The Cooperative Bank

Introduction

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This submission is made by The Co-operative Bank Limited (**Co-op Bank**, we, us) in relation to the Reserve Bank of New Zealand's (**RBNZ**) consultation paper on Mutual Capital Instruments that qualify as CET1 capital (**MCI**s) dated 16 March 2022 (**Consultation Paper**).

Co-op Bank is a registered bank structured as a co-operative company under the Co-operative Companies Act 1996 (**CCA**). While we share some of the characteristics of a company structure, we are customer-owned and operate as a co-operative. As a matter of corporate law, it would be possible for us to issue ordinary shares that qualify as CET1 (the legal framework for co-operative companies is described below), but in practice, some of the criteria for ordinary shares to qualify as CET1 are inconsistent with our core values as a customer-owned bank. Our model focuses on delivering services to our shareholders (customers) and returning any surplus profits to them.

While Co-op Bank has been able to maintain a strong capital position through retained earnings, the capital requirements have constrained our ability to grow. We have explored potential solutions but have not pursued them, in part because of uncertainty of the regulatory status of capital in a co-operative. For that reason, we are very pleased to see that the RBNZ has made the effort to consider its capital requirements through the lens of mutuality. We strongly support the development of an MCI and believe this could have a significant positive impact on the growth potential of the mutual banking sector.

Legal Background

Co-operative companies are governed by both the Companies Act 1993 (**CA**) and the CCA. For the most part, co-operative companies operate the same ways as companies, for example, the ability to issue shares is primarily governed by the CA, providing extensive flexibility in terms of the types of shares they can issue and the ability to redeem them. The overlay of the CCA provides for the following key differences between a co-operative company and an ordinary company:

(a) the principal activity of a co-operative company must be a co-operative activity (for Co-op Bank, providing goods and services to its shareholders) and this must be stated in the constitution;[1]

(b) not less than 60% of the voting rights must be held by transacting shareholders (in the case of the Co-op Bank, its customers);[2] and

[1] CCA, s 2(1).
[2] Ibid.

(c) shares may have a nominal value (which ordinary companies no longer do), including issuing different classes of shares with different nominal values.[3]

Key Submissions

We have had the opportunity to read the submission made by Southland Building Society and Nelson Building Society on the Consultation Paper (**Building Society Submission**). We support the conclusions reached in their submission and, in this submission, seek to provide additional clarification and emphasis on certain matters raised in that submission that are of particular relevance to a co-operative company.

Our key submissions are as follows:

(a) The one vote per shareholder principle applies equally to co-operatives and therefore, should qualify as full voting rights for co-operative companies in the same way it does for building societies.

(b) Policy option 1A, the Mutual Equity Instrument (**MEI**) (but with minor amendments to follow the approach of the Australian Mutual Equity Instrument as proposed in the Building Society Submission), should be available as an option for CET1 capital as it may better suit us as a co-operative company.

(c) Dividends on an MCI should be able to be calculated by reference to the amount of paid in capital (for example, using an equity index), provided that dividends are paid on the basis of a dividend policy that is completely discretionary.

(d) MCIs should be permitted to cap investors' claims or entitlements to surplus assets at the nominal value of shares.

(e) There should not be a regulatory cap on either dividends or issuance amounts. These are matters that are better managed by commercial and governance discipline.

[3] Ibid, s 15.

Problem Definition

We agree with the observation made in the Consultation Paper that the current capital requirements put mutual banks at a significant disadvantage. As a matter of corporate law, we could issue ordinary shares that would qualify as CET1 capital (subject to any restrictions in our constitution). However, there are some elements of CET1 capital for companies that do not sit well with the customer ownership that is at the heart of our business model.

Historically, co-operative companies have rarely raised capital (other than debt) from external sources. Where alternative sources of capital are required, they use debt or raise capital through corporate restructuring. This is because the interests of investors seeking to maximise profit will be at odds with the co-operative model which seeks to make profits only to the extent necessary for financial sustainability and growth. For this reason, we believe that linking distributions directly to profits will be a real challenge for co-operatives and ideally should be avoided given the potential competing interests of customers and investors.

However, access to capital is becoming a high priority issue for the international mutual sector (both in the financial and other industries), which is increasing in popularity and unable to grow to meet demand. It is also a focus of governments and regulators who see value in supporting the co-operative and mutual models. There are now various precedents for mutual capital instruments that balance mutual principles with the characteristics of equity capital.

