MEMORANDUM FOR	FSO
FROM	Susan Guthrie
DATE	17 Nov 2017
SUBJECT	A common equity instrument for mutual society banks
FOR YOUR	Information and Agreement

We recommend FSO:

a) **Note** that on 15 September FSO asked for further analysis of five issues relating to the definition of capital. One of these issues was a common equity instrument for banks structured as mutual societies.

b) **Note** that preliminary analysis has been done, and our view is that no further work is required in order to make an in-principle decision on a mutual society common equity instrument. However further work is required into order to design the policy and this work should be done in consultation with the banks that are primarily affected.

c) **Agree** that Financial Policy should develop a proposal for consultation that addresses the inclusion of a common equity instrument for mutual society banks in the capital framework, acknowledging the detailed design work will take some time and should be done in consultation with the mutual society banks.

Background

1. The Capital Review was announced in March 2017. The second paper in the Review, released in July, addressed the question "What should qualify as bank capital?" Consultation on this paper closed on 8 September.

2. On 15 September FSO discussed the content of submissions to the second paper.[1] A series of further work was agreed to by FSO:

> "The Committee agreed to the recommendations that Financial Policy undertake more work: 1) looking into the role of preference shares in the bank capital regime; 2) developing a CET1 instrument suitable for banks structured as mutual societies; 3) options for grandfathering; 4) looking into the pros and cons of a common equity regime in contrast to option four of the 'numerator paper', and 5) local issuance. The next consultation paper could rule out contingent instruments as an option."

3. The purpose of this memo is to outline the further analysis completed in relation to a common equity instrument for banks structured as mutual societies.

4. While not the subject of this paper, it is worth noting that, for similar reasons to some of the arguments outlined below, we introduced credit union securities into the Non-

[1] Refer Documentum #7188187 for the minutes; Documentum #7174890 for the paper prepared for FSO.

bank Deposit-takers capital regulations, and Insurance standards, some years ago, and are supportive of extending the policy to Friendly Societies.

Feedback on reform to the capital definition from the mutual society banks

The mutual society banks believe the current definition of capital precludes them from issuing Tier 1 capital instruments, and thus confines their Tier 1 capital to retained earnings and constrains their growth.

SBS Bank and Co-op Bank, in a collective submission to the second consultation paper alongside TSB Bank and Nelson Building Society, stated that:

> "..in our view, reduced access to capital is a key constraint in achieving highly efficient and scaled operations that will further strengthen the New Zealand banking environment and create a highly-competitive banking landscape for the consumer…
>
> …it is critical for competition and diversification of capital funding, that a range of options is available for all banks, regardless of their size, through which they can raise capital. Raising Tier 1 capital is not straightforward and is time and cost intensive, especially for smaller banks such as mutually-owned and Trust-owned, non-listed banks, and it is therefore vital that there are other options available that qualify as Additional Tier 1 ('AT1') and Tier 2 capital particularly for banks which are restricted in this way."

Rather than remove contingent debt from the regime, the mutual society banks suggest extending the capital definition to include in Tier 1 instruments issued by mutual society banks:

> "Rather than restrict capital products, New Zealand would benefit from widening its requirements as have other jurisdictions, such as Canada, where parliament has enacted legislation that enables co-operatives and mutual organisations to issue alternative instruments that qualify as Tier 1 capital."

The capital position of the mutual society banks

RBNZ s105 [redacted]

	Co-op Bank	Sep-17	Sep-16	Sep-15	Peers
Capital	CET1 ratio	13.9%	15.0%	16.2%	13.2%
	Tier 1 ratio	13.9%	15.0%	16.2%	13.2%
	Total capital ratio	16.6%	16.1%	16.2%	13.5%
	RWA ($m)	1,180	1,021	901	
	Capital ($m)	196	164	146	
	Common equity	164	154	146	

The key issues.

5. The instruments used to create membership in a mutual society may not naturally qualify as common equity instruments under Basel III. The Basel III standards, for example, require holders of “common” shares to be “entitled to a claim on the residual assets that is proportional with its share of issued capital”. In contrast, the amount of surplus assets each member can access in the context of wind up may or may not be proportional to the scale of their business with the bank. If there is any suggestion that the amount an investor is entitled to in wind-up is fixed in any way, rather than variable, the instrument begins to resemble debt, a claim against the bank and thus not “capital”.

6. Similarly, the distribution rights conferred by membership may be a poor fit with Basel III. In order to qualify as common shares (and thus common equity), under Basel III, an instrument must meet the requirement that “the level of distributions is not …subject to a contractual cap”. Depending on the society’s rules, there may be such a cap.

7. Members voting rights are also different to what is envisaged in ordinary shares. Members typically have one vote each, irrespective of the scale of their activity with the bank. In contrast, one vote per share is the norm for ordinary shares.

8. Thus, membership rights in a cooperative society may not fit comfortably with the Basel III conceptualisation of ownership (i.e. “common equity”). That leaves the prospect of mutual society banks raising capital by issuing other instruments - not relying on membership rights - and having these instruments accepted as common equity. This, however, introduces a dilemma related to subordination.

