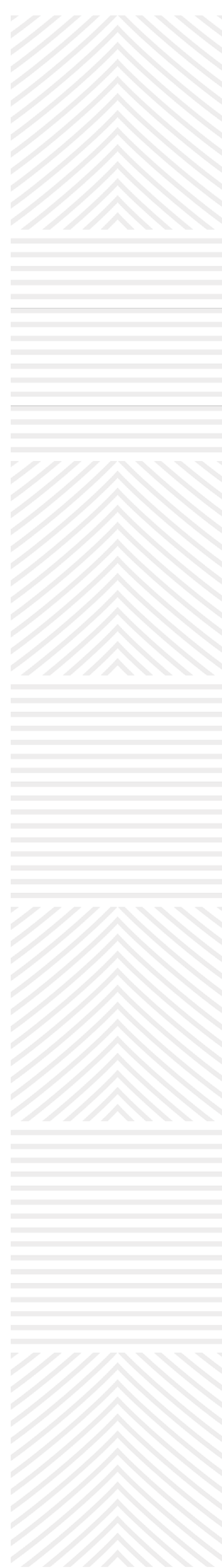

Mutual Capital Instruments

Response to Submissions

7 December 2022

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 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. The proposed policy options to facilitate the issuance of CET1 capital instruments by mutual banks were detailed in the consultation paper '*Mutual Capital Instruments. Developing options for mutual banks to issue capital which qualify as CET1 capital*'.

6. The key topics covered in the consultation material related to:

   - whether to amend *Banking Prudential Regulation 110* (BPR110) to introduce a mutual capital instrument that would qualify as Common Equity Tier 1 capital;

   - two potential policy options for a mutual capital instrument – Option 1A: the Mutual Equity Instrument and Option 1B: Mutual Equity Tier 1 capital instrument; and

   - possible design features of any potential instrument, such as limits on issuance or parameters for distributions.

7. We reviewed all submissions before making our final decisions and are now publishing a draft amended BPR110 (the Banking Prudential Regulation (BPR) document that covers capital definitions). This *Response* document summarises the Reserve Bank's response to the main points raised in those submissions.

Consultation Process

8. The Mutual Capital Instruments consultation lasted from 16 March to 10 June 2022. The Reserve Bank received two submissions, covering the mutual capital proposals which are available on our website. This paper responds to the themes and views raised in those submissions and is not intended to be an exhaustive response to all points raised. Readers are encouraged to refer to the full published submissions for further details. We also received a submission from an insurance company suggesting a similar approach in the insurance sector. This submission is outside the scope of this work and we have not considered whether such an instrument would be suitable in the insurance regulatory system.

9. In addition to receiving written submissions, the Reserve Bank engaged with the mutual banking industry through a series of workshops and 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.

10. This *Response* document follows the format of the consultation paper published in March 2022. Part One of this document covers questions 1 to 13 in the consultation paper. Part Two covers other matters raised in feedback.

11. 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 BPR110 be amended to include a mutual capital instrument that qualifies as CET1 capital?	BPR110 will be amended to include a new mutual capital instrument that qualifies as CET1 capital.
Which option (Option 1A or 1B) is the best design for a mutual capital instrument?	The design of the instrument will include the features of Option 1B: the Mutual Equity Tier 1 capital instrument.

Part One: Summary of Consultation Issues and Questions

Policy options for mutual capital instruments

Problem definition

12. Mutual banks face a number of barriers to issuing ordinary shares that qualify as CET1 capital because many of the key eligibility criteria for ordinary shares contained in BPR110 conflict with the core tenets of mutuality. This means the capital adequacy framework effectively limits mutual banks' CET1 capital to retained earnings.

13. In order to issue ordinary shares and raise CET1 capital, mutual banks might be required to demutualise. However, mutual banks see their mutual status is core to their identity and purpose.

14. 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.

15. Both submissions agreed with the Reserve Bank that the inability of banks structured as mutuals to issue capital that qualifies as CET1 capital is a significant problem. The submitters also agreed that the current capital requirements influences their capacity for growth and competition (with non-mutual banks), as well as their ability to maintain their capital position.

16. One submitter argues that the problem is more acute than described in the Consultation Paper, as mutual banks cannot simply decide to demutualise in order to improve their capital position. This submitter highlights that the process of demutualisation must be member-driven and members have greater interests than simply maximising financial outcomes.

