NEW ZEALAND'S EXCHANGE
TE PAEHOKO O AOTEAROA

Quotation of Debt Instruments

Consultation Paper

June 2021

CONTENTS

This Consultation Paper has been prepared by NZX to seek comment on the proposals contained in the paper, with a view to ensuring that the proposals will enable NZX to operate its markets on a fair, orderly and transparent basis. The proposals set out in this paper do not reflect NZX's concluded views of the matters raised. Capitalised terms which are not defined in this Consultation Paper have the same meanings given to them in the relevant Rules.

Introduction

NZX Limited (**NZX**) has been monitoring developments in the capital markets eco-system that affect the quotation of debt instruments. These developments include the proposals that were considered by the Reserve Bank of New Zealand (**RBNZ**) in 2020 in relation to negative interest rates and the registered bank capital review, and the New Zealand Financial Markets Association (**NZFMA**) consultation in relation to moving the NZ Credit Market closing rates from a yield to a clean price.

As a result of these developments, NZX has developed a suite of proposals that are designed to provide greater clarity to the market and standardise the treatment of certain types of instrument. NZX is proposing to:

- quote new negative yield or zero coupon debt instruments on a price basis;
- treat instruments that comply with the RBNZ's requirements for Additional Tier 1 (**AT1**) capital as Debt Securities for the purposes of the NZX Listing Rules, and quote these instruments on a price basis;
- quote instruments that comply with the RBNZ's requirements for Tier 2 capital on a yield basis;
- retain the yield quotation status of non-vanilla debt instruments affected by the NZFMA proposal; and
- maintain the current treatment of debt instruments which are priced to the next interest rate reset date.

NZX wishes to formally consult with the market in relation to these proposals, which are explained in more detail in this Consultation Paper. NZX's final decision in relation to the proposals described above will be informed by the views of participants, issuers, and other interested parties, that are obtained through this consultation process.

Consultation Process

NZX is seeking submissions on the proposals which are described in this Consultation Paper.

We invite interested parties to provide their views on the proposals raised in this Consultation Paper by emailing NZX Policy. Alternatively, if you would prefer to provide a verbal submission, please email NZX Policy to arrange a time to speak with us. You can contact NZX Policy at: policy@nzx.com.

The closing date for submissions is **Friday 16 July 2021**.

NZX may publish the submissions it receives, so please clearly indicate in your submission if you do not wish your submission to be published, or identify any part of your submission that contains confidential information.

If you have any queries in relation to the review, please contact:

Kristin Brandon
Head of Policy and Regulatory Affairs
Email: kristin.brandon@nzx.com
DDI: +64 4 495 5054

Background

There are three main types of debt instrument quoted on the NZX Debt Market: vanilla bonds, structured products (with reset features), and hybrid instruments (such as perpetual instruments).

Price vs Yield quotation status
The majority of instruments quoted on the NZX Debt Market are quoted on a yield basis. The features of these instruments allow a yield to be calculated with certainty because the vanilla characteristics of these instruments include a fixed interest rate and maturity date that allow a yield to be accurately determined for the instrument. Currently some structured products are also traded on a yield basis, at the request of an Issuer, even though their maturity date may be reset by the Issuer (as discussed in proposal 5 of this Consultation Paper). The yield for these products is calculated to the next maturity reset date and this is clearly disclosed on nzx.com. Yield traded instruments are denoted by tickers that end in a number series, for example: ABC010.

Debt instruments are quoted on a 'price basis' where the yield for the instrument cannot be accurately determined, for example: because the instrument is perpetual in nature; or, where the instrument has reset features which vary the yield throughout the life of the instrument. Price traded instruments are denoted by tickers that end in a number series, for example: XYZHA.

Recent developments affecting the quotation of Debt Instruments

This section of the Consultation Paper provides further context for NZX's proposals, including recent third-party consultations that have contributed to NZX developing the proposals contained in this paper.

RBNZ - Negative Interest Rates

In early 2020, the RBNZ wrote to the banking industry outlining the RBNZ's expectation that banks be operationally prepared for negative interest rates by the end of 2020. In the context of the RBNZ's indications that negative interest rates might be implemented after May 2021, NZX consulted with the industry later in 2020, in respect of a proposal to migrate affected debt instruments that were quoted on the NZX Debt Market on a yield basis, to quotation on a price basis.

