the draft requirements did not allow the minority interest portion of retained earnings, or other reserves recognised in CET1, to be recognised at all within the regulatory capital of the consolidated banking group. The submission also noted that this arrangement seemed harsh given that minority shareholders would be impacted if the bank was subject to buffer ratio related restrictions on the distributions on earnings.

Reserve Bank's response

40. The Reserve Bank accepts that the minority interest portion of retained earnings and other reserves recognised in CET1, should receive recognition within the regulatory capital of the consolidated banking group. This is subject to limits on the portion of such capital that can be recognised, as set out in the Basel III standard. Subpart 2D of BS2A and BS2B have been amended accordingly. Subpart 2D has also been amended to clarify that in calculating the capital issued by fully consolidated subsidiaries attributable to third parties, deductions attributable to those third parties also need to be accounted for.

BS2A and BS2B: Subpart 2F – loss absorbency at the point of non-viability

Changes of ownership

Submissions received

41. One submitter noted consideration should be given to the potential interaction between the conversion of AT1 and Tier 2 instruments into shares and the application of section 77A of the Reserve Bank of New Zealand Act 1989 (the Act) relating to changes of ownership.

Reserve Bank's response

42. Footnotes have been added to BS2A and BS2B to provide that, if, as the result of a conversion undertaken to comply with the Reserve Bank's loss absorbency requirements, a person gains a significant influence over the registered bank, the Reserve Bank will not pursue any prosecution against that person in the event that the person does not obtain the prior written consent of the Reserve Bank to the conversion.

Conversion of AT1 and Tier 2 instruments

Submissions received

43. The draft requirements state that the terms and conditions of AT1 and Tier 2 instruments must include a right held by the registered bank, exercisable upon the occurrence of a non-viability trigger event, to convert the instrument into ordinary shares of the registered bank or to write-off the instrument. The draft requirements also provide that in the event of a write-off, the holder of the instrument may be paid compensation in the form of ordinary shares of either the registered bank or of the ultimate parent.

44. Submitters raised several concerns about the conversion mechanism as set out below:
    i. The conversion mechanism is not consistent with APRA's requirements that only allow conversion into listed ordinary shares (except in the case of an instrument issued by an unlisted entity to a listed parent entity).
    ii. Provision for payment of compensation in the form of shares (either of the registered bank or of the ultimate parent) is inconsistent with APRA's requirements and with the Basel Committee's standards.
    iii. For Australian-owned banks, conversion to shares in the New Zealand registered bank will dilute the shareholding of the Australian parent and create a disincentive for the parent to support the New Zealand bank.
    iv. Investors prefer listed shares (as they are easier to value and trade). Adopting the option to convert to shares in the registered bank (which are unlisted) will therefore increase the cost of capital for banks relative to what it would be if the option to convert to listed parent shares was permitted and adopted.

v. Given the concerns noted above and especially given the need to comply with both the Reserve Bank and APRA requirements, Australian owned New Zealand banks will be “forced” to use the write-off mechanism (unless issuing to their parent) and this gives rise to larger potential tax liabilities than would be the case if the conversion mechanism were used (see also submissions on tax effects/tax haircuts below).

vi. Even if APRA allowed write-off with compensation in the form of shares, this arrangement might generate larger potential tax liabilities compared to conversion into shares of the parent bank.

45. Submitters offered various recommendations for altering the conversion mechanism as noted below:

 i. Conversion into the listed ordinary shares of the parent should be permitted, with write-off as a back-up option to account for any uncertainties associated with such conversion.

 ii. Alternatively, the tax haircut associated with write-off should be removed. This would address most of the unfavourable aspects of being forced to use the write-off mechanism (see also submissions on tax effects/tax haircuts below).

Reserve Bank’s response

46. The Reserve Bank notes that the Basel Committee *does not* restrict conversion to listed shares only, and the Basel Committee *does* contemplate compensation to the holders of an instrument in the form of shares in the registered bank or shares in the parent company.

47. The Reserve Bank draft standards allowed the non-viability requirement to be met by providing for a *de facto* conversion of AT1 or Tier 2 instruments into the ordinary shares of a parent entity, providing parent shares could be provided as compensation for a write-off. The Reserve Bank accepts that the terminology used in the draft standards was not clear enough to provide certainty as to what type of transactions would be recognised as compliant. The Reserve Bank has hence altered the drafting to provide that conversion of an AT1 or Tier 2 holder’s interest into parent shares is permitted if the following requirements are met:

 i. The parent entity, to the extent permitted by law, issues its ordinary shares to the holder of the AT1/Tier 2 instrument;

 ii. The registered bank ceases to have any obligations in relation to the instrument converted to repay the principal or make payments of distributions, except that a parent entity of the registered bank, being a New Zealand registered company, may receive ordinary shares in the registered bank;

 iii. In no way may the transaction in (ii) be contingent on the transaction in (i) and failure of the parent bank to issue shares to the instrument holder must not give rise to a right of redress against the New Zealand registered bank.

