Mutual Capital Instruments.

Developing options for mutual banks to issue capital instruments which qualify as CET1 capital

16 March 2022

CONSULTATION PAPER

Submission Contact Details

We invite submissions on this consultation paper by 10 June 2022. Please note the disclosure on the publication of submissions below.

Address submissions and enquiries to:

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Publication of Submissions

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We plan to publish an anonymised summary of the responses received in respect of this consultation paper.

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1 Executive Summary

Banks registered in New Zealand must comply with a range of prudential requirements developed and supervised by the Reserve Bank of New Zealand – Te Pūtea Matua to promote financial stability. These prudential requirements reduce the risk of a bank failing, and protect New Zealanders from the economic and social costs associated with a bank failure.

In December 2019 we published the final decisions from the Capital Review, which focused on improving the quality and quantity of capital banks are required to hold. The final decisions included requiring banks to hold larger buffers of Common Equity Tier 1 (CET1) capital, and changes to the eligibility criteria for instruments to qualify as Additional Tier 1 (AT1) and Tier 2 capital instruments.

One unresolved issue from the Capital Review, raised by stakeholders during consultations, is to consider developing a bespoke capital instrument for banks structured as mutuals (mutual banks) which could qualify as CET1 capital – a mutual capital instrument (MCI).

We are now consulting on two policy options to facilitate the issuance of CET1 capital instruments by mutual banks. The eligibility criteria which define CET1 capital instruments are contained in Banking Prudential Requirement 110 'Capital Definitions' (BPR110).

The issues and policy options discussed in this consultation document address mutual deposit-takers registered as banks, and are not intended to address mutual deposit-takers registered as non-bank deposit takers (NBDTs), which are covered by a separate capital regime. In the future, we may review the NBDT capital adequacy framework which might consider similar issues.

1.1 What are Mutual Banks?

While most registered banks in New Zealand are structured as companies registered under the Companies Act 1993, other ownership structures exist. For example, Southland Building Society (SBS Bank) is an example of a bank structured as a building society registered under the Building Society Act 1965, while the Co-operative Bank (Co-op Bank) is structured as a co-operative company simultaneously registered under the Co-operative Companies Act 1996 and Companies Act 1993.

Both SBS Bank and Co-op Bank are examples of mutual banks. A mutual bank is a bank that is owned by its members (customers) that use its services i.e. the people who deposit with, and borrow from, the bank.

Mutual banks are founded on the principles of 'mutuality'. While the rights of a shareholder of a company (e.g. right to vote, dividends, surplus assets) are attached to each share held by the shareholder (rights 'per share'), the rights of members come from their membership of the mutual (rights 'per member').

This means that members of a mutual bank own an equal share of the mutual, hold equal voting rights (one vote per member), and are entitled to an equal share of dividends and surplus assets (upon wind-up or liquidation), no matter their scale of business with the bank.

1.2 Problem Definition

Currently, mutual banks cannot issue instruments that qualify as CET1 capital because the eligibility criteria for ordinary shares in BPR110 conflict with some of the core tenets of mutuality. This confines mutual banks' CET1 capital to retained earnings (accumulated profits not distributed to members), which represents members' ownership interest in the bank.

The sector has emphasised their inability to issue CET1 capital instruments restricts their lending growth and ability to achieve minimum efficient scale, and prevents them from building buffers of high-quality, loss-absorbing capital.[1] This might affect their ability to compete on a level playing field, which may have implications for financial stability and their role in regional economies.

In the past, we have publicly stated that we would consider the terms of any particular instrument on a case-by-case basis to determine whether it would qualify as CET1 capital. Following the Banking Prudential Requirement Exposure Draft consultation in 2021, and subsequent feedback from the sector, we now consider it is unlikely that a mutual bank would be able to design a CET1 instrument that fully complies with our current CET1 eligibility rules in BPR110 without compromising its mutual status.

1.3 What is Common Equity Tier 1 Capital?

CET1 capital is the highest quality capital and mainly consists of ordinary shares and retained earnings. Once the Capital Review decisions are fully implemented CET1 capital must comprise a minimum 11.5% of non-systemically important banks' risk-weighted assets, through a requirement to hold a substantially larger Prudential Capital Buffer.

To qualify as an ordinary share an instrument must provide a bank with a permanent and unrestricted commitment of funds that is freely available to absorb losses on a going-concern basis. The overarching requirement is that the instrument should not resemble or behave in any way like a debt instrument.

To qualify as CET1 capital, an instrument must adhere to the key requirements in BPR110 outlined in **Table A.**

Table A: Key Features of CET1 Capital

Feature	Explanation
Permanence	A CET1 instrument should have no maturity date and should not be redeemable. If instruments are redeemable there is a risk investors will be repaid when a bank is in distress, or if not repaid, signal to the market the bank's worsening financial condition.
Subordination	Investors should be the first to absorb losses and their claim should represent the most subordinate claim on a banks' assets. Investors should only receive (a portion) of their funds (if any) once all senior liabilities have been settled.
Proportionality	Surplus assets should be distributed proportionally to the capital contributed. This reinforces market discipline; if investors participate proportionally in the gains or losses of the bank, they have greater incentives to monitor the bank.

1 For example, see the submission by SBS Bank in response to the consultation on the Exposure Drafts for the Banking Prudential Requirements: rbnz.govt.nz/-/media/ReserveBank/Files/Publications/Policy-development/Banks/Review-capital-adequacy-framework-for-registered-banks/Exposure-Draft-consultation-submissions.pdf?revision=fb50c523-9a4f-4ef2-8801-295a2eac58cf&la=en

Feature	Explanation
Distributions	Distributions must not be 'coupon-like' – i.e. be linked to the principal paid at issuance or subject to a contractual cap. Distributions must also be non-obligatory and any waived distributions must be non-cumulative.
Voting rights	Investors should have full voting rights arising from ownership of the shares.
Variable value	CET1 capital should be loss absorbing on a going concern basis. This occurs when losses are transferred to investors while the bank remains viable.

1.4 Assessment Criteria for Policy Options

For an MCI to qualify as CET1 capital we consider it should satisfy three necessary criteria. The instrument:

- must have the same loss-absorbency characteristics as ordinary shares (**Criteria 1**);
- be consistent with the mutual ethos (**Criteria 2**); and
- adhere to the Capital Review principles, e.g. instruments must readily absorb losses, be conservative relative to international peers, minimise complexity, and be clear and transparent (**Criteria 3**).

CET1 capital is the highest quality capital and therefore is required to comprise the bulk of a bank's capital. We are not considering loosening the eligibility rules for CET1 capital for mutual banks. Doing so would compromise the integrity of the bank capital adequacy framework and risk creating a precedent.

Therefore, to qualify as CET1 capital an MCI must adhere to all the key requirements outlined in Table A.

1.5 Potential Policy Options

We are consulting on two policy options to provide mutual banks with an instrument which could qualify as CET1 capital:

- Option 1A: Mutual Equity Instrument; and
- Option 1B: Mutual Equity Tier 1 capital instrument.

The consultation also contains a 'doing nothing' (status quo) option.

If the 'do nothing' (status quo) option is rejected, our preferred option at this stage is Option 1B, as we consider it to be closer to having the same loss absorbing qualities as ordinary shares. In this consultation document we articulate the basis for this conclusion and invite feedback on our assessment. This will help inform final decisions about MCIs for mutual banks.

We are also seeking feedback on a range of further topics related to the detailed design features of a potential instrument (e.g. limits on issuance, parameters for distributions, repurchase of instruments etc.).

Option 1A: Mutual Equity Instrument (MEI)

We have had constructive engagements over a number of years with banks and NBDTs structured as building societies regarding capital instruments. Some mutual deposit-takers have proposed amendments to the eligibility criteria for ordinary shares in BPR110 to enable mutual banks to issue a capital instrument which they believe would meet the substantive requirements for ordinary shares, while allowing them to retain their mutual status.

This option has some features that are similar to the Mutual Equity Interest developed by the Australian Prudential Regulatory Authority. However, some features are different and it is not the same as the approach implemented in Australia. The option should be assessed based on the description of the option in this paper.

Our engagements with mutual deposit takers have helped us develop the first policy option which we have termed: a Mutual Equity Instrument (MEI).

The key features of the MEI would be:

- The instrument would consist of an unsecured investment in the mutual bank with no maturity date and no right to redeem.
- Investors' claim would rank junior to all other liabilities (e.g. members' deposits, wholesale debt instruments, Tier 2 and AT1 instruments), but rank senior to members' equity interest.
- Upon wind-up or resolution (once all senior claims are settled) investors would receive their principal in full (subject to sufficient assets).
- Any surplus assets that remained after the return of investors' principal would be allocated between investors and members equally on a 'per member' basis.
- A board-approved distribution policy (possibly based on an equity-return index) would determine distributions to investors, however final distributions would be at the board's discretion.