As noted in the Consultation Paper, our inability to issue capital that qualifies as CET1 means our growth is capital constrained and our ability to manage our capital position is limited. This does not provide a level playing field for us to compete with non-mutual banks.

Below we set out our assessment of the criteria for ordinary shares that have been identified in the Consultation Paper as potentially inconsistent with mutual principles.

Criteria	Application to mutual banks
Subordination	Our shares (currently only held by customers) have a nominal value of nil and provide holders with a contractual entitlement (provided for in our rules) that arises in the event that there are residual assets in a wind up. This contractual entitlement is not a claim against the company that members could take to a liquidator. Therefore, where investors' claims to paid-in capital ranks ahead of the right of customer shareholders to residual assets (as provided for in the terms of the MEI) we believe this would still be the most subordinated "claim" and therefore consistent with the eligibility criteria for ordinary shares.
Proportionality	The requirement that an instrument entitles the holder to residual assets in a wind-up in proportion to their issued capital should not apply to an MCI. Any claim or entitlement of MCI holders on a wind-up should be capped at the nominal value of their MCIs. As demonstrated in the Building Society Submission, any other approach could have a significant detrimental effect on members' interests. In addition, we note that the issue of an MCI would not change the governance structure of a co-operative company (with control remaining primarily with customers) so that the benefit of proportionality (i.e. investors monitoring financial

Criteria	Application to mutual banks
	performance and holding the board to account) would not apply in this context as directors are instead accountable to customer shareholders. Therefore, in the context of a mutual bank, this requirement is unnecessary.
Distributions	In a co-operative company, distributions to transacting shareholders may be made equally or based on the business transacted with the company. We believe the inconsistency arises where distributions are directly linked to economic performance. This is because co-operative companies do not necessarily take a profit maximising approach and focus instead on shareholders' interests as customers. This potentially creates a direct conflict between the interests of investors and transacting shareholders. Distributions should, of course, be linked to economic performance in that they should only be paid where the financial position of the co-operative company would support this.
Voting	We understand that there has been some uncertainty as to whether "one vote per member" (which is fundamental to mutual principles) can be considered to be "full voting rights". The Consultation Paper and guidance in BPR 110 appear to accept that one vote per member is full voting rights in respect of building societies. We believe that this clarification should apply to co-operative companies, which are equally governed by mutual principles.

We believe that criteria should only be imposed to the extent that it has a clear prudential benefit. In the context of a co-operative company, where directors are ultimately accountable to transacting shareholders (rather than investors) we do not think the requirement that investors have proportionate entitlements to distributions or residual assets in a wind-up is necessary for prudential purposes. The requirements are ultimately inconsistent with co-operative principles. These criteria have been dispensed with for mutual banks in both the EU/UK and Australian capital requirements.[4]

We note that the RBNZ has determined that 'full voting rights' include 'one vote per member' under the Building Society Act 1965. We would like the RBNZ to confirm that this interpretation of full voting rights would apply to all mutual banks. Democratic voting rights are a fundamental principle of mutuality. Our customer shareholders are each entitled to one vote. Under the CCA, the default position is that only transacting shareholders have voting rights.[5] This position can be modified by the co-operative company's constitution (subject to transacting shareholders maintaining a controlling interest of at least 60% of voting right), but it would be generally inconsistent with the spirit of the co-operative model to extend voting rights to investors on anything other than a one vote per shareholder basis as this would result in the investors being better off in terms of voting than our customer shareholders. Co-op Bank's constitution does not currently permit such issues to occur, and would require a special resolution of Co-op Bank's shareholders (a majority of 75% or higher approval) for the constitution to be changed to permit a person to hold more than one share or voting right.

[4] Article 29 of Capital Requirements Regulation (CRR): Regulation (EU) No 575/2013, onshored by the UK by the European Union (Withdrawal) Act 2018; Prudential Standards APS 111 Capital Adequacy: Measurement of Capital (APS 111), attachment I.
[5] CCA, s 33.

In conclusion, while most of the eligibility criteria for ordinary shares as CET1 work for a co-operative company, a few of the criteria are not fit for purpose in the context of a co-operative bank. This is because they are either inconsistent with the co-operative business models and/or do not add any prudential benefits.