Ordinary shares and mutual principles

17. The Reserve Bank sought views on the eligibility criteria for ordinary shares against mutual principles. Table 2 (on the next page) summarises the submitters' views on the key requirements for ordinary shares as CET1 capital in the context of mutual banks and their principles, as well as the Reserve Bank's response to these views:

Table 2: Assessment of eligibility criteria for ordinary shares against mutual principles

Key principle	Explanation	Submitters' views	Reserve Bank response
Permanence	CET1 instruments should have no maturity date and not be redeemable. If instruments are redeemable there is a risk investors will be repaid when a bank is in distress, or if not, signal to the market the bank's worsening financial condition.	No views provided on this principle.	Not applicable.
Subordination	Investors should be the first to absorb losses and 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.	Both submissions advise that, in their view, their members do not have a 'claim' on assets and instead have a contractual entitlement. This means that investor shareholders would have the most subordinate claim even in situations where this claim ranks ahead of members' rights to residual assets, as the members' contractual entitlement would not be considered a claim.	The Reserve Bank takes a broader view of the principle of subordination, which extends beyond the submitters' legal interpretation of 'claim'. Based on the objectives of the Capital Review, our view is that members do have a claim on surplus assets. The Reserve Bank views the principle of subordination as an integral feature of CET1 capital because it ensures investor shareholders are the last to be paid in a liquidation. This increases the investors' incentives to monitor the performance of the bank and limit risky behaviour.
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.	Both submissions argue that this principle should not apply to an MCI, because: the issue of mutual capital would not alter the governance structure of a mutual bank (one vote per member)	The Reserve Bank does not agree that this principle should not apply to an MCI. We view the principle of proportionality as another key feature of CET1 capital. If investors do not participate proportionately in gains and losses, then their incentives to monitor the

Key principle	Explanation	Submitters' views	Reserve Bank response
		participation in gains and losses is not central to market discipline for mutual banks; and the benefit of proportionality would not apply as the board is accountable to customers (not investors). One submitter proposes that any claim of MCI holders should be capped at the nominal value of their MCIs upon wind-up.	performance of the bank may be eroded and this could lead to riskier behaviour by the bank. The Reserve Bank does not agree that the governance structure of a mutual bank fully protects members from risk-seeking behaviour. The Reserve Bank will allow a mutual bank to cap the entitlement of holders in a wind-up to the par value of the shares, at its Board's discretion.
Distributions	Distributions must not be 'coupon-like' – i.e. be linked to the principal invested at issuance or subject to a contractual cap. Distributions must also be non-obligatory and any waived distributions must be non-cumulative.	The two submissions had slightly differing views on whether the distributions criteria is consistent with mutual principles. One submission highlighted that within their entity; distributions to shareholders are made equally or based on the business transacted. They felt that linking distributions to economic performance was inconsistent with mutual principles, as mutual banks do not take a profit maximising approach. The distributions principle has the potential to create direct conflict between the interests of transacting shareholders and investors. The other submission agreed that equal distributions are an integral part of mutuality but contended that the distribution criteria was not necessarily inconsistent with mutual principles,	The Reserve Bank acknowledges the possible challenges associated with aligning the principle of distributions and the principles of mutuality. The Reserve Bank continues to maintain that distributions must not be linked to the principal invested at issuance or subject to a contractual cap. We are, however, minded to allow distributions to be made at the mutual bank Board's discretion, provided that the bank publishes an indicative discretionary distributions policy (separate to the terms of the instrument).

Key principle	Explanation	Submitters' views	Reserve Bank response
		acknowledging there is a legitimate cost of new capital.	
Voting rights	Investors should have full voting rights arising from ownership of the shares.	One submitter sought to clarify that the 'one vote per member' mutual principle qualifies as full voting rights, and wanted the Reserve Bank to confirm that this extends to all mutual banks, including those governed by the Co-Operative Companies Act 1996.	The Reserve Bank agrees that, for the purpose of the MCI, all mutual banks who employ a 'one member, one vote' policy provide their members with full voting rights. The amended BPR110 reflects this principle.
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.	No views provided on this principle.	Not applicable.

Option 1A: Mutual Equity Instrument

18. The Reserve Bank sought views on the proposed Mutual Equity Instrument (MEI) as a policy option for CET1 capital, noting that it was not the preferred option. The Australian Mutual Equity Interest (AMEI) adopted by APRA informed the development of this MCI option; however, it is not a complete mirror of the AMEI.

19. The key features of the MEI, as described in the Consultation Paper, included:

    - 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.