Option 1B: Mutual Equity Tier 1 (MET1) capital instrument

We have developed a second policy option which we have termed: a 'Mutual Equity Tier 1' (MET1) capital instrument. This shares some similarities with 'Core Capital Deferred Shares' that, in the United Kingdom, the Bank of England's Prudential Regulatory Authority recognises as CET1 capital for mutual banks structured as building societies. While it shares some similarities with the UK approach, the option should be assessed based on the description of the option in this paper.

The key features of the MET1 capital instrument would be:

- The instrument would consist of unsecured investment in the mutual bank with no maturity date and no right to redeem.
- Investors' claim would rank junior to all other liabilities (e.g. members' deposits, wholesale debt instruments, Tier 2 and AT1 instruments), but pari passu among themselves and members of the mutual bank.
- Upon wind-up or resolution, any surplus assets than remain (after all senior claims are settled) would be allocated to investors as a class according to a predetermined formula contained in

the terms of the instrument, used to determine investors' relative contribution to the total CET1 capital.

- Surplus assets attributed to investors would be distributed pro rata based on the number of instruments held by each investor.
- The residual surplus assets allocated to members would be distributed equally on a 'per member' basis.
- A board-approved distribution policy would be published separately to the terms of the instrument and communicate the Board's expectation for distributions. The distribution policy would be indicative only and distributions would remain at the Board's discretion.

1.6 Evaluation of Policy Options against Assessment Criteria

Criteria 1: Loss-Absorbency Characteristics

Both policy options would provide mutual banks with loss absorbing capital. In this regard both options meet a key feature of CET1 capital. However, we do not consider the MEI (Option 1A) would be the same quality as ordinary shares.

Under the MEI, investors' claim to surplus assets would not be proportionate to their capital contributed, nor would they have the most subordinate claim to the mutual bank's assets. First losses would be reflected in retained earnings, i.e. members would absorb the first losses.

We consider the MET1 instrument (Option 1B) would more closely adhere to the core requirements for CET1 capital as investors would have the most subordinate claim on mutual banks' assets, and their claim to surplus assets would be proportionate to their contributed capital.

During previous consultations, some stakeholders have suggested that the failure to meet the subordination and proportionality requirements should not be a prudential concern in a wind-up scenario, as the issues only arise if a bank has surplus assets (in which case it is solvent). We are uncomfortable with this conclusion, and have set out the reasons for this in this consultation paper. This is one of the areas we are seeking further feedback from stakeholders.

Criteria 2: Consistency with Mutual Ethos

Introducing a new class of 'investor member' would make a mutual bank inherently less 'mutual'. However, ultimately the decision to permit investor members (and on what terms) would be a commercial decision for mutual bank's board.

Both policy options would make investors members of the mutual bank and subject to its rules, including one vote per member (regardless of the size of their investment). In this respect, both policy options are consistent with the democratic principles of mutuality.

However, investors would likely only contribute capital if they expect to earn a higher return compared to being an ordinary member. As such, mutual banks would need a mechanism to distribute profits separately to 'investor members'. This could undermine a key aspect of what makes mutuals attractive to members, and risk diluting members' equity interest (and stunt long-term growth), particularly if investors' expected return exceeds investor members' proportional interest in the mutual bank's profits.

Finally, the MEI would require members to absorb operating losses first (via retained earnings), and provide investors with priority to surplus assets in the event of a wind-up or liquidation. In this respect, the MET1 instrument could be considered somewhat more consistent with mutual principles.

We welcome feedback on our assessment of the two policy options consistency with mutual principles.

1.7 Outline of the Consultation Paper

The Mutual Capital Instrument Consultation Paper March 2022 seeks stakeholders' views on:

- whether the we should amend BPR110 to introduce a MCI that would qualify as CET1 capital;
- the two potential policy options developed in the consultation paper: (i) the Mutual Equity Instrument, and (ii) Mutual Equity Tier 1 capital instrument; and
- a range of further topics related to the detailed design of any potential instrument (e.g. limits on issuance, parameters for distributions, repurchase of instruments).

Throughout this consultation document we identify a number of areas where we are seeking specific feedback. However, we welcome submissions on any matters contained in this consultation paper.

2 Introduction

The Reserve Bank of New Zealand – Te Pūtea Matua is consulting on whether to amend the Reserve Bank document Banking Prudential Requirement 110 'Capital Definitions' (BPR110) to facilitate the issuance of Common Equity Tier 1 (CET1) capital instruments by registered banks structured as mutuals (mutual banks).

BPR110 defines what qualifies as CET1, Additional Tier 1 (AT1) and Tier 2 capital under our capital adequacy framework, and specifies the eligibility criteria for instruments to qualify as different types of regulatory capital.

In December 2019 we published the final decisions from the Capital Review. The purpose of the review was to improve the quality and quantity of regulatory capital banks are required to hold to support the stability of the financial system.

The final decisions included requiring banks to hold larger buffers of the highest quality component of regulatory capital (CET1 capital) to be able to withstand a 1-in-200 year economic shock. Changes were also made to the eligibility criteria for instruments to qualify as AT1 and Tier 2 capital instruments.

For example, the definition of AT1 capital instruments was changed to remove convertibility features. One impact of this change is that mutual banks can now issue Redeemable Perpetual Preference Shares (RPPS) that qualify as AT1 capital for regulatory purposes. The concept of 'full voting rights' was also clarified to allow for 'one vote per member' under the Building Society Act 1965.

We have had constructive discussions over a number of years with mutual banks and non-bank deposit takers (NBDT) regarding how instruments issued by mutuals could be considered equivalent to ordinary shares, and without compromising their mutual status.

In the final Capital Review decision paper we communicated an in principle decision to work with mutual banks to explore the possibility of developing a bespoke capital instrument which could qualify as CET1 capital – a mutual capital instrument (MCI) – which is the subject of this consultation paper.

The issues and policy options discussed in this consultation document address mutual deposit-takers registered as banks, and are not intended to address mutual deposit-takers registered as non-bank deposit takers (NBDTs), which are covered by a separate capital regime. In the future we may review the NBDT capital adequacy framework which might consider similar issues. No timing has yet been set for this process.

2.1 What are Mutual Banks?

Types of Legal Entities

While most banks registered in New Zealand are structured as companies, other legal structures exist, including: co-operative companies, building societies, and credit unions (although there is currently no credit union with a banking licence operating in New Zealand).

Each legal structure represents a different type of legal entity established by different legislation. The legislation prescribes the ownership and governance arrangements for each type of legal entity, including: rules for registration; rules and duties of directors and senior officers; rights and powers of shareholders or members; disclosure, auditing and reporting requirements; restructuring rules; insolvency rules etc.

Table B provides a brief description of each type of legal entity.

Table B: Key features of different legal entities

Legal entity	Legislation	Key features	Example
Company	Companies Act 1993	A company is a type of separate legal entity that performs an economic activity and is owned by shareholders who have limited liability for the company's obligations. Shareholders do not have to supply or purchase goods or services from the company, or participate in the day-to-day activities or governance of the company. Instead, shareholders contribute capital which typically entitles them with a right to vote (e.g. to appoint board members or during shareholder resolutions) and to participate in the company's profits via dividends. Companies are governed by the Companies Act, which may be amended by a company's constitution.	TSB Bank Limited
Co-operative companies	Co-operative Companies Act 1996, Companies Act 1993	A co-operative company is a specific type of company that provides a 'co-operative activity' to its 'transacting shareholders' (members). Members must supply or purchase goods or services from the co-operative. To be a co-operative company it must be under the majority control of its members (at least 60	The Co-operative Bank Limited

Legal entity	Legislation	Key features	Example
		percent of voting rights). The co-operative's constitution must contain a description of the 'co-operative activity' it provides, and the board must annually attest that it remains a co-operative company. Co-operative companies must have member representation on the board and typically return profits to members as rebates. Co-operative companies are governed by the provisions of the Companies Act 1993, which may be amended by the co-operative's constitution.	
Building societies	Building Societies Act 1965	A building society is a type of separate legal entity that provides financial services (such as savings products or mortgages for purchasing property) to its members to promote members' long-term financial interest. A building society is owned by its members who are issued shares, and governed by a set of 'rules' which are adopted (and can be amended) by a special resolution of members (at least 75 percent of voting members). A building society's rules can govern matters such as: the types of economic activity able to be undertaken by the society, classes of membership, powers and duties of the board and senior officers, and members rights, including: right to vote, dividends and surplus assets etc.	Southland Building Society
Credit unions	Friendly Societies and Credit Unions Act 1982	A credit union is a type of separate legal entity that provides savings and loan facilities to its members. A common bond often exists among the members, for example, residing in a particular geographical location or being employed by a particular employer. A credit union is also governed by a set of 'rules'. A credit unions rules can govern matters such as: types of economic activity able to be undertaken by the credit union, classes of membership, powers and duties of the board and senior officers, and members rights, including: right to vote, dividends and surplus assets etc.	N/A[2]

2 There is currently no credit union registered as a bank operating in New Zealand. However, there are several examples of credit unions licensed as non-bank deposit takers. See the non-bank deposit taker register on the Reserve Bank website: rbnz.govt.nz/regulation-and-supervision/non-bank-deposit-takers/register

The company structure has proven to be a popular way to establish and operate a bank in New Zealand given the ease of raising additional capital, and the fact the Companies Act 1993 requirements are relatively prescriptive, which means the rights and powers of boards, senior officers, and shareholders are commonly understood.