Policy Options

We agree with the Building Society Submission that it makes sense to adopt the approaches already in use in comparable jurisdictions unless there is a good reason to diverge. In particular, we think that the approaches taken in the UK and Australia should hold particular weight as G20 countries that are required to adhere to international best practice in banking supervision. Both those jurisdictions have adjusted their CET1 instrument criteria for mutual and co-operative banks, which, as we are sure you are aware, is consistent with the Basel Guidelines on Banking Supervision.[6] We propose that the approaches in these jurisdictions to qualifying CET1 capital for mutual banks be accepted in New Zealand (rather than developing our own instruments).

CCDS - UK

We understand the logic in preferring an instrument that has already been issued and tested in the market. On initial analysis, we believe this instrument could work for Co-op Bank. However, we understand from discussions with UK industry bodies that there are no banks in the UK that are structured as co-operative companies and that the instrument has not been considered in that context.

In the Consultation Paper, the descriptions of the approach to distribution policies for each of the proposed instruments differ. The description of the MEI provides that distributions could be determined based on an equity return index. The description of the MET1 omits any reference to calculating distributions on that basis.

We note that the UK and Australia take an almost identical approach to their prudential requirements, removing the following criteria (which is applicable to ordinary shares) in relation to distributions for mutual CET1 instruments:

(a) the prohibition on capping the maximum level of distributions;[7] and

(b) the prohibition on the level of (surplus) distributions being determined on the basis of the amount paid in at issuance.[8]

These adaptations of the criteria for ordinary shares are consistent with our position on criteria for distributions set out above. In the UK, the building societies that have issued a CCDS to the public all appear to have adopted a "stable" distributions policy. We have included the example of the Nationwide Building Society distribution policy as an appendix. On this basis, the level of distributions will not be linked directly to profits, but rather a rate set by the board (subject always to the board's discretion). In practice, this does not appear to be that different from the Australian approach, which is described further below.

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[6] BCBS *Core Principles for Effective Banking Supervision* September 2012, p 1.
[7] CRR, article 29(3) (note that this must be in national law on entities constitution and not the terms of the instrument; APS 111, attachment I (by omission).
[8] CRR, article 28(1)(h)(iv); APS 111, attachment I (by omission).

Mutual Equity Interest - Australia

We agree with the building societies (and perhaps feel more strongly) that an instrument that reflects the terms of the Australian Mutual Equity Interest (**AMEI**) should be available as CET1 capital in New Zealand. The Australian mutual banking sector much more closely reflects our structure because the mutual authorised deposit takers in Australia are all incorporated under the Corporations Act 2001, the Australian equivalent for these purposes of our CA. For this reason, we have undertaken additional research to better understand why APRA adopted their current approach and how this is viewed by the market.

We understand that the Australian mutual banking sector is broadly satisfied with the features of the AMEI (with the exception of the caps on issuance and distributions, which are viewed as arbitrary and overly restrictive) and consider it to strike an acceptable balance between preserving mutuality, marketability and quality of capital for prudential purposes. No AMEIs have yet been issued, which we understand is due to a combination of factors, but particularly because of significant reform in relation to mutual capital under the Corporations Act 2001 (unrelated to banking prudential requirements).[9]

The AMEI allows distributions to be calculated in relation to the amount paid at issuance. This includes calculating by reference to a benchmark to the extent that such calculation methodologies are not contractual obligations. APRA provides the following guidance on how distributions on an AMEI may be calculated:[10]

> *Distributions on MEIs are entirely discretionary... This does not prevent an ADI from using an external benchmark or index in calculating a distribution on MEIs, so long as issue documentation and marketing material do not indicate that the distribution rate will be a set amount, such as a specified margin above the bank bill swap rate applied to the face value of the instrument. That is, to appropriately reflect the equity nature of MEIs and the discretionary nature of all distributions, any reference to determining distributions by reference to a benchmark or index should be illustrative only.*

The AMEI does differ from the CCDS in terms of entitlement to surplus assets. Specifically, AMEI holders have a claim to the nominal value of their shares before any surpluses are distributed to members. While this does mean that in a wind up, losses will be absorbed first by retained earnings (and therefore is more favourable to investors than members), this approach was driven by the mutual sector. Presumably the sector was balancing the benefits to members of greater access to capital against the loss of a remote benefit (i.e. a benefit that accrues only in the rare, one-off event of a wind-up). The initial AMEI used an