20. Both submissions proposed that the use of the MEI should remain an option for mutual banks (even if another option is preferred) because it is not yet known how the market will respond to MCIs. The submitters contend that the MEI would offer a simplified alternative that could provide some flexibility for mutual banks as they learn and adapt to a new capital framework.

21. Furthermore, the submitters advocated for the MEI to directly mirror the AMEI rather than follow the terms of the proposed MEI. The key differences between the proposed MEI and the AMEI is that, in the Australian approach, distributions may be calculated in relation to the amount paid at issuance and shareholders' entitlement to surplus assets is capped at the nominal value of the shares.

22. The submitters favour the AMEI over the proposed MEI because, in their view:

    - the Australian banking sector more closely reflects the structure of the New Zealand banking sector;
    - the AMEI is a simplified instrument that better protects the interests of members; and
    - although it does not meet the CET1 proportionality principle, this is acceptable because it is loss absorbing on a going concern basis (which the submitters view as more important than proportionality).

23. The Reserve Bank does not agree that the MEI is a suitable CET1 capital instrument and has decided to discount this option. Reasons for this decision include:

- The MEI does not operate like ordinary shares and therefore does not qualify as CET1 capital. This is contrary to our key objective, which was to create a capital instrument for mutual banks that qualifies as CET1 capital.

- In particular, the MEI does not meet the CET1 principles of subordination and proportionality, which are important to ensure members are protected and investors are incentivised to monitor the performance of the bank.

- The MEI is not a conservative approach compared to other jurisdictions, which is a key principle of the Capital Review.

- The Australian approach (the AMEI) which is favoured by the submitters has not yet been issued. Additionally, APRA has capped the use of this instrument at 25 per cent of mutual banks' CET1 capital requirements.

24. Ultimately, accepting the MEI as CET1 would mean that the definition of CET1 would need to be modified. We see this as contrary to our wider intention during the Capital Review to focus on higher buffers of the highest quality of capital, and the focus of this work has been to design an instrument that fits into the definition of CET1, rather than extensively modifying the definition of CET1.

Option 1B: Mutual Equity Tier 1 capital instrument (preferred option)

25. The Reserve Bank also sought views on the proposed Mutual Equity Tier 1 (MET1) capital instrument as a policy option for CET1 capital, and highlighted that this is the preferred option. The terms of the MET1 capital instrument were modelled on the approach taken by the PRA in the United Kingdom through the Core Capital Deferred Shares (CCDS) instrument, but are not an exact replication.

26. The key features of the MET1 capital instrument, as described in the Consultation Paper, included:

    - 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 equally 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.

27. Both submissions agreed with the Reserve Bank that it is logical to follow the PRA's approach, but are seeking an amendment that would more closely align the MET1 capital instrument with the CCDS instrument. The submitters would like the MET1 capital instrument to include a cap on the entitlement of holders in a wind up to the par value of the shares, as they believe this would be fairer to the members of a mutual bank.

28. One submission provided a detailed analysis to demonstrate their view that this feature would make the MET1 capital instrument more fair to members and their reasons included:

    - If a mutual bank is wound up with a surplus, a cap on investors' entitlement means that investors do not participate in both distributions and surpluses – members' entitlement to surpluses would be protected;
    - Although shareholders would not share proportionately in surpluses, the proportionality principle is not as important when considering the mutual structure and market discipline; and
    - There is international acceptance of this approach in comparable jurisdictions such as the United Kingdom, Australia and Canada.

29. The Reserve Bank considers the MET1 capital instrument to be the most suitable option and has chosen to use the features of this instrument for the MCI. Reasons for this decision include:

    - The MET1 capital instrument operates most closely like ordinary shares and qualifies as CET1 capital. This achieves our key policy objective of creating a capital instrument for mutual banks that qualifies as CET1 capital.
    - Importantly, the MET1 capital instrument meets the CET1 principles of subordination and proportionality, which ensures members are protected and investors are incentivised to monitor the performance of the bank.

30. In response to the submissions' request to include a cap on the entitlement of holders in a wind up to the par value of the shares, the Reserve Bank intends to allow this feature at the Board of a mutual bank's discretion. This feature would allow investors to participate proportionally in any losses, but protect members' claims on surplus assets in a wind-up. This feature has been incorporated into the Exposure Draft of the MCI requirements in BPR110 and BPR120.

Assessment of policy options

Consistency with key requirements for ordinary shares

31. In the Consultation Paper, the Reserve Bank outlined key assessment criteria for the proposed policy options. These criteria included the policy options' consistency with the key requirements for ordinary shares (see table on page 5).