In comparison, the Building Societies Act 1965 and Friendly Societies and Credit Unions Act 1982 are relatively flexible regimes which allow building societies and credit unions to design and amend their rules to meet their entities' particular circumstances.

A co-operative company combines the benefits of the company structure with the ability to remain member-controlled.

What is a Mutual Bank?

A mutual bank is a bank that is owned by its members (or customers) that use its services i.e. the people who deposit with, and borrow from, the bank. Theoretically, a mutual bank could adopt several different legal forms (e.g. it could be a company, a co-operative company, a building society, or a credit union).

In New Zealand there are currently two registered banks considered to be mutual banks: Southland Building Society (a registered building society) and the Co-operative Bank (a registered co-operative company).

Mutual banks are founded on the principles of 'mutuality'. While the rights of a shareholder of a company (e.g. right to vote, dividends, surplus assets) are attached to each share held by the shareholder (rights 'per share'), the rights of a member of a mutual bank come from their membership of the mutual bank (rights 'per member').

This means that each member of a mutual bank owns an equal share of the mutual, holds equal voting rights (usually one vote per member), and is entitled to an equal share of distributions and surplus assets (upon wind-up or liquidation), no matter their scale of business with the bank.

In contrast, for a shareholder of a non-mutual bank, the number of votes they have at an annual general meeting, the amount of dividends they receive, and the value of the surplus assets they are entitled to (upon wind-up or liquidation of the bank), depends on the number of shares they hold in the bank. There is also no obligation on shareholders of a non-muutal bank to be a customer of the bank they hold shares in.

In New Zealand 'a mutual' is not a legal concept, and there are no legislative reqiurements to meet the threshold to be considered a mutual.[3] Instead, the rules which establish a mutual bank's 'mutuality' are contained in its constitution (in the case of a company or a co-operative company) or its rules (in the case of a building society or a credit union). These can be found under the Companies Register, Building Society Register and Credit Unions Register.

Typically, when a new member opens a deposit account with (or receives a loan from) a mutual bank they are issued with a single share for no consideration. Generally speaking, the share confers equal voting rights (one vote), the right to participate equally in any potential future distributions, and, upon the winding up or liquidation of the mutual bank, a right to an equal share of the surplus assets (if any) after all other amounts owed have been repaid.

3 In Australia the Corporations Act 2001 s 51M specifies the legal definition for a mutual and (among other things) the Act prescribes the legal process to demutualise the entity.

The governing legislation (e.g. the Co-operative Companies Act 1995, Building Societies Act 1965) provides for mutual banks to amend their constitution and rules to establish different classes of membership with different rights. However, this could potentially make the bank 'less mutual' and could risk demutualising the entity.

2.2 What is Common Equity Tier 1 Capital?

Registered banks' conditions of registration require banks to maintain minimum CET1, Tier 1 (CET1 plus AT1) and total (CET1 plus AT1 plus Tier 2) capital ratios to absorb unexpected losses that may occur due to credit, operational or market events. CET1 capital represents the highest-quality, loss-absorbing capital and therefore is required to comprise the bulk of registered banks' capital.

Once the Capital Review is fully implemented (by July 2028) non-systemically important banks' minimum capital requirements (including the Prudential Capital Buffer) will be 16 percent of RWAs: consisting of at least 11.5 percent CET1 capital, and an additional 2.5 percent that can be made up of AT1 capital, and an additional 2 percent that can be made up of Tier 2 capital.

BPR110 defines what qualifies as CET1, AT1 and Tier 2 capital, as well as the eligibility criteria for instruments to qualify as different types of regulatory capital.

Currently under BPR110, CET1 capital comprises of: (i) paid-up ordinary shares, (ii) share premium from issuing ordinary shares, (iii) retained earnings, and (iv) other types of miscellaneous comprehensive income (e.g. unrealised gains on assets measured at fair value). Various deductions must then be made to ensure banks do not overstate their capital positions (e.g. for goodwill and deferred tax assets).

To qualify as ordinary shares, an instrument must provide the bank with a permanent and unrestricted commitment of funds, and be freely available to absorb losses on a going-concern basis. The overarching requirement is that the instrument should not resemble or behave in any way like a debt instrument.

Table C outlines the key requirements contained in BPR110 for an instrument to qualify as ordinary shares.

Table C: Eligibility rules for ordinary shares

Key feature	BPR110 reference	Requirement
Permanence	Parts D1.2(b), D1.2(g), D1.2(h), D1.2(i)	The paid-up amount must be irrevocably received by the bank so that it is perpetual (i.e. contains no maturity date). The instrument should also not be redeemable. If instruments are redeemable there is a risk investors will be repaid when a bank is in distress, or if not repaid, signal to the market the bank's worsening financial condition. The bank must create no expectation that the instrument will be redeemed, and the instrument should not contain any feature which gives rise to an expectation that the instrument will be redeemed.
Subordination	Part D1.2(c) & Part D1.2(e)	Holders of the instrument (investors) must have the most subordinate claim to the bank's assets (upon wind-up or liquidation) and take the first, and proportionality greatest, share of losses. Investors should only receive (a portion) of their committed capital (if any) once all other senior liabilities (retail

Key feature	BPR110 reference	Requirement
		and commercial deposits, wholesale debt instruments, Tier 2 and AT1 instruments) have been settled.
Proportionality	Part D1.2(f)	Investors claim to dividends and surplus assets should be proportional to their share of CET1 capital contributed. This reinforces market discipline; if investors participate proportionally in the gains or losses of the bank, they have greater incentives to monitor the financial performance and position of the bank.
Voting rights	Part D1.2(a), Part D1.2(d)	The instrument should be classified as equity under generally accepted accounting practice, and therefore holders of the instrument should have full rights associated with ownership, in particular full voting rights allowed by law.
Distributions	Part D1.3	Distributions should be contingent on economic performance and must not be 'coupon-like' – i.e. be linked to the principal paid at issuance or subject to a contractual cap. This avoids any suggestion that the payment up to the capped amount is guaranteed. Distributions must also be non-obligatory and any waived distributions must be non-cumulative. This provides a degree of loss absorbency, as distributions can be cancelled to preserve equity.
Variable value	Part D1.2(c)	CET1 capital should be loss absorbing on a going concern basis. This requires that losses are transferred to investors while the bank remains viable. Therefore the value of the instrument should fluctuate with the financial performance of the bank.

2.3 Problem Definition

Mutual banks cannot issue instruments that qualify as CET1 capital (like non-mutual banks) because many of the key eligibility criteria for ordinary shares contained in BPR110 conflict with the core tenets of mutuality.

In the past we have stated that we would consider the terms of any draft instrument developed by mutual banks on a case-by-case basis to determine whether the instrument would qualify as CET1 capital. Following the Banking Prudential Requirement Exposure Draft consultation in 2021, and the feedback from the sector, we now consider it unlikely that a mutual bank would be able to design a CET1 instrument that fully complies with our current CET1 eligibility rules in BPR110 while retaining its mutual status.

This means the capital adequacy framework currently limits mutual banks' CET1 capital to retained earnings. In order to issue ordinary shares and raise CET1 capital, mutual banks would be required to demutualise. However, mutual banks have made clear their mutual status is core to their identity and purpose.

Limited avenues to raise CET1 capital may prevent mutual banks from competing on a level playing field by restricting their lending growth and ability to achieve minimum efficient scale, and might prevent them from building buffers of high-quality, loss-absorbing capital. It also provides mutual banks with less optionality to raise additional capital if capital ratios begin to approach the regulatory minima contained in their conditions of registration.

Table D outlines how the key eligibility criteria for ordinary shares do (or do not) conflict with the principles of mutuality.

