World Council of Credit Unions, Inc.

Credit Union Shares as Regulatory Capital Under Basel III

World Council of Credit Unions

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Executive Summary

In December 2010, the Basel Committee on Banking Supervision issued "Basel III," a set of international capital and liquidity standards for commercial banks that some national or provincial regulators apply to credit unions as well as banking organizations.

Not all credit union systems will implement Basel III, nor should they. The application of the Basel III capital rules to credit unions by national or provincial regulators is a purely domestic issue, not an international one. Basel III's capital rules, however, have significant implications for the international credit union movement. Regulators in some jurisdictions remain unsure to what degree credit union shares can qualify as regulatory capital under Basel III. Basel III also likely will influence credit union capital requirements even in jurisdictions which do not expressly implement the guidelines for credit unions because regulators sometimes look to Basel Committee issuances for guidance even if they do not apply all of Basel III's requirements to credit unions.

The key for applying Basel III to credit unions is the circumstances under which credit union shares and similar cooperative shares (such as shares issued by cooperative banks) qualify as regulatory capital. Basel III sets forth multi-factor tests to determine whether a capital instrument qualifies as "Common Equity Tier 1 capital" (the most desirable form of capital under Basel III), "Additional Tier 1 capital," or "Tier 2 capital." In these tests the primary factors are:

(1) The degree to which capital is permanent (e.g., perpetual and non-withdrawable, withdrawable only after a significant waiting period, etc.); and

(2) Whether the instrument is paid-in and available to cover losses on a going-concern basis.

Most other factors in these multi-factor tests are dependent on the instruments' degree of permanence and ability to absorb losses.

This paper concludes that credit union shares which have a high degree of permanence and the ability to absorb losses on a going concern basis should qualify as Basel III "Common Equity Tier 1 capital" based on the European Union's (EU) approach to implementing Basel III in Europe. This paper also concludes that credit union shares can qualify as "Additional Tier 1 capital" or "Tier 2 capital" even when they do not meet the "Common Equity Tier 1" capital definition, depending on the shares' terms and conditions.

The EU's draft legislation to implement Basel III—which is known as the "CRD IV Package" [1]—would treat cooperative shares as Common Equity Tier 1 capital if they are not redeemable or have significant restrictions on their redemption, can absorb losses on a going-concern basis, and meet other similar requirements (such as being accounted for as "equity"). We believe that credit union supervisors who plan to implement Basel III regulatory capital rules for credit unions should adopt an approach that is the same as or similar to the EU's approach.

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[1] *See, e.g.* European Commission, *New proposals on capital requirements (CRD IV Package)*, http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm (last visited June 21, 2012). "CRD" originally stood for "Capital Requirements Directive."

Introduction

World Council of Credit Unions is committed to working with credit unions, credit union regulators, international organizations and other credit union system stakeholders to ensure that some countries' transition to regulating credit union capital under Basel III results in workable regulatory capital rules. These rules should preserve credit unions' cooperative structure while giving them the flexibility to use member shares and other capital instruments to supplement retained earnings as forms of regulatory capital.

This paper discusses the following issues related to Basel III and credit union regulatory capital:

(1) History of Credit Union Shares and Regulatory Capital;
(2) A Brief Overview of Basel III;
(3) Common Equity Tier 1 Capital and Credit Unions;
(4) Additional Tier 1 Capital and Credit Unions;
(5) Tier 2 Capital and Credit Unions;
(6) Capital Instrument Loss Absorbency;
(7) Capital Instrument Accounting;
(8) Capital Instruments and Securities Laws; and
(9) Conclusion: Next Steps for the Credit Union Movement

As the International Credit Union Regulators' Network (ICURN)[2] recognizes in its *Guiding Principles for Effective Prudential Supervision of Cooperative Financial Institutions*, credit union systems are not required to implement Basel III and "[w]hen supervisors choose to align the capital requirements of credit unions to Basel standards, a simplified approach may be adopted for small or simple credit unions that are not allowed to hold complex financial instruments."[3] Credit union-specific regulatory standards such as the ICURN *Guiding Principles* and World Council of Credit Unions' PEARLS Monitoring System[4] and model credit union law and regulations[5] are more appropriate for most credit union systems, especially those with relatively high leverage ratio requirements which limit the relevance of Basel's risk-based capital ratios.