32. One submission argued consideration of the eligibility criteria for ordinary shares should only be relevant if they had the same prudential impact in the mutual structure. The other submission held the view that both policy options were consistent with the eligibility criteria for ordinary shares, in all *relevant* aspects.

33. Both submissions strongly believed that two of the eligibility criteria for ordinary shares, namely distributions and proportionality, were not relevant for an MCI and any inconsistency could be disregarded in the context of the mutual structure.

34. Both submissions also disagreed with the Reserve Bank's view that members have a 'claim' on surplus assets, and put forth an alternate legal interpretation where members only have a contractual entitlement to surplus assets. Based on this interpretation, the submitters advise that Option 1A (the MEI) does satisfy subordination criteria (that investors should have the most subordinate claim).

35. One submitter further contended the suggestion that the MEI would not have a variable and uncertain value is not correct, and the MEI would function in the same way as ordinary shares in a non-mutual bank.

36. The Reserve Bank is of the view that all of the eligibility criteria for ordinary shares are relevant for a mutual capital instrument and have a prudential impact. Table 2 details our view on each of the principles, and we provide some additional views on the principles of subordination and proportionality below.

37. Firstly, we are taking a broader view of the principle of subordination and considering the objectives of this feature. Subordination is an integral feature of ordinary shares, because it means investors bear losses first. This means investors have greater incentives to monitor the performance of the bank and limit risk-seeking behaviour, as their investment is at stake. Members are also better protected in a situation where investors have the most subordinate claim because those investors are the first to absorb losses (before retained earnings).

38. Similarly, the principle of proportionality also creates incentives for investors to monitor the bank, because investors participate proportionally in gains and losses.

39. Under the terms of the MEI, retained earnings would absorb losses first (before investors) and, in a liquidation, instrument holders would receive their investment back in full, if there were sufficient surplus assets to make the payment. This means that investors are neither the most subordinate, nor would they participate proportionally in losses. This runs the risk of eroding their incentives to monitor the performance of the bank and could lead to risk-seeking behaviour.

40. Based on these views, we do not consider the MEI to be a suitable option for CET1 capital as it does not meet the key criteria. The MET1 capital instrument is a better match to the principles and remains our preferred option.

Consistency with mutual principles

41. The Reserve Bank sought views on how the two proposed policy options aligned with mutual bank principles. Both submissions indicated the entities were pleased that this was a consideration for an MCI.

42. One submission highlighted that the role of the Board of a mutual bank is to act in the best interests of its members, which extend beyond the financial to include intangible benefits. As such, the Board of a mutual bank is accountable to its members and is sufficiently scrutinised in its decision-making. The submitter advises this would extend to the issuing of an MCI, which would only be done if it were in the best interests of members.

43. The other submission advised the most important way to align with mutual principles was to ensure that capital does not require a profit maximising approach. The submitter maintained that a mutual bank could make any level of distributions provided it was in the best interests of their members, and linking distributions to profits is at odds with mutual principles.

44. The Reserve Bank agrees that the Board of a mutual bank is best placed to make decisions that are in the best interests of its members. We have considered mutual principles when assessing options for the design of the MCI and, wherever practicable, have had regard to these principles.

Consistency with the Capital Review principles

45. In the Consultation Paper, the Reserve Bank highlighted potential inconsistency between an MCI and the Capital Review principles, particularly that the capital framework should be practical to administer and minimise unnecessary complexity and compliance costs, and that the capital framework should be transparent to enable effective market discipline.

46. One submission acknowledged that there may be some added complexity during the process of a wind up, but disagreed that an MCI would be inconsistent with the capital review principle to avoid unnecessary complexity. This submitter argued that any added complexity would be limited only to a wind up of a mutual bank, which is an unlikely, one-off event.

47. The same submission also disagreed that an MCI would be inconsistent with the transparency principle. In their view, issuing an MCI would not impact the governance and accountability structure of a mutual bank, as members would continue to hold the board accountable for the mutual bank's performance.

48. The other submission agreed with this assessment of those Capital Review principles. They also added that if the MEI was available as an option, they did not believe that it would be inconsistent with the Capital Review principle that the capital requirement should be conservative relative to comparable jurisdictions.

49. The Reserve Bank acknowledges that neither option is totally consistent with the Capital Review principles. Option 1B in particular is considerably more complex than ordinary shares. However, Option 1B most closely matches the 'loss-absorption' Capital Review principle, in that losses would be readily absorbed proportionately by investors and members on a going-concern basis. This is a significant feature of Option 1B and may mitigate some of its complexity.