Table D: Application of key requirements for ordinary shares to mutual banks

Key feature	Application to mutual banks	
Permanence	There is no apparent conflict between the requirement for ordinary shares to be permanent and the principles of mutuality. Mutual banks can issue instruments which are permanent, with no maturity date and no right to redeem.	✓
Subordination	BPR110 requires that investors have the most subordinate claim to surplus assets upon wind-up or resolution (i.e. investors must absorb losses first). This provides banks a 'cushion' to absorb unexpected losses before creditors (particularly depositors) experience losses. However for mutual banks, members inherently have the most subordinate claim to the bank's assets. Members' equity interest is defined as the surplus assets that are left after all other amounts have been repaid.	✗
Proportionality	BPR110 requires investors participate proportionally in the gains and losses relative to their capital contributed. This reinforces investors' incentives to monitor the bank to ensure it is being run prudently. However, a core tenet of mutuality is that members are entitled to an equal share of distributions and surplus assets (upon wind-up or resolution) regardless of the scale of business they do with the bank.	✗
Distributions	A core tenet of mutuality is that members are entitled to equal distributions regardless of their scale of business with the bank. However, investors would likely only contribute additional capital if they expect to receive a higher return compared to being an ordinary member. As such, mutuals would require a mechanism to distribute profits separately to 'investor members'. This may conflict with the principles of mutuality, but does not necessarily conflict with any specific BPR110 requirements. However, the mutual banks would need to ensure the mechanism to determine distributions to investors is not 'coupon-like'. A MCI would likely be a more expensive form of CET1 capital relative to retained earnings. By issuing a MCI mutual banks could risk diluting retained earnings (which represents members' equity stake in the bank) particularly if the cost of capital exceeds investors' proportional interest in the bank's profits. In the UK, mutual banks have mitigated the risk of diluting members' equity by including caps on distributions per share. This would conflict with the BPR1110 requirement that distributions should not be subject to a contractual cap.	Uncertain
Voting rights	There is no apparent conflict between the requirement for full voting rights and principles of mutuality. During the 2021 Banking Prudential Requirement	✓

Key feature	Application to mutual banks	
	Exposure Draft consultation the concept of full voting rights was clarified to allow for 'one vote per member' under the Building Society Act 1965.	
Variable value	There is no apparent conflict between the requirement for instruments to have a variable and uncertain value and principles of mutuality. However, this would come down to the specific design of the instrument.	✓

Prima facie, there are no provisions in mutual banks' governing legislation which prevent them from issuing instruments which behave substantially like CET1 instruments, while being consistent with the mutual ethos. The question is whether we should amend the BPR110 definition of CET1 capital to recognise an MCI as regulatory capital.

Q1 We welcomes views on our problem definition, in particular our assessment of the eligibility criteria for ordinary shares against mutual principles.

2.4 Assessment Criteria for Policy Options

To qualify as CET1 capital we consider that an MCI should satisfy three necessary criteria. The instrument:

- must have the same loss-absorbency characteristics as ordinary shares (**Criteria 1**);
- be consistent with the mutual ethos (**Criteria 2**); and
- adhere to the Capital Review principles, e.g. instruments must readily absorb losses, be conservative relative to international peers, minimise complexity, and be clear and transparent (**Criteria 3**).

CET1 capital is the highest quality capital and therefore comprises the bulk of a bank's capital stack. We are not considering loosening the eligibility criteria for ordinary shares for mutual banks. Doing so would compromise the integrity of the bank capital adequacy framework, albeit for a non-systemically important subsector of the banking system, and risk creating a precedent.

Therefore, to qualify as CET1 capital, an MCI must adhere to all the key requirements outlined in Table C.

During the Banking Prudential Requirement Exposure Draft consultation, several submitters suggested the 2.5 percent cap on AT1 instruments should not apply to mutual banks on the basis that mutual banks are not required to have share capital, and therefore AT1 instruments could effectively perform as ordinary shares for prudential purposes.

Our December 2019 decisions included a judgement that we were uncomfortable with AT1 capital instruments comprising a large component of Tier 1 capital. Our assessment on AT1 instrument has not changed since the 2019 decision paper was published.

3 Potential Policy Options

We are publically consulting on two policy options to provide mutual banks with a capital instrument which qualifies as CET1 capital, as well as a third 'do nothing' (status quo) option:

- Option 1A: Mutual Equity Instrument.
- Option 1B: Mutual Equity Tier 1 capital Instrument.
- Option 2: 'do nothing' (status quo).

If Option 2: 'do nothing' (status quo) is rejected, our preferred option at this stage is Option 1B.

The remainder of the consultation document is structured as follows:

- The following two subsections provide an overview of each policy option.
- Part 4: assesses each policy option against the assessment criteria outlined in Part 2.5.
- Part 5: evaluates the costs and benefits of adopting either policy option against Option 2: 'do nothing' (status quo).
- Part 6: considers the detailed design features that would need to be considered if either policy option were to be adopted.

3.1 Option 1A: Mutual Equity Instrument

The design of the Mutual Equity Instrument (MEI) has been influenced by our discussions with mutual entities. It has some features similar to the Australian Prudential Regulatory Authority's (APRA) Mutual Equity Interest, which was developed to provide mutual authorised deposit-taking institutions (ADIs) with an instrument that qualifies as CET1 capital. However, some features are different from the approach in Australia, and Option 1A should be assessed on the basis of the features described in this paper.

The key features of the MEI would be:

- The instrument would consist of an unsecured, subordinated investment in the mutual bank with no maturity date and no right to redeem.
- Investors' claim would rank junior to all other liabilities (e.g. members' deposits, wholesale debt instruments, Tier 2 and AT1 instruments), but rank senior to members' equity interest.
- Upon wind-up or resolution (after the settlement of all senior claims) investors would receive their principal in full (subject to sufficient assets). If the mutual bank had no surplus assets, investors would receive no funds.
- Any surplus assets that remain after the return of investors' principal would be allocated between investors and members equally on a 'per member' basis.
- A board-approved distribution policy would communicate the board's expectation for distributions, but final distributions would be at the board's discretion. Members of the mutual banking sector have suggested the instrument's return could be based on an equity-return index. Investors would need to read the disclosure document in conjunction with the dividend policy to determine the relative risk/reward calculus.

- Investors would become members of the mutual bank, and be subject to its rules, including one vote per member, regardless of the number of instruments held by the investor.

Box A provides an illustrative example of how surplus assets would be allocated in the event of a wind-up or resolution.

Box A – Illustrative example of the allocation of surplus assets to MEI investors

In this hypothetical example, as at 1 January 2021 Mutual Bank's CET1 capital was $400m, comprised solely of retained earnings. Mutual Bank has 80,000 members. On 1 April 2021 Mutual Bank issued a $50m tranche of MEIs held by 1,000 unique investors with different sized holdings.

During 2021, Mutual Bank made sizable losses and depleted much of its retained earnings. With no prospects for recovery, on 1 January 2022 Mutual Bank was placed into resolution. After all senior claims are settled Mutual Bank's surplus assets are assessed to be $100m.

In this example, investors (as a class) would receive their $50m principle in full. The residual $50m surplus assets would be distributed equally on a 'per member' basis amongst the bank's 80,000 members and 1,000 investors. Each member/investor would receive $617.28, regardless of the size of their investment in, or scale of business with, Mutual Bank.

APRA's Experience with the Mutual Equity Interest

APRA developed its Mutual Equity Interest in 2017 in response to the Hammond Report (Reforms for Co-operatives, Mutuals and Member-owned Firms 2017). This was an independent government review into the state of the Australian mutual sector, which recommended a number of regulatory and legislative changes to improve mutuals' (including mutual ADIs) access to equity.

APRA capped the volume of issuance at no more than 25 percent of a mutual bank's total CET1 capital. APRA also capped annual distributions at 50 percent of a mutual ADI's net profit after tax. APRA require new issuances to be subject to regulatory approval, and require an ADI to submit to an independent legal opinion on an instrument's eligibility under the prudential framework (and other matters).

Q2 We welcome views on the Mutual Equity Instrument. Including views on the key features on the instrument, marketability of the instrument to investors, minimum viable issuance, etc.

3.2 Option 1B: Mutual Equity Tier 1 capital instrument

This option has some features that are similar to the United Kingdom's Core Capital Deferred Shares (CCDS) which are recognised by the Bank of England's Prudential Regulatory Authority as CET1 capital for mutual building societies. While it shares some similar features with the UK approach, Option 1B should be assessed on the basis of the description in this paper. We have termed this option the 'Mutual Equity Tier 1' (MET1) capital instrument.

The key features of the MET1 capital instrument would be:

- The instrument would consist of an unsecured, subordinated investment in the mutual bank with no maturity date and no right to redeem.

