Mutual Capital Instruments

Regulatory Impact Assessment

7 December 2022

Reserve Bank of New Zealand
Te Pūtea Matua

Contents

Adequacy Assessment

This Regulatory Impact Assessment (**RIA**) provides the Reserve Bank's analysis of the costs and benefits of options for a Mutual Capital Instrument, which would be eligible as Common Equity Tier 1 capital in New Zealand's prudential framework.

The RIA has been prepared by the Reserve Bank in accordance with the requirements of section 255 of the Reserve Bank of New Zealand Act 2021 (the Act).

This Assessment provides a qualitative assessment of all decisions.

Consultation

Consultation on options for a Mutual Capital Instrument was completed by the Reserve Bank from 16 March to 10 June 2022.

The Reserve Bank received two submissions to the consultation paper. A response to submissions will be published alongside this RIA that summarises the feedback received.

Quality Assurance

The RIA has been peer reviewed by Reserve Bank staff.

Executive summary

1. Mutual banks make up a small but important part of New Zealand's banking sector. A mutual bank is founded on the principles of mutuality and is owned by its members, who all have an equal share in the bank and equal voting rights. These banks contribute to making New Zealand's financial system more diverse and inclusive, through their unique structure and mutual ethos.

2. A key challenge currently faced by mutual banks is their limited ability to raise high-quality, loss-absorbing capital. This is significant, as it restricts mutual banks' ability to grow and compete with other, non-mutual banks who do not face the same challenge. The impact of this issue may become more significant, as the amount of high-quality capital New Zealand banks are required to have is set to increase over the next decade.

3. The Reserve Bank is responding to this issue by undertaking work to develop a new capital instrument for mutual banks which could qualify as Common Equity Tier 1 capital – the highest quality, loss-absorbing capital. The new instrument is categorised as a 'mutual capital instrument' (**MCI**).

4. The Reserve Bank has created and consulted on two policy options for an MCI. Consultation on these options has now closed, which has led to the publication of this Regulatory Impact Assessment.

5. This Regulatory Impact Assessment sets out the options consulted on and analyses the options against key assessment criteria. The criteria include:

   - The Reserve Bank's legislated objectives;
   - Capital Review principles; and
   - the Financial Policy Remit.

6. Based on this criteria, we have decided to proceed further with one of the options for a mutual capital instrument (the Mutual Equity Tier 1 capital instrument). The Regulatory Impact Assessment provides further analysis of the costs and benefits of this option and considers the impact of its implementation.

Background

7. Banks registered in New Zealand must comply with a range of prudential requirements developed by the Reserve Bank of New Zealand – Te Pūtea Matua to protect and 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.

8. In December 2019 we published the final decisions from our Capital Review[1], which focused on improving the quality and quantity of capital banks are required to have. The final decisions included requiring banks to have 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.

[1] Capital Review - Decisions 2019 (rbnz.govt.nz)

9. One outstanding issue from the Capital Review was to consider developing a bespoke capital instrument for banks structured as mutuals (**mutual banks**) which could qualify as CET1 capital – an **MCI**. Currently, many of the key requirements for CET1 capital instruments can conflict with mutual banks' structures and the mutual ethos.

10. In response to this issue, the Reserve Bank undertook work to develop potential policy options for an MCI. The investigation into options was informed by international approaches to mutual capital by prudential regulators including the Australian Prudential Regulation Authority (**APRA**) and the Bank of England's Prudential Regulation Authority (**PRA**).

11. This Regulatory Impact Assessment (**RIA**) describes these options, assesses them against key criteria and provides our qualitative evaluation of the preferred option. Note that the options and analysis in this RIA only applies to registered banks, as they are subject to the capital adequacy framework. Requirements for other mutually-owned entities, such as credit unions are contained in the Non-bank Deposit Takers Act 2013 and in the Deposit Takers Regulations 2010, and are outside the scope of this RIA.

What are mutual banks?

12. 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, for example it could be a company, a co-operative company, a building society, or a credit union.

13. 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).

14. 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').

15. 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.

16. 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-mutual bank to be a customer of the bank they hold shares in.