Cost-benefit analysis of adoption versus the status quo

50. One submission emphasised the belief that the introduction of an MCI that qualifies as CET1 capital would provide a clear net benefit and agrees with the Consultation Paper's assessment of the positive impact an MCI may have on the stability and efficiency of the financial system.

51. The same submission also put forth the view that there is potential for the mutual banking sector to grow in New Zealand over the long-term and an 'enabling regulatory environment', such as through the adoption of an MCI, could assist in this growth.

52. This submission assessed the costs associated with an MCI and advised that potential arguments against the introduction of these instruments should not be highly regarded. It again highlighted that demutualisation is not a likely or realistic alternative to an MCI and while there may compliance costs associated with raising capital, these costs would only be assumed when it benefits members.

53. While the other submission did not make comments on the cost-benefit analysis of the policy options, it did voice support for the previous submission's assessment.

54. The Reserve Bank agrees that the benefits of introducing an MCI are likely to exceed the costs. Our assessment is that regulatory and supervisory costs of an MCI 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.

Design features of a potential mutual capital instrument

Limits on issuance and distributions

55. In the Consultation Paper, the Reserve Bank proposed that limitations on the issuance of an MCI and the level of distributions might not be necessary. Both submissions agreed with this initial view.

56. In regards to issuance, both submission maintain the board of a mutual bank is in the best position to determine whether to issue capital, as they are mandated to act in the best interests of their members.

57. Similarly, the submissions felt that the level of distributions should also be left to the board's discretion. While the board may choose to impose its own limits on distributions, a prescriptive limitation could negatively on the marketability of an MCI, which is a concern the submitters have raised elsewhere in their submissions.

58. The Reserve Bank continues to hold the view that issuance of an MCI and the level of distributions should not be capped, and instead left to the discretion of the Board of a mutual bank. This will support the mutual bank's Board in making decisions in the best interests of its members.

Notification regime and repurchase of mutual capital instruments

59. Both submissions agreed that it would be best practice for an MCI to be subject to the same requirements as ordinary shares, such as the notification requirement or requiring approval for any repurchase. Neither submission viewed these requirements as an unreasonable regulatory burden nor likely to significantly increase their compliance costs.

60. Some submitters advised us that in their view, repurchasing MCIs would be no different to a non-mutual bank conducting a share buy-back, and therefore agreed that permission from the Reserve Bank should be required as it is for non-mutual banks.

61. The Reserve Bank agrees with this rationale and sees the merit in following the parameters of the wider capital framework. When drafting the BPRs to include an MCI, we have aimed to replicate the regulatory framework for ordinary shares, as well as other bespoke capital instruments. For the purpose of notification requirements at the time of instrument issuance, we intend to include notification processes in Banking Prudential Regulation 120 (BPR120): Capital Adequacy Process Requirements for MCIs that similar to those that apply for AT1 and Tier 2 capital instruments.

Incorporation of rules into the Banking Prudential Regulations

62. In the Consultation Paper, the Reserve Bank proposes that an MCI should be included in the BPR110 as a new component of CET1 capital. Both submitters agree with this approach.

63. One submission advocates for following other jurisdictions by setting out the eligibility criteria for ordinary shares and describing the exceptions to these criteria for an MCI. Both submission agreed that it is important to make the difference between ordinary shares and MCIs clear, to improve understanding and transparency.

64. Exposures Drafts of revised BPR110 and BPR120, incorporating the preferred option, have been published alongside this *Response* document to seek stakeholder feedback about how we propose to incorporate the instrument into the BPR documents. Annex 1 provides explanatory notes for the Exposure Drafts.

Limits on investor type

65. The Reserve Bank's Consultation Paper noted that other jurisdictions had experienced difficulty with issuing MCIs to retail investors and sought views on limiting investor type. Both submitters would prefer to retain the option of issuing an MCI to their retail customers, particularly as mutual banks are largely funded by their retail customers.

66. The two submissions believe the regulation of this matter should be left to the Financial Markets Authority to oversee, as they do not think investor type is a factor of prudential regulation.

67. The Reserve Bank is minded to allow mutual banks to issue MCIs to retail investors. We will work closely with the Financial Markets Authority to ensure the appropriate disclosures are made so that investors are fully informed of the terms of the instrument.

Part Two: Other Matters Raised in Submissions

Amendments to BPR110 guidance on voting rights

68. One submission requested clarification that the guidance in BPR110 that explains the 'one member, one vote' policy qualifies as 'full voting rights' for all mutual banks. Currently, the guidance specifies this applies to building societies created under the Building Society Act 1965. The submitter asked that this be extended to include co-operative entities created under the Co-operative Companies Act 1996.