- Investors' claim would rank junior to all other liabilities (e.g. members' deposits, wholesale debt instruments, Tier 2 and AT1 instruments), but pari passu among themselves and members of the mutual bank.
- On the wind-up or resolution of the mutual bank, investors would be entitled to a share of surplus assets (if any) following the settlement of all senior claims. Surplus assets would be allocated to MET1 holders (as a class) according to a predetermined formula contained in the terms of the instrument used to determine MET1 investors' relative contribution to the total CET1 capital. If the mutual bank had no surplus assets, neither investors nor members would receive any funds.
- Surplus assets attributed to MET1 investors would then be distributed pro rata based on the number of instruments held by each investor.
- The residual surplus assets allocated to members would be distributed equally on a 'per member' basis.
- A board-approved distribution policy would be published separately to the terms of the instrument and communicate the board's expectation for distributions. The distribution policy would be indicative only, and final distributions would be at the board's discretion. Potential investors would need to read the terms of the instrument in conjunction with the distribution policy to determine the relative risk/reward calculus.
- MET1 investors would become members of the mutual and subject to its rules, including one vote per member, regardless of the number of instruments held by the investor.

The formula to apportion surplus assets between MET1 investors and members would be board-approved and contained in the terms of the instrument at the time of issuance.

The board would need to balance the competing interests of different classes of members; recognising the mutual bank's retained earnings have been built up by members (often over generations), and MET1 investors' proportional interest in the profit and losses of the mutual bank on an ongoing basis.

Figure 1 provides an illustrative example of the formula contained in Nationwide Building Society's (Nationwide) CCDS prospectus used to attribute surplus assets to investors.

***Figure 1: Nationwide Building Society's Core Capital Deferred Share allocation formula*[4]**

$$(1)\ Surplus\ assets\ per\ MET1\ instrument\ (\$) = \frac{Surplus\ assets_t \times MET1CP_t}{total\ number\ of\ MET1\ instruments\ on\ issue}$$

$$(2)\ MET1CP_t\ (\%) = \frac{new\ issuance\ amount_t + (MET1CP_{t-1} \times total\ CET1\ capital_t)}{new\ issuance\ amount_t + total\ CET1\ capital_t}$$

4 The MET1 contribution proportion (MET1CP) is the proportion (expressed as a percentage) of total CET1 capital determined at time 't' to have been contributed by MET1 investors. The formula contains an adjustment for cancelled instruments or instrument held by Nationwide's treasury, however that detail is unnecessary for the purpose here. Under the terms of the Nationwide instrument, investors' claim to surplus assets are re-calculated each time a new tranche is issued, or instruments are cancelled.

Box B provides an illustrative example of how surplus assets would be allocated in the event of a wind-up or resolution using the Nationwide formula.

Box B – Illustrative example of attribution of surplus assets to MET1 investors

As in the example in Box A, in this hypothetical example, as at 1 January 2021 Mutual Bank's CET1 capital was $400m, solely comprised of retained earnings. Mutual Bank also has 80,000 members. On 1 April 2021 Mutual Bank issued an initial $25m tranche of MET1 instruments to 1,000 unique investors with different sized holdings. According to the Nationwide formula the proportion of surplus assets attributable to MET1 investors upon resolution would be:

$$MET1CP\ (\%) = \frac{\$25 + (0 \times \$400)}{\$25 + \$400} = 5.9\%$$

On 1 July 2021 Mutual Bank issued a second $25m tranche to 500 unique investors with different sized holdings. Assuming Mutual Bank made $0 net profit after tax, paid no distributions, and repurchased no instruments in the intervening period, according to the Nationwide formula the proportion of surplus assets attributable to MET1 investors upon resolution would be:

$$MET1CP\ (\%) = \frac{\$25 + (0.059 \times \$425m)}{\$25 + \$425} = 11.1\%$$

During the rest of 2021 Mutual Bank recorded losses, depleting much of its retained earnings. With no prospects for recovery, on 1 Jan-22 Mutual Bank was placed into resolution. After all senior claims are settled Mutual Bank's surplus assets are assessed to be $100m.

The share of residual assets accruing to investors as a class would be $11.1 million. This amount would be distributed between the 1,500 investors *pro rata* in proportion to the number of instruments held by each investor. As a class, investors would face losses of $38.9 million, which is the difference between their investments of $50m and the $11.1 million that they are repaid as a class.

The residual surplus assets ($88.9 million) would be distributed to Mutual Bank's 80,000 members equally on a 'per member' basis. Each member would receive $1,111.25.

UK Experience with Core Capital Deferred Shares

The United Kingdom has a large mutual sector, including 43 building societies. The industry is heavily concentrated; Nationwide (total assets: £285b, Sep-21) accounts for approximately 60 percent of the mutual sector by total assets, with the next largest roughly a quarter of the size.

The Bank of England's Prudential Regulation Authority and the European Banking Authority approved CCDS to qualify as CET1 capital under Capital Requirements Directive IV. Previous mutual capital instruments (Permanent Interest Bearing Shares and Profit Participating Deferred Shares) did not meet the Basel II requirements as they did not contain convertibility or write-down features.

Nationwide has issued £1.334b of CCDS and the instrument is publicly listed on the London Stock Exchange. Several other smaller societies (Cambridge Building Society, Coventry Building Society, West Brom, and others) have also issued CCDS, often through private placements with sources of capital peculiar to them (e.g. local authorities, community trusts and charities, and philanthropic high net worth individuals).

CCDS tend to be more expensive capital for issuers than AT1 capital, and because the instrument is a hybrid between an equity and a bond it does not lend itself well to managed funds with equity or bond mandates.

Q3 We welcome views on the Mutual Equity Tier 1 capital instrument. Including views on the key features on the instrument, marketability of the instrument to investors, minimum viable issuance, etc.

4 Evaluation of Policy Options against Assessment Criteria

4.1 Criteria 1: Loss Absorbency Characteristics

The Basel Committee for Banking Supervision encourages regulators to take into account banks' ownership structure when designing CET1 capital instruments, provided the substantive quality of regulatory capital is preserved.

Neither the MET1 capital instrument, nor the MEI, are a perfect match with the existing definition of CET1 capital. Each option would require us to flex (to differing degrees) the definition of CET1 capital in BPR110. This might weaken the definition of CET1 capital, and compromise the relative simplicity of the bank capital adequacy framework by introducing a new class of instrument.

Nevertheless, we consider the MET1 capital instrument (Option 1B), closely adheres to BPR110's key eligibility criteria for ordinary shares:

- Investors would have the most subordinate claim on mutual banks' assets – ranked equally alongside members of the mutual bank;
- Individual investors' claims to surplus assets would be proportionate to their relative contribution to total CET1 capital; and
- The value of an MET1 capital instrument would be variable and uncertain, and absorb losses on a going concern basis, as investors' proportional claim to surplus assets would grow or shrink according to the mutual bank's financial performance.

The MEI (Option 1A) would provide loss absorbing capital on a going concern basis. In this regard it meets a key feature of CET1 capital. However, while it does meet this critical role, we do not consider the MEI to be the same quality as ordinary shares on the basis that:

- Investors would not have the most subordinate claim on a mutual bank's assets: investors would receive their principal investment in full, before they participate equally in surplus assets alongside members. Therefore it is members of the mutual bank who have the most subordinate claim to the surplus assets.
- Investors' claim would not be proportionate to their capital contributed: investors would receive their principal in full before participating equally alongside members in any surplus assets.

- The value of an MET1 capital instrument would not be variable or uncertain, and would not absorb losses on a going-concern basis: first losses would be reflected in retained earnings (i.e. members would absorb the first losses). The only circumstances where investor value would decline would be when retained earnings had been completely depleted. In this case, further losses would continue to detract from CET1 capital, which would at this stage only consist of the MEI.

Some stakeholders have suggested that because the MEI would be the most subordinate claim on assets after retained earnings it would effectively be performing the same prudential role as CET1 capital, i.e. the instrument would be the most subordinate claim on assets, but for members' unrealised 'paper interest' in undistributed historical profits.

This argument is an extension of the argument against the 2.5 percent cap on AT1 instruments for mutuals banks, on the grounds that because mutual banks do not have share capital, AT1 capital instruments could effectively perform the same role as ordinary shares for prudential purposes. As previously stated, this is not consistent with our position that AT1-like instruments should not comprise a large part of a bank's capital stack on the grounds it is not the same quality as ordinary shares.

Like AT1 capital, while the MEI does provide loss absorbing capital, it is not the same quality as ordinary shares, and we do not consider that it meets the key requirements for CET1 capital (e.g. subordination and proportionality). Indeed, other than the equity-like return and the fact there would be no call date after five years, the MEI bears close similarities to AT1 capital instruments.

In previous consultations, some stakeholders have suggested that this issue should not be a prudential concern, as it only arises when a bank has surplus assets. This would suggest that if a mutual bank has surplus assets when it is resolved it was (by definition) solvent, and the distribution of surplus assets should not be a prudential concern, i.e. whether surplus assets are distributed between investors and members proportionally or equally should not be a regulatory concern if all liabilities to creditors have been repaid.

