

Mutual Capital Instruments

Response to Submissions on Exposure Drafts

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Reserve Bank
of New Zealand
Te Pūtea Matua



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Background

1. 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 if a bank failure were to occur.
2. In December 2019, we published the final decisions from the Capital Review, which focused on improving the quality and quantity of capital that banks are required to have. 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.
3. One unresolved issue from the Capital Review, raised by stakeholder during consultations, was to consider developing a capital instrument for banks structured as mutual (mutual bank) which could qualify as CET1 capital – a mutual capital instrument (MCI).
4. 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).
5. In March 2022, we released the consultation paper '*Mutual Capital Instruments: Developing options for mutual banks to issue capital which qualify as CET1 capital*'¹. This paper contained two policy options for an MCI including possible design features of any potential future instrument and its incorporation into the *Banking Prudential Requirements* (BPR) documents.
6. In December 2022, after consideration of feedback to the consultation paper, we announced our preferred design for the MCI. This involved publishing Exposure Drafts of *BPR110 Capital Definitions* (BPR110) and *BPR120 Capital Adequacy Process Requirements* (BPR120) for feedback. We also published a *Regulatory Impact Assessment*² and our *Response to Submissions*³, which set out our analysis for our preferred design.
7. We have considered the feedback on the Exposure Drafts and further refined the design of the MCI. We are now in a position to publish revised Exposure Drafts for final technical drafting comments. Following that, we will publish the amended BPR documents.
8. This *Response* document summarises the feedback we received on the Exposure Drafts and the Reserve Bank's response to the matters raised during consultation.

¹ https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/consultations/banks/mutual-capital-instruments/mutual-capital-instruments-consultation-paper.pdf?sc_lang=en&hash=68AC7DB23C32F359102B11B09EE689A

² <https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/regulation-and-supervision/banks/capital-review/mci-regulatory-impact-assessment-for-publication.pdf>

³ <https://www.rbnz.govt.nz/-/media/project/sites/rbnz/files/regulation-and-supervision/banks/capital-review/mci-response-to-submissions-for-publication.pdf>

Consultation Process

9. Consultation on the Exposure Drafts was open from 7 December 2022 to 31 March 2023. The Reserve Bank received a joint submission from the mutual banking industry. That group of respondents are collectively referred to in this paper as ‘the submitters’.
10. This paper responds to the technical feedback and drafting suggestions raised in that submission and is not intended to be an exhaustive response to all points raised. Readers are encouraged to refer to the full published submission for further details.
11. Additionally, this paper does not cover all aspects of the MCI’s design. It focuses on key technical aspects highlighted in the submission. Readers are encouraged to refer to the previously published *Response to Submissions* and *Regulatory Impact Assessment* for further details on the design of the instrument and rationale for those decisions.
12. In addition to receiving their written submission, the Reserve Bank engaged with the mutual banking industry through a series of meetings. In some cases, these meetings saw additional feedback raised beyond what was included in the formal submissions. Where possible, we have also responded to this additional feedback or points of clarification.
13. This content of this *Response* document aligns with the key points in the written submission we received. Part One of this document covers the design of the MCI expressed in the Exposure Drafts. Part Two covers other matters raised in feedback.
14. The table in the following section summarises the issues raised by submitters and the associated decisions made by the Reserve Bank. The tables are not exhaustive and other issues are described in more detail throughout the *Response*.

Summary of Decisions

Table 1: Key Consultation Topics

Issue	Decision
Should the requirements for the mutual capital instrument be incorporated into subpart D1 in BPR110 (the requirements for ordinary shares)?	We will create a new subpart ‘D1A’ in BPR110, specific to the requirements for the mutual capital instrument and separate to ordinary shares.
Should the mutual capital instrument be required to be denominated in New Zealand Dollars?	The mutual capital instrument may be issued in foreign currencies with additional notification requirements.
Should the mutual capital instrument and all constituting documents be required to be governed by New Zealand law?	The mutual capital instrument may be governed by permitted foreign law, with additional legal sign-off requirements.
Should a member of the bank’s banking group be permitted to purchase a mutual capital instrument previously issued by the banking group?	Members of the bank’s banking group may purchase a mutual capital instrument previously issued by the group, but these instruments must be deducted from total CET1 capital.

Part One: Summary of Consultation Issues and Feedback

Design features of the mutual capital instrument

Distribution policy

15. A key principle of CET1 capital is that distributions to instrument holders must not be 'coupon-like', meaning they must not be linked to the principal invested at issuance or subject to a contractual cap. As a result, any distributions on an MCI are wholly at the Board of the mutual bank's discretion. In order to facilitate distributions on an MCI, the Reserve Bank would require a mutual bank to publish an indicative discretionary distributions policy, separate to the terms of the instrument.
16. In their feedback, the submitters highlighted that any distributions policy would be a key aspect of the marketability of the MCI. They note that the requirement for distributions to not be linked to the amount paid at issuance could impact their ability to market the instrument through the distribution policy document.
17. In response, the submitters suggested the addition of a guidance note into BPR110 that clarifies that the distribution principle does not prevent mutual banks from indicating an intended or projected return to investors as part of the discretionary distribution policy.
18. The Reserve Bank is comfortable with this approach, provided the distribution policy makes clear that any return or distributions per MCI are totally discretionary. We have had initial discussions with the submitters to explore the possible content and wording of a future distribution policy to ensure it aligns with our policy approach. The Reserve Bank will continue to engage with the submitters on their proposed distribution policies.