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[2] ICURN, About the Network, http://curegulators.org/curegulators_about (last visited Mar. 14, 2012) ("The International Credit Union Regulators' Network (ICURN) is an independent international network of credit union regulators that promotes the guidance given by the leaders of the Group of 20 (G-20) nations for greater international coordination among financial services regulators.").
[3] ICURN, *Guiding Principles for Effective Prudential Supervision of Cooperative Financial Institutions* (2011) [hereinafter *ICURN Guiding Principles*], *available at* www.curegulators.org/functions/view_document.php?id=ICURN_Guiding_Principles_for_Supervision.
[4] *See, e.g.*, David C. Richardson, *PEARLS Monitoring System* (2002), *available at* www.woccu.org/functions/view_document.php?id=Monograph_4.
[5] World Council of Credit Unions, *Model Law for Credit Unions* (2011), *available at* www.woccu.org/functions/view_document.php?id=2011ModelLawEnglish; World Council of Credit Unions, *Model Regulations for Credit Unions* (2008), *available at* http://www.woccu.org/bestpractices/legreg.

The Basel Committee on Banking Supervision, an intergovernmental panel with its secretariat located at the Bank for International Settlements in Basel, Switzerland, has since 1988 set capital standards for internationally active commercial banks. These rules, commonly referred to as the "Basel Accords," are now in their third incarnation, known as *Basel III: A global regulatory framework for more resilient banks and banking systems*, also called "Basel III."[6] Basel III builds upon the rules of the earlier "Basel I" (1988, revised in 1998)[7] and "Basel II" (2004, revised in 2006)[8] capital accords in order to address weaknesses in the Basel II accord recognized during the last global financial crisis, which began in 2007-2008.

The Basel Accords originally only applied to commercial banks, but some national and provincial credit union regulators have over time expanded these rules to apply to credit unions and other types of financial institutions either expressly or, in some cases, have created regulations that do not implement particular Basel standards per se but were inspired by Basel principles.[9] Application of the Basel Accords to credit unions has occurred in part because the Basel Committee's standards apply to banking institutions (and credit unions engage in lending, deposit-taking, payments services and other business activities that banks engage in) but also because credit union regulators had not created their own international standards for credit unions.

Recently, however, ICURN has begun developing credit union-specific supervisory rules. In September 2011, ICURN issued its *Guiding Principles for Effective Prudential Supervision of Cooperative Financial Institutions* which are based on the Basel Committee's *Core Principles for Effective Banking Supervision*.[10] ICURN's "guiding principle" regarding credit union capital adequacy reads as follows:[11]

> The supervisory authority must establish and enforce the rules for an appropriate capital framework with which all regulated institutions must comply. The rules should balance cooperative principles and objectives with the need to protect depositors. Accordingly, supervisory authorities will need to carefully consider what meets the criteria for capital and to ensure that capital instruments are able to absorb losses in the event of failure.
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> When supervisors choose to align the capital requirements of credit unions to Basel standards, a simplified approach may be adopted for small or simple credit unions that are not allowed to hold

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[6]Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (Dec. 2010, rev. June 2011) [hereinafter *Basel III*], *available at* http://www.bis.org/publ/bcbs189.pdf. Basel III's capital rules are in some respects a revision to Basel II. *See* Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework Comprehensive Version* (June 2006) [hereinafter *Basel II*]), *available at* http://www.bis.org/publ/bcbs128.pdf.

[7] Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards* (July 1988, rev. Apr. 1998), *available at* http://www.bis.org/publ/bcbsc111.pdf.

[8] *Basel II*.

[9] Countries such as Australia, Brazil, Bolivia, several Canadian provinces, Ecuador, and others have enacted capital and other rules for credit unions that are based on the Basel Accords. Other countries, including the United States, have indirectly applied Basel principles to credit unions by modeling aspects of their regulations on the Basel Accords. *See, e.g.*, 12 C.F.R. § 704.3 (setting forth capital requirements for U.S. corporate (i.e. second level) credit union regulatory capital based on Basel I and Basel II).

[10] *ICURN Guiding Principles* at 3; *see* Basel Committee on Banking Supervision, *Core Principles for Effective Banking Supervision* (2006), *available at* http://www.bis.org/publ/bcbs129.pdf.

[11] *ICURN Guiding Principles* at 2.

> complex financial instruments. For such institutions, compliance with the most advanced risk measurement techniques may be beyond their resources. Therefore, the regulator may require additional capital to support the limited information that may be available for supervisory authorities.

Under ICURN's principles, credit union systems are not required to implement Basel III's rules for regulatory capital and, even when they do, credit union regulators have leeway to deviate from Basel III to some degree. In addition, future work by ICURN and other credit union stakeholders regarding regulatory capital under Basel III may provide additional clarity to the credit union movement regarding the necessary terms and conditions for credit union shares and other capital instruments to qualify as regulatory capital.