This would then suggest that how surplus assets are allocated is a contractual matter entered into by investors, who generally pay little regard to how surplus assets are distributed, and are more concerned with the security of their principal and projected future income streams.

However, we have reservations about this reasoning described above. Market discipline remains a core pillar in our regulatory approach. Therefore, the distribution of surplus assets is a prudential concern. As demonstrated in Box A and Box B, the potential for investors to participate proportionately in the surplus assets (rather than receive their principal in full before members) reinforces investors' incentive to monitor the financial position of the mutual bank, and is a key characteristic which differentiates an equity instrument from a debt instrument.

There are also scenarios in which a bank might be in resolution with positive surplus assets. For example, a bank may have depleted capital to a point below the minimum capital ratio (4.5%) but still have a positive level of capital, but no prospects for recovery. In this scenario, if the holder of the MEI is repaid in full first this process could absorb all the surplus assets. The members would effectively 'absorb' the losses before investors, which we consider would violate the principle of subordination.

Finally, the suggestion that investors' return could be based on an equity-return index would likely be unacceptable as it could make the distribution 'coupon-like'. We would expect the distribution policy to provide forward guidance to investors based on forecasts of financial performance, or at the very least a target dividend pay-out ratio. This would be similar to how publically-listed companies provide shareholders earnings guidance based on key performance indicators.

Table E assesses each policy option against the key requirements for ordinary shares.

Q4 We welcome views on our assessment of two potential policy options against the key prudential requirements for CET1 capital.

Table E: Comparison of the two policy options against the eligibility criteria for ordinary shares

BPR110 requirement	Option 1A: Mutual Equity Interest's charateristics		Options 1B: Mutual Equity Tier 1 capital instrument's characteristics	
Permanence	The instrument would have no specified maturity date. A mutual bank could redeem the instrument through a non-compulsory offer to purchase at the prevailing market price (although this may require an amendment to the mutual bank's constitution or rules). During the design phase we would need to consider whether the repurchase of MCI would require our approval (as is required for the repurchase of an AT1 instrument).	✓	The instrument would have no specified maturity date. A mutual bank could redeem the instrument through a non-compulsory offer to purchase at the prevailing market price (although this may require an amendment to the mutual bank's constitution or rules). During the design phase we would need to consider whether the repurchase of MCI would require our approval (as is required for the repurchase of an AT1 instrument).	✓
Subordination	Subordination would not be achieved as currently understood. Upon winding up or liquidation, investors would be entitled to a claim on the surplus assets capped at the principal amount of the investment. After which investors would participate in any residual surplus assets equally on a 'per member' basis with members.	✗	The MET1 capital instrument would represent the most subordinate claim on a mutual bank's assets. On a winding up or liquidation MET1 instruments would rank (i) junior to all other claims (e.g. members' deposits, wholesale debt instruments, T2 and AT1 instruments), and (ii) *pari passu* amongst themselves and members in aggregate.	✓
Proportionality	Proportionality would not be achieved as currently understood. Investors would receive the principal of their investment in full before participating in the surplus assets equally on a 'per member' basis with members. This would require us to take a more flexible interpretation regarding the proportionality of claims.	?	Investors' claim to surplus assets would be proportionate to total CET1 capital contributed. A predetermined, board-approved formula contained in the terms of the instrument would be used to determine the share of surplus assets (if any) attributable to MET1 investors (as a class) based on their relative contribution to CET1 capital. Individual investors would then receive a *pro rata* share of surplus assets based on the number of instruments they held. The mechanism to attribute surplus assets to MET1 holders would introduce significant contractual complexity into the terms of the instrument and could potentially make it more difficult for a resolution authority or liquidator to administer.	✓
Distributions	A separately published, board-approved distribution policy would set out the board's expectation for distributions. The sector has suggested this could be based on an equity return index. The distribution policy would be indicative only, and distributions would be at the discretion of the board. The distribution policy could be amended by the board. However, in practice boards would likely do this sparingly as they would have made representations to investors on future income streams, and would risk disappointing investor expectations and confidence. During the detailed design phase we would need to consider whether boards could set caps on distributions to preserve retained earnings and members' equity interest in the mutual bank.	✓	A separately published, board-approved distribution policy would set out the board's expectation for distributions. The distribution policy would be indicative only, and distributions would be at the discretion of the board. This would be similar to how companies provide shareholders and potential investors' earnings guidance based on key performance indicators. The distribution policy could be amended by the board. However, in practice boards would likely do this sparingly as they would have made representations to investors on future income streams, and would risk disappointing investor expectations and confidence. During the detailed design phase we would need to consider whether boards could set caps on distributions to preserve retained earnings and members' equity interest in the mutual bank.	✓
Voting rights	Investors would become members of the mutual, and subject to its rules, including one vote per member, regardless of the number of instruments held by the investor.	✓	Investors would become members of the mutual, and subject to its rules, including one vote per member, regardless of the number of instruments held by the investor.	✓
Variable and uncertain value	Because investors would receive their principal in full (before any residual surplus assets are distributed) the instrument's value would essentially remain fixed at the principal value of the investment. The only circumstances where the value would decline would be when retained earnings had been depleted. In this case, further losses would continue to detract from CET1 capital, which would at this stage only consist of the MCI. In such a case, an investor would receive less than the face value of their investment if there were any surplus assets to distribute.	✗	MET1 investors' claim to surplus assets would be contractually capped according to a predetermined formula specified in the terms of the instrument. But the value of the investors' claim would be variable and uncertain, and hence loss absorbing on a going concern basis.	✓

4.2 Criteria 2: Consistency with Mutual Ethos

Mutual banks exist to promote the long-term interests of their members and are founded on mutual principles. Each member has equal voting rights and an equal right to distributions and surplus assets. Members of a mutual bank can realise the value of their membership directly, through receiving distributions (e.g. rebates), or indirectly, via 'better' banking services or more competitive mortgage and deposit pricing.

Introducing a new class of 'investor member' who have priority over distributions (and possibly surplus assets) may make a mutual bank inherently less 'mutual'.

Ultimately, the decision to permit investor members would be a commercial decision for a mutual bank's boards. Mutual bank's boards have a legal duty to promote the interests of their members, and therefore would need to carefully consider whether to permit a new class of membership, and if so, on what terms (e.g. the attribution rule, distribution policy), and how many instruments to issue. These are important considerations as a MCI could undermine what makes a mutual bank attractive to its members, and the premium paid on an MCI could begin to erode the benefits of the additional capital.

A MCI may be a more expensive source of CET1 capital relative to retained earnings. Although mutuals can (and do) pay their members rebates, in practice mutual banks have tended to retain the majority of their profits to accumulate CET1 capital to meet regulatory requirements and support credit growth. The lower cost of retained earnings can benefit mutual banks by lowering the average cost of funds, increasing net interest margins, and can allow mutual banks to pay more competitive term deposit rates (compared to the counterfactual).

However, investors' main motivation would likely be to maximise the return on their capital, and would have an expected rate of return in mind. Investors would likely only contribute capital if they expect a return comparable to other investment opportunities which carry similar risk. The pressure on boards to deliver on investors' expectation could risk diluting members' retained earnings and stunt long-term growth, particularly if investors' expected return exceeds investor members' proportionate interest in the mutual bank's profits.

In the UK, mutual banks have mitigated the risk of diluting members' interest by including caps on distributions per share. While in Australia, APRA has limited annual distributions to no more than 50 percent of net profit after tax.

When it comes to comparing the two policy options being considered in this paper, under both options investors would become members of the mutual bank and subject to its rules, in particular one vote per member. The instruments would therefore conform with the democratic principle of mutuality.

However, both instruments would provide investor members with a priority over distributions. The MEI would also provide investors with priority to surplus assets ahead of members. In this respect, the MET1 instrument could be considered slightly more consistent with principles of mutuality, as investors and members would rank *pari passu*.

Q5 We welcome views on our assessment of the consistency of the two potential policy options with mutual principles.

4.3 Criteria 3: Consistency with Capital Review Principles

Throughout the Capital Review we used six principles to guide policy development and evaluate potential policy options. We have assessed the two policy options in this consultation paper against the four principles that are relevant to capital instruments.

Table F provides a summary of our evaluation of the policy options against the relevant Capital Review principles.