17. In New Zealand 'a mutual' is not a legal concept, and there are no legislative requirements to meet the threshold to be considered a mutual. Instead, the rules which establish a mutual entity'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.

18. 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.

19. 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, in practicality this may be difficult to execute and could risk demutualising the entity.

What is Common Equity Tier 1 capital?

20. Registered banks' conditions of registration require the bank 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.

21. Once the Capital Review is fully implemented (by July 2028), non-domestic systemically important banks' (including mutual banks) minimum capital requirements (including the Prudential Capital Buffer) will be 16 percent of RWAs: consisting of at least 11.5 percent CET1 capital, 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.

22. The Banking Prudential Requirements (BPR) documents specify the requirements that banks must follow as part of their conditions of registration. BPR110 defines what qualifies as CET1, AT1 and Tier 2 capital, as well as the eligibility criteria for instruments to qualify as these different types of regulatory capital.[2]

23. 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).

24. The focus of our analysis is on the criteria for ordinary shares, given that these are the only qualifying CET1 capital instruments that can be used as an external source of capital generation.

25. 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. The New Zealand requirements for CET1, including ordinary shares, are based on the international banking regulations developed

[2] The BPR documents can be found here: https://www.rbnz.govt.nz/regulation-and-supervision/oversight-of-banks/standards-and-requirements-for-banks/capital-and-credit-risk-requirements

by the Bank for International Settlements in order to promote stability in the international financial system.[3]

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

Table A: Key requirements of our definition of ordinary shares (as outlined in BPR110)

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 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.
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.
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.
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

[3] https://www.bis.org/publ/bcbs118.htm

Key feature	BPR110 reference	Requirement	
		bank remains viable. Therefore the value of the instrument should fluctuate with the financial performance of the bank.	

Problem definition

27. Many of the key eligibility criteria for ordinary shares contained in BPR110 conflict with the core tenets of mutuality. This means that mutual banks are highly constrained in their ability to issue instruments that qualify as CET1 capital.

28. 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 BPR Exposure Draft consultation in 2021, and the feedback from the sector, we consider it unlikely that a mutual bank would be able to design a CET1 instrument that fully complies with our current eligibility rules in BPR110 while retaining its mutual status.

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

30. 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 options for raising additional capital if their capital ratios begin to approach the regulatory minima contained in their conditions of registration.

31. **Table B** outlines our assessment of how the key eligibility criteria for ordinary shares do (or do not) conflict with the principles of mutuality.

Table B: Application of eligibility criteria 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.	✗

Key feature	Application to mutual banks	
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 is likely to 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 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.	✓

32. While the table above suggests a number of barriers for mutual banks issuing instruments similar to ordinary shares as CET1 capital, we are not aware of any provisions in mutual banks' governing legislation that prevent them from doing so, 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, and if so, how to do this in a way that most closely matches existing CET1 requirements.

Objectives

Legislated objectives

33. The Reserve Bank Act 2021 sets the Reserve Bank's financial stability objective of protecting and promoting the stability of New Zealand's financial system.

34. The Banking (Prudential Supervision) Act 1989, provides for the Reserve Bank's role as prudential supervisor of the banking sector. This Act provides that powers be exercised for the purposes of promoting the maintenance of a sound and efficient financial system, or avoiding significant damage to the financial system that could result from the failure of a registered bank.

35. We recently published our first Statement of Prudential Policy (SoPP), which provides for transparency in how we act, or propose to act, when performing our functions as a prudential regulator and supervisor.[4]

36. As set out in the SoPP, we carry out our prudential functions with the objective of protecting and promoting the stability of New Zealand's financial system (the financial stability objective); and in accordance with the other purposes and objectives of the prudential legislation for different sectors. For banks, which are the scope for this RIA, the purposes include avoiding the significant damage to the financial system that could result from the failure of a regulated entity.

37. This RIA has been developed in accordance with the SoPP, including the RIA framework described in the SoPP, and considers the extent to which the options considered for mutual bank capital instruments help deliver the objectives set in Acts described above.

38. We have also considered the Financial Policy Remit during the preparation of this RIA. The Financial Policy Remit is issued by the Minister of Finance under the Reserve Bank Act 2021. It specifies or provides for matters that the Minister considers are desirable for the Reserve Bank to have regard to in relation to our financial stability objective, the objectives or purposes of our prudential legislation, and acting as a prudential regulator and supervisor.