9. If the cooperative society wishes to raise capital that qualifies as common equity, the providers of this capital must be the most subordinate of all - they must rank behind members when it comes to participating in surplus assets in wind up. However, members are inherently the most subordinate of all - with the society’s rules defining “surplus assets” as what is left after amounts contributed by non-members are paid. Reconciling the Basel III most subordinate requirement for a common equity instrument with the inherent subordinate nature of mutual society membership is problematic.

10. Note that under Basel III mutual society banks have been able to issue Tier 2 capital easily. This has taken the form of subordinated long term debt that ranks above members rights. Where the debt is purchased by a society member, in the event of wind up, the member will have a claim equal to the face value of the subordinated debt instrument, plus they will participate alongside other members in surplus assets (if any are available).

APRA's proposal

11. In July 2017 APRA released a discussion document outlining amendments to APS 111 (the capital standards) that will enable mutual society banks to issue common equity instruments.

12. The key features of APRA's proposal are as follows:

    - An instrument (a "mutual equity interest or MEI") can be issued that gives holders a claim to net assets in the event the bank is wound up that is senior to the claims of members;

    - The maximum that can be paid in wind-up is equal to the face value of the MEI;

    - The MEI is perpetual and is only repayable in liquidation (unless APRA agrees otherwise);

    - Holders of MEIs have a prior claim (vis a vis members) to distributed profits but this claim is capped, in aggregate, at 50% of the bank's annual net profit after tax (the balance being available to members). The distribution to MEIs is not guaranteed, and the bank has full discretion not to pay any distribution to MEI holders.

    - The distribution payable on a MEI may be based on a benchmark interest rate (but the distribution cannot be sensitive to the credit standing of the bank);

    - The distributions on MEI's are subject to the conservation buffer rule; and

    - The total face value of MEIs issued by a bank must not exceed 15% of the bank's CET1 capital (which means that, in essence, much of the banks CET1 capital will consist of accumulated past retained earnings).

    - The instrument has to be classified as equity by the prevailing accounting standards.

13. With distributions based on interest rates, distributions subject to a conservation buffer rule, and payment in wind-up capped at the face value of the MEI, APRA is, in effect, proposing to accept what looks like a perpetual preference share as CET1 capital for banks structured as mutual societies.

14. However there is one important difference between the MEI and a preference share: tying the aggregate cap on distributions on MEIs to the current year's earnings creates less certainty about the distributions paid to MEI holders (the actual distribution may depart from the benchmark interest rate because of the operation of the cap). The risk of disappointment is, in theory, less with preference shares given that preference share distributions might, in practice, be paid out of accumulated retained earnings.

EU's CRD (IV)

15. Articles 27 to 29 of EU Regulation 575/2013 relate to banks structured as mutual societies. The Articles envisage instruments issued by mutual societies being

accepted as common equity despite departing from the requirements of ordinary shares in that:

- They may have a cap or restriction on the maximum level of distributions;
- They may have a cap on the owners claim to residual assets in liquidation; and
- The level of distributions may reflect the amount for which the instrument was purchased.

UK's Mutual Deferred Shares

16. The UK has adopted EU 575/2013 which limits, but only in the broadest terms, the mutual society instruments that can be recognised as capital.

17. Since 1981 mutual societies in the UK have been able to issue deferred shares, with these instruments counting as non-core Tier 1 capital. The UK government reviewed the legislation in 2010 and In March 2015 passed legislation allowing mutual societies to issue non-voting shares known as "mutual deferred shares" (Mutuals Deferred Shares Act 2015).

18. The Act envisages a new type of society member being permitted - a "shareholder member". Thus, unlike APRA, rather than create a capital instrument that sits outside the membership structure of a mutual society, the UK approach seems to have been to try and make membership more capital-like.

19. Holders of mutual deferred shares are also members of the mutual society. If the mutual deferred share is an "ordinary mutual deferred share" the holder participates in any members' funds in wind up in proportion to their financial interest in the issuer (where the financial interest is the nominal value of the shares they hold). The ordinary mutual deferred share cannot acquire a value greater than its face value (i.e. its value in wind-up is capped at its face value). Other than in wind up, the distributed amount paid on an ordinary mutual deferred share (i.e. the income paid) cannot be linked to the issued value of the share. This suggests the shares cannot have an interest-like distribution.

20. "Member funds" include the mutual society's historic surplus attributable to members, together with future profits, but does not include capital raised from mutual deferred shares. Regular distributions are paid out of members' funds, so the latter is important beyond just wind up. If members are paid a distribution, members who hold ordinary mutual deferred shares don't necessarily get a distribution from their deferred share as well (i.e. the ordinary shares are not 'preferred' in any way to members' distributions).

21. The Act also permits "preferred mutual deferred shares" to be issued by mutual societies, but a society cannot issue both ordinary and preferred mutual deferred shares. Preferred mutual deferred shares rank ahead of members interests in wind up, with the wind up value capped at the face value of the share. Outside of wind up, distributions may be paid on preferred mutual deferred shares ahead of distributions to members.