69. Full voting rights are a key requirement of CET1 capital, where investors in ordinary shares receive full voting rights arising from the ownership of their shares.

70. The Reserve Bank has amended BPR110 to clarify that when issuing the MCI, the 'one member, one vote' policy qualifies as full voting rights. This will ensure that investors in the MCI receive the same benefits as any other CET1 capital investor.

Annex 1: Explanatory Note for Exposure Drafts

This Annex provides some explanatory notes for the proposed changes to BPR110 and BPR120 to incorporate the Mutual Capital Instrument. We welcome feedback from stakeholders about the Exposure Drafts.

BPR110

In general, the approach we have taken is to replicate the requirements of ordinary shares contained in BPR110, with adjustments where needed to reflect the characteristics of the Mutual Capital Instrument. The table below summarises the proposed requirements.

Table 3: Explanation of amendments to BPR110

BPR110	Explantory Note
B1.2(f)	Add 'paid-up' mutual capital instruments to the components of CET1, provided the detailed criteria in section D1.5 are met.
D1.2 guidance box	This guidance box has been modified following a request during the consultation period that clarifies that 'one member, one vote' system can be applied by any mutual entity, not just a building society, and still satisfy the full voting rights requirement in D1.2(d).
D1.5(2), D1.5(3), D1.5(4)	These requirements establish the role of the checklist that mutual banks must complete and provide the Reserve Bank when issuing and MCI. This is in-line with the processes that apply for all banks when issuing AT1 or Tier 2 capital instruments.
D1.5(5)	Issuers may include other terms and conditions as part of an MCI, provided these do not affect compliance.
D1.5(6)	(a) Matches the requirement for ordinary shares on D1.2(a). (b) Confirms that the instrument must also be legal form equity. (c) All MCI must be governed by New Zealand law to maximise simplicity. (d) While it might be possible to structure an MCI in foreign currency, this would introduce additional layers of complexity. (e) Matches the requirement for ordinary shares in D1.2(b) (f) Ensures the instrument is perpetual, as for ordinary shares in D1.2(g). (g) The MCI must not be redeemable. Matched requirement for ordinary shares in D1.2(h). (h) Matches the requirement for ordinary shares in D1.2(i). (i) Matches the requirement for ordinary shares in D1.2(j). (j) Matches the requirement for ordinary shares in D1.2(d). (k) This ensures that the subordination principle for CEt1 is met. It notes that all holders of MCI must have equal ranking. The guidance box establishes the role of the formula in apportioning any surplus assets between the two different classes that would receive a payment – one class made up of MCI holders and one class made up of members of the mutual bank. This ensures that all of the 'owners' have the

BPR110	Explantory Note
	same ranking, as any distribution of surplus assets is made based on the proportions in the formula in D1.2(m). (l) Clarifies that if there are no surplus assets at all, then the instrument holder receives no return on their investment. (m) Sets out the formula that separates the payment of surplus assets to the group of instrument holders and the group of members. (n) Once the payment to the group of instrument holders has been determined in (m), the requirement in (n) is that the amount that each instrument holder receives is proportionate to the number of instruments that they hold. This meets the proportionality requirements, similar to the proportionality requirements for ordinary shares in D1.2(c). The issuer may cap the total payment at the face value of the instrument at the time of issuance, as requested by some submitters during consultation. (o) Requires the formula to be included in terms and conditions. (p) Requires that the formula cannot be amended (q) All distribution requirements for ordinary shares must be met. (r) While the distribution requirements for ordinary shares must be met, the mutual bank must also have an indicative distribution policy. (s) The issuance requirements for ordinary shares in D1.4 must be met. (t) The requirements in D.15(6)(s) do not prevent the bank from lending to a borrower to fund the purchase of a well-diversified portfolio that may include the mutual capital instrument.
Appendix 3	Replicated the requirements for MCI for the purposes of banks completing the process requirements in BPR120.

BPR120

We are proposing a number of small changes to BPR120 to ensure that the MCI is also covered by notification requirements, in a similar way as this applies to AT1 and Tier 2 capital instruments. As with those instruments, the directors of a bank are responsible for ensuring that the MCI complies with the capital adequacy framework. The Reserve Bank will not be approving the specific issuance of instruments.

The Legal Template requirements in B1.3 are the same as for AT1 and Tier 2 instruments.