Capital Review objectives

39. The underpinning rationale for the Capital Review was "to promote the soundness and efficiency of the financial system".[5] Although there were several decisions made during the Capital Review, a key decision was to increase both the quantity and the quality of capital banks must hold as buffers, with the most significant increase being for CET1 capital.

40. The introduction of an MCI would provide mutual banks with another avenue to raise CET1 capital, which could be particularly useful as bank capital buffers increase over the coming years.

41. Additionally, the Capital Review was guided by a set of principles, which we have also used to direct our assessment of the options for an MCI. These principles included:

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[4] https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/regulation-and-supervision/statements-of-approaches/sopp-2022.pdf
[5] Capital Review Decisions: https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/review-capital-adequacy-framework-for-registered-banks/decisions/capital-review-decisions.pdf?sc_lang=en&hash=1E2D9F0C3E11033AC83E604E68C12236

- Capital must readily absorb losses before losses are imposed on creditors and depositors.
- Capital requirements should be conservative relative to those of international peers.
- The capital framework should be practical to administer, minimise unnecessary complexity and compliance costs.
- The capital framework should be transparent to enable effective market discipline.

Options considered for a mutual capital instrument

42. 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);
    - must 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).
43. We publicly consulted 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 (**MEI**)
    - Option 1B: Mutual Equity Tier 1 capital instrument (**MET1 capital instrument**) (*Reserve Bank preferred option*)
    - Option 2: 'Do nothing' (status quo)

Explanation of Options 1A and 1B

44. The design of Option 1A (MEI) was influenced by our discussions with mutual entities. It includes some features similar to APRA's Mutual Equity Interest (**AMEI**) which was developed to provide mutual authorised deposit-taking institutions (**ADIs**) with an instrument that qualifies as CET1 capital. However, some features of the MEI are different from the approach in Australia.
45. The other option we consulted on (Option 1B) was the Mutual Equity Tier 1 (MET1) capital instrument, which is the Reserve Bank preferred option. 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 PRA as CET1 capital for mutual building societies. However, some features of the MET1 capital instrument differ from the PRA's approach.
46. **Table C** outlines the key features of each instrument:

Table C: Key features of each Mutual Capital Instrument option

	Option 1A: Mutual Equity Instrument	Option 1B: MET1 capital instrument
Permanence	The instrument would consist of an unsecured, subordinated investment in the mutual bank with no maturity date and no right to redeem.	The instrument would consist of an unsecured investment in the mutual bank with no maturity date and no right to redeem.
Subordination	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.	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.
Proportionality	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.	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.
Distributions	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.	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.

	Option 1A: Mutual Equity Instrument	Option 1B: MET1 capital instrument
Voting rights	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.	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.

Evaluation of policy options against assessment criteria

47. Consultation with the mutual banking sector indicated that the inclusion of an MCI (either Option 1A or 1B) would be preferable over the status quo (Option 2), based on the reasons in the 'problem definition' section. Therefore, the following evaluation focuses on assessing Option 1A (MEI) and Option 1B (MET1 capital instrument) against the key assessment criteria.

Criteria 1: Loss absorbency characteristics

48. The Basel Committee on 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.

49. 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.

50. 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.

51. 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 MEI 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.

52. Option 1B, the MET1 capital instrument, most closely aligns with the current definition of CET1 capital and is more likely to ensure that investors are incentivised to monitor the performance of the bank, as their own money is at risk.

Criteria 2: Consistency with mutual ethos

53. 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.

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

55. Ultimately, the decision to permit investor members would be a decision for a mutual banks' 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.

56. 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 status quo).

57. 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.

58. 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.

59. 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 to the democratic principle of mutuality.

60. However, both instruments would provide investor members with a priority over distributions. The MEI (Option 1A) would also provide investors with priority to surplus assets ahead of members. In this respect, the MET1 instrument (Option 1B) could be considered slightly more consistent with principles of mutuality, as investors and members would rank *pari passu* (on equal footing).

Criteria 3: Consistency with Capital Review principles

61. 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.