[9] The Mutual Capital Instrument was an industry initiative intended to support the mutual sector grown and innovate by providing access to investment capital that did not threaten the mutual structure or status. The requirements to qualify as a Mutual Capital Instrument provide flexibility for individual mutuals to determine how distributions will be calculated and the entitlement of Mutual Capital Instrument holders to surplus assets, including sufficient flexibility to issue instruments that would qualify as a Mutual Equity Interest.
[10] APRA *Measurement of Capital – Frequently Asked Questions* <www.apra.gov.au/measurement-of-capital-frequently-asked-questions>.

approach to wind-up that was similar to the CCDS and the complexity of the instrument (exacerbated by being available on conversion from AT1 instruments) posed significant challenges to the marketability of the instrument.

In light of the market preference for this approach in Australia, we believe that this instrument feature should remain an option for a MCI in New Zealand. We cannot know with any level of certainty what terms will be acceptable to the market until we test it with investors. We think the RBNZ should take comfort in the fact that at least two G20 regulators (APRA and the PRA in respect of PPDS) have accepted this approach and allow mutual banks a reasonable level of flexibility to ensure they can meet the market.

Policy Considerations

Below we set out our assessment of the policy considerations relating to the design of the MCI in response to the questions posed in the Consultation Paper:

Criteria	Application to mutual banks
Consistency with Eligibility Criteria for Ordinary Shares	We believe that the UK and Australian instruments are consistent with the eligibility criteria for ordinary shares in all relevant respects. There is a minor inconsistency in respect of distributions (which are still entirely discretionary but are permitted to be based on a dividend policy that can be linked to the amount paid in at issuance). This is necessary for consistency with the co-operative model. The CCDS is partially inconsistent with the proportionality criteria (holders participate proportionately in residual assets up to the nominal value of shares). The AMEI is inconsistent with proportionality in that holders have a claim to the nominal value of shares but do not participate in residual assets over their nominal claim. None of these inconsistencies is likely to have a material impact on market discipline (which we understand is the reason for their inclusion) which will still be exercised by the customers through their ownership and voting rights. The Consultation Paper also suggests that the MEI would not have a variable and uncertain value because investors would receive their principal back in full before residual assets were distributed. We do not see how this would operate any differently to ordinary shares in a non-co-operative company. This capital would absorb losses on a going concern basis after retained earnings and other reserves (which is the requirement at D1.2(b) of BPR 110). Effectively the nominal value of shares would reduce as their capital was depleted.
Consistency with Mutual Principles	From the perspective of a co-operative, we believe that the key to consistency with our principles is that any capital does not require (or unduly pressure) us to profit maximise. We can make any level of distribution to the extent that we determine this to be in the best interests of our customer shareholders (i.e. the return on capital, financial or otherwise, will be greater than the cost of capital). However, directly linking distributions to a proportion of profits is inherently problematic for our co-operative model, which focuses on providing value to our customers (who are also our owners). Therefore, for consistency with mutual principles, the prudential requirements need to enable different approaches. We do not think that prudential requirements should impose any limitations for the purpose of maintaining consistency with mutual principles. In fact, we think this would likely be detrimental as it may fetter the board's ability to make decisions in the best interests of our customer shareholders.
Consistency with Capital Review Principles	We agree with the assessment made in the Building Societies Submission of consistency with the capital review principles. We would also add that we do not believe the MEI instrument (or the Australian Mutual Equity Interest) would be inconsistent with the principle that the capital requirement should be conservative relative to comparable jurisdictions. This approach to proportionality requirements for mutual instruments has already been accepted by prudential regulators in the two G20 jurisdictions with the most comparable legal systems to New Zealand.
Costs and Benefits	We agree with the assessment of the Building Societies Submission on the costs and benefits of introducing an MCI.

Restrictions

Caps on distributions

We have a strong preference to avoid any caps on distributions being set out in the MCI criteria. We understand that this has been widely criticised by the mutual banking sector in Australia and has been one of the factors that has held back adoption of the AMEI due to the concerns that arbitrary limits will impact marketability. Instead, we believe the UK approach is superior whereby the prudential requirements allow mutuals to set caps on distributions in their constitutions. This avoids any concerns with including the caps in the terms of the instrument creating investor expectations, while providing mutual banks the autonomy to determine how to limit distributions in the best interests of their customers (including by getting approval from customers to include such caps in the constitution).