Table F: Evaluation of options against Capital Review principles

Capital Review principle	Option 1A: Mutual Equity Intstrument	Option 1B: Mutual Equity Tier 1 capital instrument
Capital must readily absorb losses before losses are imposed on creditors and depositors.	✓ Option 1A would provide loss absorbing capital that would provide an additional buffer to shield creditors (in particular depositors) from potential losses. In this respect Option 1A is consistent with this Capital Review principle. However, investors would only begin to absorb losses once retained earnings had been depleted (i.e. members experience the first losses). In this case, further losses would continue to detract from CET1 capital, which would at this stage only consist of the MEI.	✓ Option 1B would provide loss absorbing capital that would provide an additional buffer to shield creditors (in particular depositors) from potential losses. Losses would be readily absorbed proportionately by investors and members on a going-concern basis. Option 1B is therefore consistent with this Capital Review principle.
Capital requirements should be conservative relative to those of international peers.	✗ Option 1A would require us to adopt a less conservative interpretation for the subordination and proportionality requirements. Option 1A is therefore not consistent with this Capital Review principle.	✓ Option 1B would not require a reinterpretation of subordination or proportionality, but would achieve the outcomes through novel means to reflect mutual bank's ownership structure. Option 1B is therefore consistent with this Capital Review principle.
The capital framework should be practical to administer, minimise unnecessary complexity and compliance costs.	✗ While Option 1A conceptually simple, it would add complexity to the capital framework by requiring the reinterpretation of subordination and proportionality features for mutual banks. It would also require a new class of capital instruments to be	✗ Option 1B would likely be complicated for mutual banks to administer day-to-day, and potentially more challenging for a resolution authority or liquidator to administer during a wind-up. It would also require a new class of capital instruments to be

Capital Review principle	Option 1A: Mutual Equity Intstrument	Option 1B: Mutual Equity Tier 1 capital instrument
	incorporated into BPR110 to qualify as CET1 capital, adding complexity to the capital regime. Option 1A is therefore less consistent with this Capital Review principle than the status quo.	incorporated into BPR110 to qualify as CET1 capital, adding complexity to the capital regime. Option 1B is therefore less consistent with this Capital Review principle than the status quo.
The capital framework should be transparent to enable effective market discipline.	- Option 1A is a conceptually simpler instrument but would still would require clear disclosure to potential investors. We assess Option 1A as not inconsistent with this Capital Review principle.	✗ Option 1B is considerably more complex than ordinary shares (due to the attribution rule and distribution policy). The more complicated features of this instrument would require clear disclosure to potential investors. Option 1B is therefore less consistent with this Capital Review principle than the status quo.

Table F shows the assessment against the Capital Review principles is finely balanced. Both policy options would provide loss-absorbing capital that would absorb and shield creditors and depositors from first losses.

Option 1B is more conservative as it would not require a reinterpretation of the subordination and proportionality requirements for CET1 capital instruments. Both instruments would increase the complexity of the CET1 capital definition, and be more complex than ordinary shares, reducing the clarity of the capital regime.

Q6 We welcome views on our assessment of the consistency of the two potential options with the Capital Review principles.

5 Evaluation of Policy Options against Status Quo

This section of the consultation paper evaluates the potential costs and benefits of incorporating an MCI into BPR110 (via either Option 1A or 1B), against adopting Option 2: 'do nothing' (status quo).

We will continue to develop this assessment, including considering any perspectives raised during the consultation process.

Under both policy options, the definition of CET1 capital in BRP110 would be amended to facilitate mutual banks issuance of instruments which qualify as CET1 capital. Under Option 2 'do nothing' (status quo), mutual banks would continue to be able to issue non-CET1 capital instruments for inclusion as regulatory capital (for AT1 and Tier 2 capital), but would continue to be restricted from issuing instruments which qualify as CET1 capital without compromising their mutual status.

This consultation document does not attempt a sophisticated quantitative analysis of the expected costs and benefits of adopting either policy option. We will complete a detailed Regulatory Impact Statement once the public consultation is completed and a preferred policy option is arrived at.

Financial Stability & Resolution Options

Banks are required to hold minimum levels of capital to absorb unexpected losses that may arise due to credit, operational or market events. The final Capital Review decisions included requiring banks to hold larger buffers of CET1 capital to be able to withstand a 1-in-200 year economic shock.

Once the Capital Review decisions are fully implemented, non-systemically important banks will be required to maintain a minimum CET1 capital ratio of 11.5%, through the requirement to hold a substantially larger Prudential Capital Buffer.

Incorporating an MCI into BPR110 would provide mutual banks with another option to meet rising minimum CET1 capital requirements on an ongoing basis, without compromising their mutual status. Rather than be dependent on growing retained earnings via profit growth.

Both mutual banks currently registered in New Zealand have total capital ratios that exceed the minimum total capital ratio that will be required from 1 July 2028.[5]

The mutual banking sector is small (accounting for only 1.3 percent of locally-incorporated bank assets) and is therefore unlikely to pose a significant risk to wider financial stability. However, the optionality to raise CET1 capital would help support the financial position of mutual banks and promote public confidence in the mutual banking sector (particularly during times of stress).

Under the future Deposit Takers Act, we will be required to develop resolution strategies for each licenced deposit taker. An MCI might provide the resolution authority with optionality to recapitalise a failing mutual bank, while retaining its mutual status. However, resolution plans for mutual banks might also include options which effectively demutualise the bank (e.g. sale to competitor, restructuring the bank as a company and issuing ordinary shares).

The adoption of either policy option could therefore be expected to have a small, positive impact on financial stability in the future.

5 See the RBNZ Financial Strength Dashboard bankdashboard.rbnz.govt.nz/summary?utm_source=web&utm_medium=web&utm_campaign=bankdashboard

Diversity in the Banking Sector and 'Levelling the Playing Field'

Mutual banks are important members of the New Zealand banking community, and are active in many regional centres. While mutual banks have the option to demutualise to raise further CET1 capital, they see mutuality as core to their identity and purpose.

During the Capital Review, mutual banks emphasised they consider their limited avenues to raise CET1 capital disadvantages them relative to their competitors that operate as non-mutual banks. T

While we do not have a legislative mandate to promote competition or consumer outcomes in the banking sector, we do consider the competitive impact of policy changes as part of our 'efficiency mandate'.

By accommodating mutual banks we would provide an additional source of funding, allow these entities to compete more effectively, and recognise that diversity of ownership structures in the banking sector can improve societal outcomes.

Given the current size of the mutual banking sector, we would expect the competitive benefits to be small. However, adopting either option would likely support financial system efficiency more that the 'do nothing' (status quo) option.

The challenge of raising CET1 capital is not unique to mutual banks. Other small, non-mutual domestic banks also primarily rely on profit growth to grow CET1 capital. However, these banks do not face the same inherent obstacles as mutual banks.

Providing mutual banks with an avenue to raise CET1 capital could also promote financial system efficiency by lowering a potential barrier to entry to the banking sector for NBDTs wanting to obtain a banking licence in the future. Many licensed NBDTs are structured as mutuals, and would face similar challenges when it comes to issuing instruments that qualify as CET1 capital in order to meet minimum bank capital adequacy requirements.

The adoption of either policy option could therefore be expected to have a small, positive impact on financial system efficiency in the future.

Complexity and Weakening of Regulatory Capital Definition

One of the underlying principles of the Capital Review was to create a simple and coherent capital adequacy framework. This included simplifying the definition of regulatory capital (e.g. by removing write down and convertability features from the definition of AT1 instruments) to increase confidence that instruments would perform as expected, by absorbing losses and shielding creditors from losses, when needed.

Adopting either policy option would require a weakening of the eligibility criteria for ordinary shares by introducing a new class of capital instrument which do not comply with all the key requirements for ordinary shares (or complies via a more complex mechanism).

Although MCIs have been successfully issued in other jurisdictions, they remain untested in a wind-up or resolution scenario. It is also uncertain whether issuing an MCI would impact mutual banks' ability to demutualise in the future, if desired.

Adopting either Option 1A or 1B could also risk setting a precedent for other banks to ask for changes to our capital regime to meet their own specific circumstances, further weakening the capital regime.

Compliance Costs

Under Options 1A or 1B, mutual banks could incur additional compliance costs related to ensuring instruments comply with the new CET1 capital definition. Other additional costs may also be incurred via enhanced disclosures, changes to the mutual bank's constitution or rules (if required), or a resolution by members (if required). However, these costs would only be incurred if a mutual bank chooses to issue an MCI.

Retaining the status quo would have no additional compliance costs. However, this option does not assist mutual banks to improve their capital management flexibility.

Q7 We welcome views on our high-level evaluation of the costs and benefits of adopting either potential policy options against Option 2: 'do nothing' (status quo).

6 Detailed Design Features

If we decide to proceed with either policy option, there will be a range of detailed design features that will need to be considered. These are summarised below.

We have not finalised our views on these matters and welcome interested stakeholders to make sumissions to help us develop our thinking further.

6.1 Limits on Issuance

Prima facie, we would be uncomfortable if MCIs (either Option 1A or Option 1B) comprised a large component of a mutual bank's CET1 capital, on the grounds that:

- adopting either option would result in some relaxation of the BPR110 requirements for ordinary shares;
- both policy options are untested in a wind-up or resolution scenario;
- an MCI is likely to be an expensive type of CET1 capital, and an overreliance on a MCI could adversely impact mutual banks' ability to generate CET1 capital via retained earnings; and
- issuing any type of mutual capital instrument would make a mutual bank inherently less mutual, and the more MCIs a mutual bank issues the more it risks departing from the principles of mutuality.