At that time, while some NZX Issuers supported the change, others expressed a preference that their affected instruments remain yield traded. In addition, some NZX Participants raised concerns with the proposed migration of quotation status. As a result, NZX determined to allow yield traded debt instruments to continue to trade on a yield basis in a negative interest rate environment.

NZX intends to implement functionality as part of its Trading System Upgrade project to enable instruments quoted on the NZX Debt Market on a yield basis to trade at a zero percent yield or a negative yield. In the interim, until this functionality is available, NZ RegCo has granted a class waiver, to facilitate the trading of debt instruments on a yield basis in a negative interest rate environment.

While the FMA has acknowledged that the likelihood of the RBNZ imposing interest rates has declined since late 2020, the FMA has indicated its expectation that FMA licensed entities continue to prepare for negative interest rates[1].

In the context of these developments, NZX wishes to consult with the industry in relation to proposal 1 that is contained in this Consultation Paper.

RBNZ – Registered bank capital review

As part of its consultation in relation to the implementation of the capital review decisions for registered banks that were made in 2019, the RBNZ undertook further consultation in November 2020, in relation to changes to the banking supervision handbook. The RBNZ's consultation paper is available here.

[1] 'Negative Interest Rates – Readiness Survey Results', FMA, May 2021.

The consultation included details of the requirements for certain instruments to qualify as bank capital, including the proposed features of additional tier 1 (**AT1**) and tier 2 instruments. Quotation of these types of securities may be sought by the relevant issuing Registered Banks.

The RBNZ proposed that one of the criteria which must be met for an instrument to qualify as AT1 capital, is that it must be structured as legal-form equity, and noted that the RBNZ is working with the relevant agencies to understand how these instruments would be considered under the Financial Markets Conduct Act 2013 (**FMC Act**) and how the relevant disclosure requirements in the FMC Regulations, would apply[2].

NZX and NZ RegCo have been considering the effects of these proposals on current practices, and as a result wishes to consult on proposals 2 and 3 set out in this Consultation Paper.

NZFMA – NZ Credit Market Closing Rate Consultation

In January 2021, the NZFMA consulted on a proposal to change the format of Credit Market closing rates (**NZNG**), a daily valuation tool, from a yield to a clean price (being a price that does not include accrued interest between coupon payment dates). The NZFMA proposed this change for a number of reasons, including because in its view: the complexity of certain debt instruments had resulted in assumptions about calls and resets which may reduce the information value of yield pricing information; and, internationally it is best practice to value fixed income instruments on a price basis. The NZFMA's consultation paper is available here.

As the NZFMA's proposals related to certain instruments that are quoted on the NZX Debt Market, NZX has engaged bi-laterally with certain NZX Participants and the NZFMA in relation to these proposals.

On 30 March 2021, the NZFMA released a paper 'Consultation Feedback and Next Steps' which is available here. In the response paper the NZFMA confirmed that the NZFMA Credit Market Committee had determined that the NZFMA would continue to quote all vanilla bonds on a yield basis for NZFMA closes, while non-vanilla bond and floating rate note closes would be published by the NZFMA as a clean price.

The NZFMA's response paper listed the instruments that it considered to be non-vanilla that would be affected by the change in closing rate information which included 14 instruments that are currently quoted on the NZX Debt Market, by 10 discrete Issuers. NZX has attended subsequent NZFMA Credit Committee meetings, and understands that the NZFMA has re-considered the criteria for categorizing bonds as non-vanilla and that its proposal is now likely to affect four instruments quoted on the NZX Debt Market and one wholesale debt security issuer.

NZX has been considering the effects of the NZFMA's consultation on its current practices in relation to the quotation of debt instruments, and wishes to consult with the market in relation to proposals 4 and 5 which are described in this Consultation Paper.

[2] 'Changes to the Banking Supervision Handbook: Exposure Draft for Capital Review Changes", pg 17, RBNZ, November 2020.

Proposal 1: Quotation of new negative yield or zero coupon debt instruments on a price basis

Background

As discussed in the 'Background' section of this Consultation Paper, NZX undertook consultation in 2020 that resulted in NZX determining to allow debt instruments to continue to be quoted on a yield basis in a negative interest rate environment.

Proposal

NZX is proposing that new negative yield or zero coupon debt instruments be quoted on a price basis rather than a yield basis.

NZX is considering whether to introduce a price/yield calculator on nzx.com to support this proposal.

