

# Your guide to Bank Capital Notes

## And similar products such as Perpetual Subordinated Notes or Hybrid Securities



Capital notes are often issued by well-known banks, but are riskier than bank deposits. They may not be suitable for many investors. A household name and high headline rate of return alone are not good reasons to invest. You also need to understand the complex and potentially risky nature of these investments, and whether they are suitable for you.

### What are bank capital notes?

Banks must hold a certain amount of 'capital' to make them less likely to become insolvent (go out of business). Banks issue capital notes to help them raise the capital they need. You may hear different investments being described as 'Tier 1 capital' or 'Tier 2 capital' – this describes how the bank can use your money to meet its capital requirements. The important thing for investors to remember is that different capital notes have different terms and conditions, so **it's always important to read the investment statement or product disclosure statement carefully**. Common features of bank capital notes include:

- The bank may stop interest payments, or reduce the amount of interest they pay to investors, even if they're still in business.
- The bank can convert the notes into shares in the bank (or their parent company). The value of those shares at the time they are converted may be a lot less than the amount you paid for the capital notes.
- The notes may be cancelled so you lose some or all of your investment, even if the bank is still in business.

Where these features are included, they will be described in the offer document (investment statement or product disclosure statement). These features are usually subject to complex tests and conditions even experienced investors can find hard to evaluate.

Capital notes can also be issued by companies other than banks, and there are other financial products with similar features and risks to capital notes. These may be called 'hybrid securities', 'subordinated notes', 'preference shares' or 'convertible preference shares'. The product's investment statement or product disclosure statement will describe its features.

### Payments can be unpredictable

Bank capital notes will usually offer a good headline interest rate, but investors should think about whether this is enough to make the higher risks worthwhile, and whether those risks fit their investment needs. Some features of bank capital notes can be difficult to predict, including:

#### Interest payments may be reduced or stopped

Capital notes often allow the bank to stop paying interest, or reduce the amount of interest they pay, under certain circumstances. Sometimes interest payments are completely the bank's decision, even if their business is profitable. It might be difficult to predict the circumstances in which a well-known bank chooses to stop paying interest on its capital notes, but you shouldn't assume this would never happen.

#### Buy-back is usually the bank's decision

Although capital notes are long term investments, sometimes of 'perpetual' duration, they often contain provisions that lead investors to expect the bank will buy the notes back (called buy-back) after an initial period, often five years. Any buy-back is usually the bank's decision. You shouldn't assume that because the bank is a household name they will buy-back the notes after this initial period.

Capital notes are deliberately designed with features that give banks flexibility over payments. Although it can be difficult to predict when a bank might use these features, you should be aware that they can be used when it's in the bank's interests to do so.

### The market price can change quickly

Bank capital notes are usually listed on NZX, but this doesn't necessarily mean you will be able to sell your notes quickly, or at all. The market price for capital notes can change quickly. For example, the value of the note may suddenly fall if the bank suspends or defers interest payments, or if they don't buy-back the notes when the market expected them to.

### Bank capital notes are designed to protect the bank

Bank capital notes are designed to make banks less likely to become insolvent. Their terms are often controlled by the requirements of 'prudential regulation', which is regulation to protect the stability of the financial system, rather than your specific investment. The risk of loss to the bank is reduced by passing this risk on to investors who purchase their capital notes.

The same features that give banks flexibility to cancel or postpone their obligations create complex risks for investors.

### Common terms used in bank capital notes

<b>Capital</b>	This means wealth, in the form of money or assets, used to measure the bank's financial strength.
<b>Perpetual</b>	This means that your investment may never be repaid, because there is no set date the bank has to repay it on. There may be terms allowing the bank to repay early, but you shouldn't assume this will happen.
<b>No fixed maturity date</b>	This means the same thing as 'perpetual'.
<b>Loss absorbing</b>	This means the product protects the bank, not you, from loss. You may lose some or all of your investment if the bank needs to use the loss absorbing features of the product.
<b>Unsecured</b>	This means your investment is not secured (made safer) by a mortgage or security over any asset.
<b>Subordinated</b>	This means if the bank goes out of business, investors will get paid after other creditors (people or businesses owed money), if funds are available.
<b>Non-cumulative</b>	This means where interest is not paid, the bank doesn't have to pay that interest at a later date.
<b>Convertible</b>	This means your investment can change into equity. For example, it could start as a note that pays an interest rate but then be converted into shares that may not pay any dividends.
<b>Credit rating</b>	This is an independent opinion of the capability and willingness of a business to repay its debts (in other words, its creditworthiness). Don't confuse the credit rating for a bank with the credit rating for their capital notes. Capital notes will usually have a lower credit rating than the general credit rating of the bank, because of the product's higher risk. No credit rating is ever a guarantee the financial product being offered is a safe investment.

### Seek financial advice

If you are not sure about an investment, seek financial advice from an Authorised Financial Adviser (AFA). Ask whether the financial product you are considering is right for you. Our website has information on how to choose an adviser and the questions you should ask.

Always read the investment statement or product disclosure statement and ask questions if you are not sure of any feature, before investing.

For more information on different ways to invest and different types of investment see the consumer section of our website, [www.fma.govt.nz](http://www.fma.govt.nz).