Distribution of surplus assets upon wind-up

19. Another key principle of CET1 capital is proportionality; which is the idea that surplus assets should be distributed proportionally to the capital contributed. This reinforces market discipline; if investors participate proportionally in the gains and losses of the bank, they have greater incentives to monitor the bank.
20. The Exposure Draft of BPR110 included a formula to calculate the proportion of surplus assets that would be allocated to MCI holders (as a class) in a wind-up of a mutual bank. This formula was designed to ensure that the principle of proportionality is upheld in a wind-up scenario and to protect the claims of member-customers of the mutual bank.
21. The submitters suggested some amendments to the formula to take into account any MCI cancellations and to clarify the definition of 'total CET1 capital' expressed in the formula. The submitters also sought to add some clarifying changes to the description of how to use the formula to ensure it is applied to the correct group of members (MCI holders), at the correct time.
22. The Reserve Bank has reviewed the suggested changes to the formula and is comfortable that it still operates as intended, to allocate a proportion of surplus assets to MCI holders.
23. Additionally, the submitters had previously requested that the distribution of surplus assets to instrument holders in a wind-up may be capped at the amount paid-in at issuance. Upon review of international approaches to MCI, the submitters have requested the additional

flexibility to cap the distribution of surplus assets in a wind-up to the 'Average Principal Amount' rather than the exact amount paid in by each instrument holder. This aligns with the approach used by the PRA in the Core Capital Deferred Shares (CCDS) regime. While the submitters have not yet determined which approach is most appropriate in the New Zealand context, they wish to retain the flexibility to use either approach and have suggested some amendments to the wording in BPR110 to reflect this.

24. The Reserve Bank is generally comfortable with allowing mutual banks the discretion to cap distributions of surplus assets in a wind-up in accordance with their preferred approach. We note that this discretionary feature would limit instrument holders' participation in any upside upon wind-up while ensuring they participate proportionally with any losses in a downside.

Alignment with requirements for ordinary shares

25. The submitters have requested the removal of certain requirements in BPR110 to better align the MCI with the requirements for ordinary shares, which has been a key focus during the development of the instrument.

Issuances in foreign currencies

26. The proposed requirements in BPR110 initially specified that the MCI must be denominated in New Zealand dollars. The submitters have requested that issuances in foreign currencies be permitted, as in addition to this not being a requirement for ordinary shares, this may unnecessarily restrict their ability to raise capital, particularly in more established capital markets.
27. Although issuances in foreign currencies introduces complexity to the operation of the instruments, it is still workable within the capital framework. The Reserve Bank has conducted analysis on how such issuances might work, particularly in a wind-up, and tested this with the submitters, who agree with our approach.
28. Based on this, we are comfortable with permitting issuances in foreign currencies. We have added provisions for the use of foreign currencies, including additional notification requirements in BPR120.

The use of foreign governing law

29. The Exposure Drafts initially required the MCI to be governed by NZ law. The submitters requested that this requirement be removed, and the use of foreign governing laws be permitted. The rationale for this request is that there is no equivalent requirement for ordinary shares, and such a requirement may limit mutuals' ability to raise capital in jurisdictions with more mature mutual markets.
30. The Reserve Bank has previously considered the use of foreign governing laws for other capital instruments (such as Tier 2 instruments). At present, there are four permitted foreign laws: New South Wales (Australia), Victoria (Australia), England and New York. We are comfortable with the use of these four permitted foreign governing laws for the MCI.
31. To manage the risks associated with the use of foreign governing law, we have added requirements that a mutual bank must provide the Reserve Bank with a foreign law opinion that confirms that there are no identified impediments in that foreign jurisdiction that could

affect certain key terms of the instrument operating as intended. This aligns with the Reserve Bank's approach to the use of foreign governing law for Tier 2 instruments.

Limitations on members of a bank's group purchasing its MCI

32. The Exposure Drafts previously stipulated that no member of a bank's banking group may purchase an MCI previously issued by the banking group. This requirement was included because it is a standard approach used with Additional Tier 1 and Tier 2 instruments to avoid the risk that banks buy their own capital instruments.
33. The submitters suggested that, as we are trying to align the MCI with ordinary shares, this requirement is not necessary, and that it is sufficient to exclude such instruments (purchased by the banking group) from total CET1 capital. This is the way such purchases are managed for ordinary shares and means that the issuing bank will have flexibility to repurchase the MCI in the future if this meets their approach to capital management.
34. The Reserve Bank is comfortable with this approach and has confirmed that other provisions in the BPRs adequately ensure that any such instruments are not included in total CET1 capital.

Part Two: Other Matters Raised in Submissions

Amendments to BPR001

Addition of new definitions

35. The incorporation of the MCI into BPR110 resulted in some new definitions being added to that document, namely 'mutual entity' and 'mutual capital instrument'. The submitters suggested amending *BPR001 Glossary* to include these new defined terms.
36. At present, updating *BPR001 Glossary* is out of scope, as these terms are specific to only BPR110 and BPR120. The addition of the new terms to Part A (Definitions and Transitionals) of BPR110 ensures their meaning is sufficiently communicated. The Reserve Bank will have the opportunity to review the definitions used in the BPR documents in the near future.

Structure of BPR110

Creation of a new subpart for MCIs

37. The requirements for the MCI were initially incorporated into the existing requirements for ordinary shares in BPR110. In their feedback, the submitters advised that it would be beneficial for the requirements for MCIs to be set out in a separate subpart.
38. The Reserve Bank agrees with this suggestion and has restructured BPR110 to now include Subpart D1A, which is specific to the requirements for MCI. These are separate to Subpart D1, which contains the criteria for ordinary shares. The new subpart will assist in ensuring BPR110 and the specific requirements themselves are clear and accessible.