NZX considers that the quotation of these types of instruments on a price basis is consistent with the manner in which commercial paper is currently traded, where instruments are usually traded at a discount or premium from the face value of the instrument.

NZX's decision to allow existing negative interest instruments to trade on a yield basis was informed by concerns that are not relevant in the context of new instruments. This included feedback from some Issuers who expressed a strong preference that the quotation status of their instruments was not changed to a price basis.

NZX notes that a disadvantage of this proposal is that there will be a divergence in the quotation basis between new and existing instruments with similar characteristics, however NZX expects it to be unlikely that there will be significant issuances of new negative yield instruments in the near term.

NZX is also considering the information available for investors in relation to the value of these instruments and whether a price/yield calculator on nzx.com would be useful to enable investors to easily convert the price valuation to a yield basis, and vice-versa. NZX is interested in views as to whether the introduction of a calculator would be helpful, in particular, whether a calculator based on generic assumptions would provide meaningful information for specific instruments with unique features.

NZX is seeking the views of interested parties, to enable NZX to determine whether proposal 1 is the most appropriate to enable NZX to continue to operate its markets on a fair, orderly and transparent basis.

Proposal 2: AT1 Instruments ruled to be a Debt Security and traded on a price basis

Background

As discussed in the 'Background' section of this Consultation Paper, the RBNZ has proposed that an instrument must be structured as a legal form equity instrument to qualify as additional tier 1 (AT1) capital for a registered bank.

Proposal

NZ RegCo is considering issuing a class ruling that would define instruments that comply with the RBNZ's requirements for Additional Tier 1 (**AT1**) capital as Debt Securities for the purposes of the NZX Listing Rules.

NZX is also proposing that AT1 instruments would be quoted on a price basis.

Proposal 2 is consistent with current practice, where the features of an instrument such as its voting status and ranking in the event of an Issuer's liquidation, determine the status of the instrument as a Debt Security or an Equity Security.

The consequence of the AT1 instruments being defined as Debt Securities for the purposes of the Listing Rules is that the Listing Rule protections that apply to Equity Securities will not apply to AT1 instruments. This means that Issuers of AT1 instruments will not need to seek shareholder approval for issuances of additional AT1 instruments, major transactions, and related party transactions. This is considered appropriate given the nature of the AT1 instruments, including that under the RBNZ's proposed terms of AT1 instruments, AT1 holders will not have the right to vote except in relation to amendments relating to the rights, privileges, limitations and conditions attached to the AT1 instruments.

The AT1 instruments would most likely be denoted with a XYZHA ticker code, and displayed on nzx.com under the hybrid filter, that enables identification of their unique features and that they are traded on a price basis. NZX and NZ RegCo intend to work with relevant agencies in relation to the disclosure settings for AT1 instruments under the FMC Act, to ensure that investors receive appropriate disclosure to enable them to make an informed decision as to whether to acquire or dispose of an AT1 instrument.

NZX and NZ RegCo are interested in views on the proposal, including as to whether there are additional matters that should be considered in relation to the quotation status of AT1 instruments.

Proposal 3: Quotation of Tier 2 instruments on a yield basis

Background

As part of the RBNZ's consultation on changes to the banking supervision handbook, the RBNZ has consulted on the features of instruments that qualify for Tier 2 capital status.

Proposal

> NZX is proposing that instruments that instruments that meet the RBNZ's requirement for Tier 2 capital would be quoted on a yield basis.

NZX considers that it will be most appropriate to ensure that the features of Tier 2 instruments, can be readily identified by investors, by denoting these instruments with a hybrid ticker code, and displaying the instruments on nzx.com under the hybrid filter.

As Tier 2 instruments are more likely to be traded by retail investors, NZX considers that it is most appropriate for Tier 2 instruments to be traded on a yield basis as these investors benefit from the transparency and visibility provided by a yield based quotation status.

NZX is interested on views as to whether quotation of Tier 2 instruments on a yield basis is the most appropriate quotation basis for these types of instruments.

Proposal 4: Quotation of non-vanilla debt instruments affected by the NZFMA proposal on a yield basis

Background

As noted in the 'Background' section of this Consultation Paper, NZX has been participating in the NZFMA's consultation process in relation to the NZFMA's decision to provide Credit Market closing rates (**NZNG**), on a clean price rather than a yield basis for non-vanilla instruments.