48. Clarification about the mechanism for conversion into parent shares addresses concerns about the dilution of the shareholding of the Australian parent, and investor preferences in relation to converting into listed shares upon a non-viability event, as well as concerns around certain banks being “forced” to use the write-off mechanism.

From discussion with APRA we also understand the *de facto* conversion mechanism will comply with APRA's requirements.

Conversion of shares issued by an SPV

Submissions received

49. One submitter considered that it should be made clear that where an SPV issues an instrument, conversion of that instrument will be into the shares of the registered bank and not the SPV.

Reserve Bank's response

50. The Reserve Bank has added some additional text to subpart 2E and subpart 2F to clarify the application of these subparts to instruments issued by subsidiaries and SPVs.

Immediate conversion

Submissions received

51. The draft requirements stated that where an instrument provides a right of conversion, the terms of the instrument must provide that where, following a non-viability trigger event, conversion of a capital instrument is not capable of being <u>immediately</u> undertaken or is revocable, the registered bank has the right to write-off the principal amount and any accrued interest owing under the instrument.

52. Some submissions sought clarity on how to interpret the word "immediately" above.

Reserve Bank's response

53. The Reserve Bank considers that in the event of a non-viability trigger event a conversion must happen quickly. However, the Reserve Bank accepts that to give legal effect to the transaction there may be some delay. To balance these points, subpart 2F has been amended to provide that the Reserve Bank will consider that a transaction is not capable of being immediately undertaken if the registered bank is unable, within five working days, to obtain a legal opinion satisfactory to the Reserve Bank stating that there are no legal obstacles to the transaction occurring.

Governing Law

Submissions received

54. APRA's standards require that the loss absorption and non-viability requirements be governed by Australian law. Some submitters sought clarification that a capital instrument would meet the requirements of BS2B if it was governed by Australian law.

Reserve bank's response

55. Under the draft requirements Tier 2 instruments are required to be subject to New Zealand law or a satisfactory alternative. The Reserve Bank has clarified in subpart 2C that it will generally consider Australian law to be a satisfactory alternative.

Principal and interest conversion / write-off

Submissions received

56. The draft requirements envisage that both the principal and accrued unpaid interest on a capital instrument be subject to conversion or write-off upon the occurrence of a non-viability trigger event. Some submitters noted that APRA requires conversion or write-off of the principal only, and argued that the Reserve Bank's requirements should be aligned with APRA's on this matter.

57. Another submitter argued that accrued interest should be able to be written off before the principal so that in a partial write-off scenario the maximum amount of principal is preserved, providing the investor with more opportunity to participate in any recovery of the bank.

58. One submitter argued that the requirement to convert or write-off accrued unpaid interest should also be applied to distributions given that capital instruments can be either debt or equity. However, this submitter noted in the case of AT1 instruments the dividends may have already been cancelled given that the bank will have discretion to do so at any time.

Reserve Bank's response

59. We understand that APRA will recognise instruments that provide for the write-off or conversion of principal *and* accrued and unpaid distributions even though APRA do not *require* write-off or conversion of accrued and unpaid distributions. The Reserve Bank has therefore retained the requirement to write-off both the principal and accrued unpaid interest of a capital instrument

60. The Reserve Bank considers that declared dividends that are unpaid at the point on non-viability should also be able to be converted or written off. Also the Reserve Bank agrees that banks should be given the option of structuring their instruments so that dividends/interest are written off or converted before the principal. BS2A and BS2B now accommodate both these points.

Prospectus requirement

Submission received

61. Some submissions noted that in the event of a conversion, the affected bank would be required under current securities law to provide a prospectus and this could frustrate the immediate conversion to common equity.

Reserve Bank's response

62. The Reserve Bank and the Financial Markets Authority are in discussion about a possible exemption from prospectus requirements in the case of a conversion undertaken in the context of the Reserve Bank's Basel III requirements.