1. History of Credit Union Shares and Regulatory Capital

Credit unions have issued shares that operate as equity capital since the inception of the credit union movement. The first credit unions in Massachusetts required members to subscribe to a $5 share as early as 1909, and shares initially represented these credit unions' only form of capital.[12] Other early European and North American cooperative credit societies similarly used shares to raise capital beginning in the 19th and early 20th centuries.[13] Restricting credit unions' ability to use shares as regulatory capital is inconsistent with the credit union movement's history and would hinder future credit union growth and development.

In many credit union systems — including most Latin American, African and Caribbean systems as well as Australia and the Canadian provinces of Alberta, British Columbia, New Brunswick, Ontario and Quebec — credit union shares currently qualify as regulatory capital to at least some extent. Sometimes only special classes of shares qualify as regulatory capital, such as the recently established "deferred shares" issued by credit unions in Great Britain. In other systems, however, ordinary credit union shares are accounted for as liabilities and do not qualify as regulatory capital.[14]

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[12] *See* J. Carroll Moody & Gilbert C. Fite, *The Credit Union Movement: Origins and Development 1850-1980* 5-29 (2d ed. 1984).

[13] For example, German cooperative banks organized by Hermann Schulze-Delitzsch in the 1850s required members to subscribe to one $12 share and Alphonse Dejardins's *caisses populaires* formed in Canada in the early 1900s required members to subscribe to a $5 share. *Id.* Further, the first cooperative organizations, including the Rochdale Society of Equitable Pioneers — formed in 1844 in Rochdale, England — required members to subscribe to shares as a means of raising capital and members received 5 percent interest on their shares as well as a division of the cooperative's profits at the end of the year. *Id.* at 1.

[14] The current treatment of shares issued by federal credit unions under the United States' Federal Credit Union Act, 12 U.S.C. §§ 1751-1795k, is a good example of the phenomenon of credit union shares over time being considered a liability rather than equity capital. Except in the case of "corporate" (i.e. second level) credit unions, federal credit unions shares are technically classified as equity as a legal matter but are accounted for as a liability and also do not qualify as regulatory capital. *See* 12 U.S.C. §§ 1757(6), 1790d(o)(2) (stating that shares represent "equity" but, since 1998, defining regulatory capital to include only retained earnings in most cases and not shares); *CUNA v. AICPA,* 832 F.2d 104 (7th Cir. 1987) (holding that U.S. credit unions did not have legal standing to challenge U.S. accounting authorities' determination in the mid-1980s that credit union shares should be classified as liabilities instead of equity for accounting purposes because accounting standards are theoretically independent from shares' legal and regulatory capital treatment).

The Basel III capital accord and the EU's CRD IV Package both expressly recognize that some forms of cooperative financial institution shares can be classified as the "equivalent" of "common shares" and included in "Common Equity Tier 1 capital."[15] Also under Basel III and the CRD IV Package, capital instruments such as shares and subordinated debt that do not meet the 14 requirements of "Common Equity Tier 1 capital" can theoretically be treated as "Additional Tier 1 capital" or "Tier 2 capital."

2. A Brief Overview of Basel III

Basel III is in many respects a revision of Basel II. Basel III makes three significant changes to Basel's treatment of capital instruments and regulatory capital ratios, as well as other significant changes.[16] Basel III, however, retains Basel II's "Three Pillars" approach ("Minimum Capital," "Supervisory Review Process" and "Market Discipline")[17] as well as Basel II's risk-weighting of assets based on the type of asset and its perceived creditworthiness with additional capital charges to control for operational risk (e.g., fraud, legal risk) and market risk (e.g., interest rate risk, foreign exchange risk).[18]

As summarized by the Basel Committee, Basel III makes the following changes with respect to regulatory capital:[19]

> Tier 1 capital must be common shares and retained earnings. This standard is reinforced through a set of principles that also can be tailored to the context of non-joint stock companies to ensure they hold comparable levels of high quality Tier 1 capital. Deductions from capital and prudential filters have been harmonised internationally and generally applied at the level of common equity or its equivalent in the case of non-joint stock companies. The remainder of the Tier 1 capital base must be comprised of instruments that are subordinated, have fully discretionary noncumulative dividends or coupons and have neither a maturity date nor an incentive to redeem. Innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses, currently limited to 15% of the Tier 1 capital base, will be phased out. In addition, Tier 2 capital instruments will be harmonised and so-called Tier 3 capital instruments, which were only available to cover market risks, eliminated. Finally, to improve market discipline, the transparency of the capital base will be improved, with all elements of capital required to be disclosed along with a detailed reconciliation to the reported accounts.

a. *Three Tiers of Regulatory Capital*

Basel III's first major change to capital requirements is that it revises Basel II's three tiers of regulatory capital—"Tier 1," "Tier 2" and "Tier 3"[20]—to a new three tier system. This new

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[15] *See Basel III* at 14 n.12; CRR Articles 23-28.