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

Table D: 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		

Capital Review principle	Option 1A: Mutual Equity Intstrument	Option 1B: Mutual Equity Tier 1 capital instrument
relative to those of international peers.	Option 1A would align us with the Australian approach. 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 align us more closely with the UK approach. 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 incorporated into BPR110 to qualify as CET1 capital, adding complexity to the capital regime. Option 1A is therefore not consistent with this Capital Review principle.	✗ 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 incorporated into BPR110 to qualify as CET1 capital, adding complexity to the capital regime. Option 1B is therefore not consistent with this Capital Review principle.
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 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 not consistent with this Capital Review principle.

63. Table D 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.

64. 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.

Costs and Benefits

Assessment of costs and benefits

65. We have considered the costs and benefits of the new MCI through the consideration of the options for the MCI's design. Our assessment is that the regulatory and supervisory costs of the preferred option are expected to be small and are proportionate to the risks (such as diluting the definition of CET1 capital) and benefits to the financial system. While there will be compliance costs for mutual banks issuing the new instrument, we expect that these costs will be exceeded by the benefits to the banks and the financial system that will arise from having more access to capital.

66. **Table E** summarises that main costs that we have identified.

Table E: Costs of mutual capital instruments

Cost	Assessment
Compliance costs	Mutual banks issuing the new instrument will need to ensure that it complies with the requirements set out in the revised BPR110. An Exposure Draft of these changes has been published alongside this RIA. This is true of both the options considered in this RIA, although it is possible that the compliance costs of the preferred option (1B) may be somewhat higher than 1A, due to the additional complexity in the design of the instrument.
Cost of capital	The costs of bank capital requirements were extensively considered during the Capital Review, including in the decisions announced in December 2019.[6] The MCI will provide mutual banks with an additional option for lifting capital, including meeting higher regulatory capital requirements in the future. Banks decisions about how to meet capital requirements, including through the mix of different capital instruments that are available in the prudential framework, may affect the cost of capital that they face. Mutual banks that choose to issue the new instrument will face costs from paying dividends to the holders of the asset and these costs may differ from the costs of other forms of capital. This is true of both the options considered in this RIA. It is possible that the preferred option (Option 1B) will have a higher cost of capital than Option 1A, as the instrument is more complex and holders are exposed to a greater risk of loss. In Option 1A, holders are initially protected from losses as the retained earnings are depleted first. Investors may expect to be compensated for these higher risks.

[6] https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/review-capital-adequacy-framework-for-registered-banks/decisions/capital-review-cost-benefit-analysis.pdf

Cost	Assessment
	As these instruments are new the likely costs are uncertain. We have not attempted to quantify the costs, but will closely monitor developments during implementation.

67. **Table F** summarises that main benefits that we have identified.

Table F: Benefits of mutual capital instruments

Benefit	Assessment
More flexibility to raise loss-absorbing capital	Mutual banks issuing the new instrument will have more scope to raise capital, which is true for both options.
Financial stability	The main financial stability benefits arise from the higher capital requirements imposed as a result of the Capital Review. The preferred option helps provide mutual banks an additional way to meet these higher capital requirements. In a stress event the option may also provide a mutual bank more scope to rebuild capital and support financial stability, although this might be constrained due to the stress event itself. As Option 1B meets subordination and proportionality requirements more effectively than Option 1A, we consider Option 1B provides more financial stability benefits, including my closely aligning the shareholders' financial interests with the performance of the bank.
Competition and financial inclusion	Mutual banks contribute to financial sector diversity. They can play an important role in particular sectors of the economy and regions of the country. An MCI could help enhance financial inclusion by growing the diversity of the financial sector and lift the capacity of mutual banks to grow and compete on a more level playing field with other banks.

Conclusion

68. It is possible that the preferred option (Option 1B) may be associated with some higher costs to the issuing banks, if investors consider that they are exposed to more risks in Option 1B than in Option 1A, due to the subordination and proportionality features of Option 1B. This outcome is consistent with financial stability, as in addition to absorbing losses as they arise, CET1 capital also aligns shareholders' financial interests with the performance of the bank. Shareholders have greater incentives to monitor the financial performance of the bank because they participate in its gains and losses. An increased level of CET1 capital increases the shareholders' 'skin in the game' and encourages better market discipline, a higher level of scrutiny and ultimately better supports financial stability.