One option to address these concerns would be to place limits of the volume of MCIs a mutual bank could issue.

However, there are several counterarguments against placing limits on the volume of issuance, including:

- the decision on how many instruments to be issued (and on what terms) should be a commercial decision for a mutual bank's board;
- if the limit is set too low it could restrict mutual banks to a single issuance, or to multiple small issuances, which would increase compliance costs;
- a small pool of available instruments could indicate an illiquid secondary market, which might discourage potential investors;

- placing limits on distributions may be more effective at addressing some of the concerns listed above; and
- limits on the volume of MCI able to be issued could indicate that we do not have confidence in the loss absorbing quality of the instrument.

Limits on the volume of MCIs able to be issued may be appropriate if Option 1A was adopted due to our reservations about the quality of these instruments. But may not be necessary for Option 1B, where we are more comfortable that an MET1 capital instrument would meet the substantive requirements for CET1 capital.

Q8 We welcome views on whether limits should be placed on the volume of mutual capital instruments able to be issued by mutual banks, and if so, how this could best be achieved.

6.2 Parameters for Distribution Policy

Under both policy options, mutual banks' boards would be required to publish a distribution policy separately to the terms of the instrument. The distribution policy would communicate the board's expectation for distributions, but would be indicative only and could be amended by the board.

The distribution policy would have to comply with the existing requirements for distributions (e.g. not be coupon-like). We would expect the distribution policy to be based on forecasts on the mutual bank's financial performance, or an indication of a target dividend payout ratio.

As discussed in section 4.2, there is a risk a mutual bank's board may be pressured to deliver on investor expectations by paying higher distributions than is sustainable. This could dilute members' retained earnings, and stunt a mutual bank's long-term growth potential, particularly if distributions exceeds investor members' proportional interest in the mutual bank's profits.

To address this we could set parameters for the distribution policy.

At one end of the spectrum we could provide hard specifications for distribution policies. For example, APRA limits distributions on MCIs to a maximum of 50% of mutual bank's annual net profit after tax.

Alternatively, we could provide guidance on the contents of the distribution policy, but leave the specification to individual boards. For example, in the UK the Prudential Regulatory Authority allows the terms of CCDS to contain a board-determined cap on distributions per instrument.[6] Currently, under BPR110 ordinary shares must not include a cap on distributions. This would have to be amended for mutual banks if this option was adopted.

There is also a strong argument that mutual banks' existing Internal Capital Adequacy Assessment Process requirements already require mutual banks' boards to analyse the impact of a range of anticipated distribution rates on the mutual banks' capital adequacy. Therefore it could be argued that caps on distributions would not be necessary.

Q9 We welcome views on whether we should provide parameters for the distribution policy, and if so, how this could best be achieved.

6 For example, when Nationwide Building Society issued its CCDS it set a cap on distributions at £15 per CCDS, to be adjusted annually for inflation by reference to the Consumer Price Index. For FY20-21 the cap on distributions per CCDS is £16.73 per instrument.

6.3 Notification Requirement

Banking Prudential Requirement 120 'Capital Adequacy Process Requirements' (BPR120) sets out the notification process that banks are required to follow for capital instruments to qualify as AT1 or Tier 2.

This process requires banks to provide an independent legal opinion attesting that the instrument complies with the eligibility criteria set out in BPR110. This notification process is not required to be followed when banks issue ordinary shares.

Due to the complexity and novel nature of MCIs, we would need to consider whether we would require mutual banks to provide a legal opinion attesting that the instrument complies with the eligibility criteria for an MCI, and that there is nothing in the bank's constitution or rules that would adversely impact the loss absorbency of the instrument.

Q10 We welcome views on whether mutual banks should be required to follow a process similar to the notification regime outlined in BPR120 when issuing mutual capital instruments.

6.4 Approval to Repurchase

BPR120 sets out the process banks must comply with to redeem an AT1 or Tier 2 capital instrument. Banks may redeem AT1 and Tier 2 capital instruments only with our prior approval, after demonstrating that it will replace the capital instrument with an instrument which is the same or higher quality, or by demonstrating that the bank will continue to meet minimum capital requirements in the foreseeable future. This process requires banks to produce detailed forecasts of projected capital paths.

However, non-mutual banks may repurchase ordinary shares from holders at any point in time (via a non-compulsory offer to purchase) without our approval, so long as they remain compliant with their conditions of registration, e.g. minimum capital requirements.

We would need to consider whether this same flexibility should be afforded to mutual banks issuing MCIs. Alternatively, an approval process similar to the one that applies for AT1 capital and Tier 2 instruments could be considered.

Q11 We welcome views on whether mutual banks should require our approval to repurchase mutual capital instruments.

6.5 Amendments to BPR110

Adopting either policy option would require changes to BPR110 to amend the definition of CET1 capital.

Rather than amend the eligibility criteria for ordinary shares (BPR110 Part D.1), our preference would be to add a new component of CET1 capital to BPR110 Part B1.2(2). This would reference a new section in BPR110 Part D (e.g. a new Part D4.4) which would set out the eligibility criteria for an MCI.

This approach would make clear the eligibility criteria for the MCI and avoid adding unnecessary complexity to the definition of ordinary shares.

Q12 We welcome views on how best to incorporate the rules for a mutual capital instrument into BPR110.

6.6 Investors and Market Conduct Issues

While we are not the conduct regulator, poor investor outcomes (particularly for retail investors) can undermine the loss absorbency of capital instruments.

In Europe, there are several examples of mutual banks that issued hybrid capital instruments to members who did not appreciate the risk they were assuming; believing they held an insured savings product rather than an equity instrument. When the mutual banks experienced financial difficulty disgruntled constituents pressured governments to intervene with public funds.

We would need to consider whether MCIs should be able to be issued to retail investors. Our early thinking was MCIs should only be able to be issued to retail investors to reduce the risk of a concentration of shares being held by an anchor investor, who could potentially give effect to redemption.

However, there may be conduct risks if mutual banks do not adequately disclose (or retail investors don't fully appreciate) the loss-absorbing properties of their investment. Sophisticated wholesale investors may be best placed to conduct due diligence and appreciate the risk they would be assuming.

New Zealand's demanding disclosure requirements, particularly for retail offers, could mitigate this risk. We will consult with the Financial Markets Authority if either policy option proceed to the next stages.

Q13 We welcome views on whether limits should be placed on the type of investors mutual capital instruments may be sold to.

7 Overview of the Consultation Paper

This consultation paper seeks stakeholders' views on:

- whether we should amend BPR110 to introduce a MCI that would qualify as CET1 capital;
- the two potential policy options developed in the consultation paper: (i) Option 1A: the Mutual Equity Instrument (based), and (ii) Option 1B: Mutual Equity Tier 1 capital instrument; and
- a range of further topics related to the detailed design of any potential instrument (e.g. limits on issuance, parameters for distributions, repurchase of instruments).

Throughout this consultation document we have identified a number of specific areas where we are seeking feedback:

- Question 1: We welcomes views on our problem definition, in particular our assessment of the eligibility criteria for ordinary shares against mutual principles.
- Question 2: We welcome views on the Mutual Equity Instrument. Including views on the key features on the instrument, marketability of the instrument to investors, minimum viable issuance, etc.

- Question 3: We welcome views on the Mutual Equity Tier 1 capital instrument. Including views on the key features on the instrument, marketability of the instrument to investors, minimum viable issuance, etc.
- Question 4: We welcome views on our assessment of two potential policy options against the key requirements for CET1 capital.
- Question 5: We welcome views on our assessment of the consistency of the two potential policy options with mutual principles.
- Question 6: We welcome views on our assessment of the consistency of the two potential options with the Capital Review principles.
- Question 7: We welcome views on our high-level evaluation of the costs and benefits of adopting either potential policy options against Option 2: 'do nothing' (status quo).
- Question 8: We welcome views on whether limits should be placed on the volume of mutual capital instruments able to be issued by mutual banks, and if so, how this could best be achieved.
- Question 9: We welcome views on whether we should provide parameters for the distribution policy, and if so, how this could best be achieved.
- Question 10: We welcome views on whether mutual banks should be required to follow a process similar to the notification regime outlined in BPR120 when issuing mutual capital instruments.
- Question 11: We welcome views on whether mutual banks should require our approval to repurchase mutual capital instruments.
- Question 12: We welcome views on how best to incorporate the rules for a mutual capital instrument into BPR110.
- Question 13: We welcome views on whether limits should be placed on the type of investors mutual capital instruments may be sold to.

We also welcome submissions on other any matter contained in this consultation paper.