Tax effects

Submissions received

63. Several submissions were concerned about the proposed requirement that in determining the value of an instrument for the purposes of regulatory capital recognition, the nominal value of an instrument must be reduced by potential tax (the "tax haircut") and other offsets that occur at the time of conversion or write-off. The particular views expressed were:

The tax haircut requirement should be removed.

i. Arguments submitted in support of this view were: it is likely that a bank would have existing losses to offset any tax liability that would arise upon conversion or write-off; the tax haircut would increase the cost of capital for New Zealand banks; it would be difficult for banks to avoid the tax haircut and for the Australian-owned banks this could mean the parent bank would itself raise regulatory capital and inject capital into the NZ subsidiary rather than the NZ subsidiary raising capital through NZ capital markets. This in turn could result in a parent bank running up against APRA imposed limits on the amount of capital that can be provided to the New Zealand subsidiary.

In the event the tax haircut requirement is not removed:

ii. Where conversion is the primary loss absorbency mechanism, the tax haircut should be calculated assuming conversion occurs, and no tax haircut should apply in respect of the potential tax liability arising from write-off as the "back-stop" mechanism. (Some submissions argued that no tax haircut should apply at all where conversion is the primary loss absorbency mechanism.) It was argued that this approach should be followed because convertibility would normally be effective with only a small risk of taxable income arising, and applying a tax haircut to cover write-off as the back-stop mechanism would be out of proportion to the capital risk being mitigated. It was also argued that this approach would align with APRA's requirements.

iii. The tax haircut requirement should be amended to take into account the tax losses that the bank has at the time of the non-viability trigger event. It was argued that following a non-viability trigger event it is highly likely a bank will have tax losses sufficient to offset the tax on any debt forgiveness income that would arise from a write-off.

Reserve Bank's response

64. The objective of the loss absorbency requirement is to generate additional CET1 capital. The Reserve Bank therefore wishes to remove any risks to the generation of this capital at the time of conversion or write-off. The Reserve Bank accepts that if a bank had tax losses at the time of the non-viability event, then these losses could be

offset against the income generated from a write-off. However, the Reserve Bank considers it is not possible to forecast the size of such losses in advance. Also, it is possible that a distressed bank is sold to preserve its viability and as a result its tax losses are extinguished. The Reserve Bank has not therefore changed its tax haircut requirement.

65. However, the Reserve Bank accepts that applying a tax haircut to cover write-off as the back-stop mechanism would be out of proportion to the capital risk being mitigated. Banks will therefore not be required to adjust for potential tax liabilities that might occur in the event of write-off as a back-stop mechanism, where conversion is the primary mechanism.

Trigger event definition

Submissions received

66. Several submissions expressed concerns about the way the trigger event is defined. The draft requirements define a non-viability trigger event as: a direction given to the registered bank under section 113 of the Act, on any of the grounds (a)-(e) of that section requiring the registered bank to exercise its right under the instrument to either write-off its value or to convert it into ordinary shares; or the registered bank being made subject to statutory management pursuant to section 117 of the Act.

67. One concern noted by submitters was that Australian-owned banks seeking to comply with both the Reserve Bank and the APRA requirements would not be able to do so because:

    i. The Reserve Bank's trigger event is different to APRA's. The relevant part of APRA's trigger event (as it applies to New Zealand subsidiaries of Australian banks) is "the issuance of a notice by an host regulator of an overseas subsidiary that conversion or write-off of capital instruments issued by a fully consolidated subsidiary of an ADI is necessary because, without it, the host regulator considers that the subsidiary would become non-viable". Some submissions recommended that the Reserve Bank align with the APRA definition and then provide guidance on when the Reserve Bank may give effect to a conversion or write-off.

    ii. The Reserve Bank's requirements do not permit the home supervisor to exercise a non-viability trigger.

68. Another concern expressed by submitters was that the trigger should be restricted to when a direction was issued or statutory management imposed on the basis that section 113(1)(a) or (b) of the Act is met, that is:
    - the registered bank or associated person is insolvent or is likely to become insolvent;
    - the registered bank or associated person is about to suspend payment or is unable to meet its obligations as and when they fall due.

69. Submitters considered the circumstances in sections 113(1)(c)-(e) are not so clearly related to non-viability and in some cases could result in a trigger event that is unpredictable. Submitters noted that including sections 113(1)(c)-(e) as grounds for the trigger event would make the pricing of capital instruments difficult.

70. On a related matter, one submitter argued that investors in the bank should not suffer a loss absorption event because of the circumstances of an associated person (unless these circumstances affected the viability of the registered bank).

Reserve Bank's response

71. The substance of the Reserve Bank's trigger event is the same as the trigger event set out in APRA's standards. We understand that the trigger event defined by the Reserve Bank will therefore be recognised as a host regulator trigger event by APRA. Differences in the detailed specification of the trigger event remain, although the BS2A and BS2B documents have been amended to address some of these differences.