22. The mutual society shares are complex instruments. In June 2015 the Financial Conduct Authority (FCA) announced that additional requirements would apply when selling mutual society shares that qualified as bank regulatory capital, pointing to the difficulties faced by "ordinary retail investors" trying to value instruments that are

"deeply subordinated and perpetual" and "do not have the usual voting rights of company shares, such as voting in proportion to shareholding".[2]

Canada's provincial regulations relating to mutual societies

23. The situation in Canada appears quite complicated and we have not yet assessed this in any depth. The joint New Zealand mutual society banks' submission to the second consultation paper included a cross-country comparative summary by Russell McVeagh which stated that "regulation in Canada is significantly different from New Zealand and we have not reviewed the applicable law in detail".

24. It appears that the Cooperative Credit Associations Act applies to all banks operating in Canada, including federal credit unions. Provincial credit unions are covered by provincial legislation (hence the rules relating to credit unions may vary from province to province).

25. In Ontario, for example, the Credit Unions and Caisses Populaires Act 1994 ("CUCPA") governs credit unions. Many credit unions have issued investment shares to their members but these shares have not typically qualified as common equity and, as they have typically been redeemable, have not qualified as AT1 capital either. A 2015 review of the CUCPA recommended that redeemable investment shares issued by credit unions be accepted as AT1 capital.

26. In 2017 the Australian Mutual Group, representing 10 member-owned ADIs, provided information about Canada's regulations in a submission to APRA. The information suggests that, in Ontario and British Columbia, and as is being proposed by APRA, the capital instruments may be held by parties other than society members. The submission provided the following information about Canada's rules applying to mutual societies:

- "In Ontario, the *Credit Unions and Caisses Populaires Act* provides for dividend-bearing membership shares, of which members may own more than one, as well as additional classes of shares which do not carry voting rights or rights to capital on dissolution.
- In British Columbia, the *Credit Union Incorporation Act* provides for membership shares of which a maximum of 1000 may be issued to any member, as well as additional classes of shares, all of which may receive dividends and a share of surplus assets on winding up, but each member has at most one vote.
- In Manitoba, the *Credit Unions and Caisses Populaires Act* allows for each member to own more than one common share, on which dividends may be paid and which rank last in a winding up, and which carry no voting rights except as to certain resolutions affecting the rights of shareholders.
- The Canadian federal *Bank Act* now includes provisions for federal credit unions which allow members to own more than one membership share (each of which may receive dividends and carries an equal right to surplus assets on dissolution), although membership shares may be redeemed.

Features of a mutual society instrument than would support common equity status

27. The above examples suggest there may be features, that when combined, deliver a mutual society instrument that both resembles common equity and has some appeal to investors. It is not clear that including all of the features below will create an

[2] FCA (June 2015) Policy Statement PS15/14

instrument that meets both purposes, but some combination may do so (further analysis is required and we propose this be done in consultation with the mutual society banks):

- If the mutual share is perpetual, the funding will be available to the society irrespective of its financial condition and, unlike redeemable instruments, will not be an added source of pressure when the society is in distress.
- If the mutual share confers membership, it can only be registered to individuals (companies and trusts won't qualify as members under mutual society constitutions).
- When only individuals can hold mutual society shares, there is less risk that a requirement to be non-redeemable will be circumvented (there is no obvious entity that could buy the shares en masse to give effect to redemption).
- If the distribution on the share is limited to a portion of *current year's* earnings, the distribution is less certain than the distributions paid on preference shares (and more like a dividend paid on ordinary shares).
- This is reinforced by not permitting the distributions to be linked to the face value of the share (unlike preference shares).
- If the share does not confer preference for the shareholder member over other members in the context of wind up and when distributions are paid outside of wind up, the share is the most subordinate instrument and similar to ordinary shares in a limited company.
- The above considerations point to ordinary mutual shares that are perpetual, confer society membership, have distributions limited as indicated above, and are not preferred over usual members rights, being capable of absorbing losses on a going concern basis and therefore potentially acceptable as common equity.

Comparing mutual shares and preference shares

- Based on feedback from Deutsche Craigs, it will be difficult to enforce any requirement for preference shares to be non-redeemable. This means preference shares are not committed capital and thus may be an added source of pressure on a struggling bank.
- Distributions on preference shares are preferred over distributions on ordinary shares, are related to the face value of the share, and can be paid out of accumulated retained earnings. We believe these features mean banks will be under pressure to pay distributions on preference shares even when they are struggling and thus, distributions on preference shares are unlikely to be loss absorbing on a going concern basis (i.e. they will cease only when the bank approaches non-viability).
- It seems possible to set requirements for mutual society shares that set them apart from preference shares and thus enables them to qualify as common equity whilst preference shares qualify as, at most, Tier 2 capital.

Conclusion:
In principle, it seems reasonable to recognise as common equity instruments (with appropriate features) issued by banks structured as mutual societies.

If preference shares are only to have Tier 2 status in the regime, the instrument issued by mutual society banks needs to differ in material ways from a preference share.

Further work is required and this should be done in conjunction with the affected banks. The design of appropriate requirements may take some time, but it would be useful to convey the in-principle decision to undertake this work when providing feedback on the submissions.