NZX has been working with the NZFMA to understand the effect of this change on the quotation status of these instruments. The NZFMA has confirmed to NZX that it is not proposing changes to market making quote methods and that each bank is free to quote as it sees fit (e.g. price to reset, call, clean price[3], dirty price[4]etc). The NZFMA has also recognised that NZX's decision on

[3] A clean price does not include accrued interest between coupon payment dates.
[4] A dirty price includes accrued interest between coupon payment dates, calculated based on the coupon rates.

the quotation basis for these instruments will be informed by Issuer and NZX Participant feedback. NZX is seeking that feedback through this consultation process.

Proposal

NZX is proposing that the quotation status for the non-vanilla bonds that are quoted on the NZX Debt Market on a yield basis, that are affected by the NZFMA's change to NZNG closing rates is not amended, and that those instruments continue to be quoted on a yield basis.

NZX is proposing to retain the current yield status of these instruments based on feedback received from Issuers and NZX Participants, as part of the 2020 discussions regarding the effects of a negative interest rate environment on the quotation status of yield quoted instruments. NZX's proposal is also based on targeted engagement that NZX has undertaken with certain NZX Participants in relation to the NZFMA's proposal.

In particular, NZX understands from its bi-lateral engagement on these matters that there is a strong preference for the affected instruments to be traded on a yield basis, as investors benefit from the transparency and visibility provided by these instruments being quoted on a yield basis. NZX considers that the availability of a price/yield calculator on nzx.com may support appropriate information being available for those investors who would prefer valuation information to be provided on a price basis, although as noted earlier in the paper we are interested in views of the utility of a calculator and the assumptions on which it should be based.

Participant comments and submissions received by the NZFMA also noted that the lack of NZNG closing rate information being provided on a yield basis, should not be determinative of the quotation status for these instruments on the NZX Debt Market, because the quotation status of the instruments and closing rate information did not need to be consistent.

NZX understands that if yield instruments are migrated to a price traded status, that NZX Participants' WRAP portfolio systems will require both a change to the instrument's ISIN, and for the instruments to be recognised as new instruments, which is undesirable. In addition, certain affected Issuers have expressed a preference for the quotation status of these instruments to be maintained on a yield basis.

NZX's engagement on these matters has not demonstrated that there is behaviour to indicate that there are wide-spread concerns in terms of the accuracy of yield pricing, as is suggested in the NZFMA's consultation paper.

NZX is interested in views of submitters as to whether its reasons for the preferred treatment of the instruments affected by the NZMFA proposal are correct, and whether there are any additional matters that should be considered in relation to this proposal.

Proposal 5: Instruments with an early call or redemption date are priced to next interest rate reset date

Background

NZX currently has ten instruments quoted on the NZX Debt Market that have an interest rate reset date on which they may be called or redeemed by the Issuer. NZX sets the maturity date for these instruments as the next scheduled interest rate reset date, and prices these instruments to that date.

This is clearly denoted on nzx.com on the overview page for these instruments, for example:

NZP010

3.30%

0.00% / 0.00%

52 Week Change: -1.90% / -36.54%

Instrument Name	NZP 15/05/21 4.23% - New Zealand Post Group Finance Limited
Issued By	New Zealand Post Group Finance Limited
ISIN	NZNZPD1114L0
Type	Structured Debt
Price Per $100	$101.784
Maturity Date *	15 May 2021
Previous Payment Date	15 Nov 2020

** The Maturity Date displayed above for NZP010 is the next scheduled interest rate reset date, being the next scheduled date on which NZP010 may also be called or redeemed by NZP (subject to any applicable conditions). NZP010 is scheduled to mature on 15/11/2039.*

In light of the views expressed in the NZFMA's consultation paper regarding the market integrity concerns arising for the instruments which are priced to the next interest rate reset date, NZX has been considering whether its current practices remain appropriate.

Proposal

NZX intends to maintain the current treatment of debt instruments which are priced to the next interest rate reset date on which those instruments are callable or redeemable by an Issuer.

NZX considers that its treatment of these instruments is well understood by the market, and clearly disclosed on nzx.com, and is not aware of any market behaviours or sentiment that would require a change to its current practices.

NZX is interested in the views of submitters as to whether any changes or enhancements are required to its current practices, in light of the concerns raised in the NZFMA's consultation paper that the complexity of certain debt instruments had resulted in assumptions about calls and resets which may reduce the information value of yield pricing information.