72. The incorporation of a home supervisor trigger event into the terms and conditions of an instrument will not prevent the instrument from being recognised as regulatory capital by the Reserve Bank. The BS2A and BS2B documents have been amended to clarify this point.

73. The Reserve Bank does not agree the trigger should be restricted to when a direction is issued, or statutory management imposed on the basis that section 113(1)(a) or (b) of the Act is met. This would restrict the application of loss absorbency to instances of actual or potential insolvency, or illiquidity. The Reserve Bank may wish to trigger loss absorbency prior to a potential insolvency with a view to supporting the bank as a going concern. However, in order to tie the trigger event more closely to grounds that relate to non-viability, the BS2A and BS2B documents have been amended so that the Reserve Bank can trigger loss absorbency on the basis that the *financial position* of the registered bank is such that it meets any of the grounds in section 113(1)(a)-(e).

74. The Reserve Bank accepts that the bank should not suffer a loss absorption event because of the circumstances of an associated person (unless these circumstances affected the viability of the registered bank). The Reserve Bank will therefore permit the terms of banks' capital instruments to allow for a loss absorbency event through a direction of the Reserve Bank made on the basis that the registered bank itself (not an associated person) meets the relevant criteria in section 113 of the Act. However, where an instrument included in the regulatory capital of a banking group has been issued by a fully consolidated subsidiary of the registered bank, the terms of that instrument must allow for a loss absorbency event through a direction of the Reserve Bank. Such a direction will be given to the subsidiary on the basis that the subsidiary meets the relevant criteria in section 113 of the Act.

Write-off of preference shares

Submissions received

75. One submission questioned whether write-off would be possible for preference shares.

Reserve Bank's response

76. The Reserve Bank considers that it would be appropriate for an instrument to provide for write-off of preference shares through either a redemption or acquisition mechanism, consistent with the Companies Act 1993. BS2A and BS2B have been amended to clarify this.

Write-up

Submissions received

77. One submission argued there should be scope for AT1 instruments written off following a loss absorbency event to be written back up over time if the bank successfully returned to viability. It was argued this feature would provide a fairer risk / return matrix, provide for cheaper funding and reduce the competitive disadvantage of New Zealand owned banks.

Reserve Bank's response

78. The Reserve Bank noted its views on this issue in its response to an earlier round of submissions published in September 2012. As noted in this earlier document, the write-up feature is not included in the Basel III framework and is not being adopted by APRA. Moreover, the Basel Committee has explicitly ruled out any temporary write-down mechanism as it could result in capital holders having a contingent claim that could rank in preference to any public sector injection. Consequently we do not support the creation of write-up features.

BS2A and BS2B: Part 3 – capital ratios

Distributions

Submissions received

79. The Reserve Bank's Basel III policy requires banks operating inside the buffer ratio limit set by the Reserve Bank to comply with certain restrictions on distributions. Some submissions expressed concerns about the definition of distributions that would apply in this context as set out in Part 3 of BS2A/BS2B, and sought more clarity about what is caught within the definition.

Reserve Bank's response

80. The Reserve Bank has amended Part 3 of BS2A/BS2B to clarify that the following are not distributions for the purposes of the buffer ratio:

    i. Distributions the bank is contractually obliged to make (such distributions will not exist in the case of Common Equity Tier 1 or Additional Tier 1 instruments).

    ii. Payments which do not result in a depletion of Common Equity Tier 1 Capital, such as scrip payments.

Miscellaneous

Minimum requirements

Submissions received

81. Some submissions were concerned that the Reserve Bank's requirements did not allow capital instruments to have certain features that banks may wish to include.

Reserve Bank's response

82. The Reserve Bank has clarified in BS2A and BS2B that these documents contain the minimum requirements that must be met for instruments to qualify as regulatory capital, and that additional terms included in an instrument will not disqualify it from being treated as regulatory capital, provided that those terms do not affect the instrument's compliance with the requirements contained in this document.

83. The Reserve Bank notes that other regulators may take a similar approach (i.e. an offshore home regulator may still recognise an instrument as regulatory capital even if it contains additional terms compared to the home regulators requirements, such as those that may be required by the host regulator).

Approval process

84. As of January 2013 registered banks will need to seek a notice of non-objection from the Reserve Bank to recognise AT1 and Tier 2 capital instruments in regulatory capital. The process for approval is set out in a new subpart, subpart 2H. The approval process for repayment of AT1 and Tier 2 (prior to maturity instruments) has also been included in subpart 2H.