69. Any additional costs in Option 1B therefore arise because the instrument performs more like CET1 than Option 1A. We consider that this helps support financial stability, by ensuring capital is high quality.

70. If mutual banks consider the costs of the new instrument to be too large then they are not required to issue MCI, provided they meet capital requirements in other ways, such as through retained earnings.

71. As demonstrated throughout the RIA, Option 1B is consistent with the Capital Review by helping provide a way for mutual banks to use high quality capital that preserves the most fundamental CET1 requirements. In addition, Option 1B is more closely matched with those CET1 requirements than Option 1A. For these reasons, plus our assessment that benefits will exceed costs, Option 1B is the preferred option identified in this RIA.

Financial Policy Remit

72. The Financial Policy Remit, issued by the Minister of Finance on 30 June 2022, to take effect on 1 July 2022, emphasises the desirability of a strong, efficient and inclusive financial system, with a low incidence of failure of regulated entities. It also signals that we should encourage a competitive financial system and have regard to Government priorities on climate change, financial inclusion, cyber resilience and supporting sustainable house prices. This section outlines how we have had regard to the Financial Policy Remit in the policy proposals in this RIA. The full text of the Remit is available on the website of the New Zealand Gazette.[7]

73. The options considered for mutual capital instruments affect only two registered banks in New Zealand and are likely to have little impact on most of the matters specified in the Financial Policy Remit.

74. The regulatory and supervisory costs of the preferred option are expected to be small and are proportionate to the risks and benefits to the financial system. While there will be compliance costs for mutual banks issuing the new instrument, we expect that these costs will be exceeded by the benefits to the banks and the financial system that will arise from having more access to capital.

75. The preferred option is not expected to have a significant impact on the following matters specified in the Financial Policy Remit:

    - The sustainable long-term growth of the economy;
    - The sustainability of house prices or investor demand; and
    - Risks related to climate change.

76. **Table G** outlines the components of the Financial Policy Remit that are relevant for the changes to the prudential capital framework discussed in this paper, through the introduction of a new mutual capital instrument.

[7] The text of the Financial Policy Remit is available here in the NZ Gazette: https://gazette.govt.nz/notice/id/2022-go2497

Table G: Financial Policy Remit assessment

Component of Financial Policy Remit	Connection with the preferred options for the design of a mutual capital instrument
"It is desirable to have a financial system that is strong, efficient and inclusive, with a low incidence of failure of entities regulated by the Reserve Bank."	The design of the new mutual capital instrument will provide mutual banks with more flexibility to raise high quality, loss-absorbing capital. This will help support the resilience of those entities, helping to underpin the strength and stability of the financial system.
"Within the appetite of a low incidence of failure, a competitive financial system should be encouraged so as to best ensure ongoing financial efficiency and inclusion."	More options to raise capital should help mutual banks to compete on a more level playing field with other banks.
"Encouraging new investment and financial innovation that raise the productive potential of the economy"	More options to raise capital should help encourage investment in the financial system. However, due to the relatively small size of the affected entities, the overall impact on the productive potential of the economy is likely to be small.
Financial inclusion	Mutual banks contribute to financial sector diversity. They often play an important role in particular sectors of the economy and regions of the country. An MCI could help enhance financial inclusion by growing the diversity of the financial sector and lift the capacity of mutual banks to grow and compete.

Implementation

77. The banking industry, as well as the wider population, will be consulted on the amended BPRs and have the opportunity to comment on the practical application of the new MCI.

78. This consultation will be particularly useful given the complexity of the MCI. Initial discussions with the mutual banking sector has indicated that the Reserve Bank's preferred option (Option 1B) may be more complex to implement, though the sector has not yet tested this option with investors. Feedback on implementation and compliance costs will help inform the final design of the MCI.

Monitoring, Evaluation and Review

79. The Reserve Bank will consider reviewing the terms of the MCI at some point in the future, after allowing for a reasonable period of time to assess implementation and outcomes. As part of this, we will closely monitor the use of the instrument by banks.