Caps on issuance

We strongly believe that the board of a mutual bank is in the best position to determine whether or not to make an issuance on a case-by-case basis and that blanket caps would not be in the interests of mutual banks or their customers. We recognise that an additional reason given by APRA for imposing caps on issuance was that the AMEI were untested. Like the building societies, we do not see the merits of this argument. We believe (on the basis of the opinion of our legal advisors) that there is sufficient legal certainty as to how these instruments would operate in a wind up. Furthermore, similar instruments (namely the CCDS) have been issued in the UK which has a very similar legal system (in fact ours was modelled on it) without any such concern. In terms of market discipline, as noted above, the introduction of an MCI will have no material impact on the status quo. However, if we have misunderstood the nature of the concern, we would be interested to discuss this further with the RBNZ.

Restrictions on offers to retail investors

As a co-operative company, our traditional source of funding would be from our customers. Our preference would be to have the ability to issue to retail customers so that we would not be excluded from making offers to our customers. We believe that our existing market conduct regulation provides sufficient safeguards for retail investors and that this matter should rightly be left for the Financial Markets Authority to oversee.

BPRs

In light of our discussions with the Australian sector, we agree with the RBNZ's assessment in the Consultation Paper that an MCI should be included in the BPRs as a new component of CET1 capital. We do not expect that either approach would add to our regulatory burden or compliance costs, but given our company structure, we believe that clearly differentiating the MCI from ordinary shares will help other market participants to understand the instrument and improve transparency.

In all other respects, we think it would be simplest for the MCI to be subject to the same requirements as ordinary shares in the BPRs. However, we would not be opposed to a notification requirement which requires a legal opinion attesting to compliance with the eligibility criteria of an MCI if the RBNZ deemed that necessary as we do not think that would materially increase regulatory burden or compliance costs.

APPENDIX – NATIONWIDE BUILDING SOCIETY DISTRIBUTION POLICY

9 December 2013

Core Capital Deferred Shares – Distribution Policy

This is the Board's distribution policy relating to the payment of periodic investment returns ("**Distributions**") from time to time in respect of the Society's Core Capital Deferred Shares ("**CCDS**"), which are deferred share (core capital) investments for the purposes of the Rules of the Society.

When determining the interim or final Distributions (if any) to be declared in respect of the CCDS in respect of any given financial year, the Board will have regard to all relevant factors which it considers to be appropriate, including:

- the profitability of the Society and its resources available for distribution;
- the outlook for the Society's business, its short-term and long-term viability and the impact on the Society of the macro-economic environment in the UK, including inflation;
- the capital and liquidity position of the Society at the time of declaring the Distribution;
- the value to the Society of the capital provided by CCDS holders and rewarding investment in the capital of the Society in a commercially responsible manner, having regard to the risks inherent in such investments and the Society's need to maintain access to capital in the future;
- the benefits received by other members of the Society through the operation of the Society's business in accordance with the principles of mutuality; and
- the cap on Distributions under the Society's Rules,

and subject always to applicable law and regulation and the following overriding fiduciary duties and principles:

- the duty of the directors to act in the best interests of the Society;
- the duty of the directors to have due regard to the interests of all categories of member, both current and future, of the Society; and
- the principles of mutuality that apply by virtue of being a building society.

If the CCDS had been in issue for the financial year ended 4 April 2013, and taking into account the policy set out above, the Board is likely to have declared an interim Distribution of £5.125 per CCDS for payment in December 2012 and a final Distribution of £5.125 per CCDS for payment in June 2013.

Given the expected timing of the issue of CCDS within the Society's financial cycle, the Board currently expects to make a final Distribution payment in June 2014 which, based on the indication above, would be £5.50 per CCDS.

The Board currently expects, under normal circumstances, to adopt a stable distribution policy and therefore expects that the distribution level indicated above would be appropriate for future years, subject to Nationwide's current and anticipated financial position being viewed as satisfactory.

The indications stated above are not binding on the Society and the Board will have absolute discretion (subject to applicable law and regulation) whether or not to declare any interim or final Distribution in respect of any financial year and, if any such Distribution is declared, the amount of such Distribution. Accordingly, in respect of any given financial year, the Board may elect not to declare any Distributions, or may declare an interim and/or a final Distribution, and any such Distribution may be higher (subject to the cap on Distributions under the Society's Rules) or lower than the indications stated above.