[16] With respect to capital requirements, Basel III also requires institutions to accumulate capital during boom periods (the "countercyclical capital buffer") and to restrict dividends and bonuses to staff during stress periods (the "capital conservation buffer"). *Basel III* at 54-60. In addition, Basel III for the first time sets forth liquidity rules for banking organizations. *See* Basel Committee on Banking Supervision, *Basel III: International framework for liquidity risk measurement, standards and monitoring* (Dec. 2010), *available at* http://www.bis.org/publ/bcbs188.pdf.

[17] *Basel II* at 12-203.

[18] *See id.* at 19-203 (setting forth Basel II's "standardized approach" to calculating asset risk-weights to control for credit risk, as well as its rules for controlling operational risk and market risk).

[19] *Basel III* at 2.

[20] *See Basel II* at 14-17. Tier 3 capital under Basel II only included short-term subordinated debt to cover market risk, and was not implemented in all countries that adopted Basel II. *See id.* at 16-17.

three-tier system eliminates "Tier 3" entirely and splits "Tier 1" into two categories, "Common Equity Tier 1" and "Additional Tier 1," while preserving the basic "Tier 2" concept.[21]

b. *Leverage Ratio and Revised Risk-Based Capital Ratios*

The second major change to capital requirements in Basel III is that institutions will be subject to a minimum Tier 1 leverage ratio of 3% (i.e. total Tier 1 capital relative to total assets, without regard to risk-weights) and the following risk-based capital ratio requirements:[22]

- Common Equity Tier 1 (e.g., retained earnings, common shares, etc.) must be at least 4.5% of risk-weighted assets at all times.
- Total Tier 1 Capital must be at least 6.0% of risk-weighted assets at all times.
- Total Capital (i.e. total Tier 1 plus Tier 2 Capital) must be at least 8.0% of risk-weighted assets at all times.

c. *Qualitative Tests for Capital Instruments*

The third and perhaps most significant change is that Basel III does not declare that certain types of instruments generally fall within a specific regulatory capital tier classification. Basel III instead uses multi-point tests to determine whether an instrument is Basel III-compliant. This is a major change from Basel II, which listed specific types of joint stock bank capital instruments (e.g., common shares, non-cumulative preferred shares, hybrid debt-equity instruments, subordinated debt) and classified them as either Tier 1 or Tier 2 instruments.

Basel III uses a 14-point test for Common Equity Tier 1 capital instruments, a separate 14-point test for Additional Tier 1 capital instruments, and a 9-point test for Tier 2 capital instruments. This paper discusses these tests and their implications for credit union capital in sections 3 (Common Equity Tier 1), 4 (Additional Tier 1) and 5 (Tier 2), below. The Committee decided to implement this test-based, qualitative capital classification system in Basel III because in the last financial crisis "inconsistency in the definition of capital across jurisdictions and the lack of disclosure that would have enabled the market to fully assess and compare the quality of capital between institutions."[23]

d. *Basel Asset Risk-Weighting Methodology*

Basel III's risk-based capital ratios (which are listed above under "b") can only be calculated by using the still applicable Basel II asset risk-weighting and other rules for controlling credit, operational, and market risks.[24] The Basel asset risk-weighting "Standardized Approach" —

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[21] *Basel III* at 12-26.
[22] *Id.* at 12, 61.
[23] *Id.* at 2.
[24] *See Basel II* at 19-203.

the method usually applied to credit unions — assigns standard assets risk-weightings based on the assets' perceived credit risk and/or the perceived credit risk of loan collateral.[25]

3. Common Equity Tier 1 Capital and Credit Unions

Under Basel III, the most desirable classification for a capital instrument is "Common Equity Tier 1" (CET1) capital. The EU's CRD IV Package treats cooperative shares as CET1 capital if they meet terms and conditions that mostly depend on the instrument's degree of permanence and ability to absorb losses. Credit union regulators planning to implement Basel III regulatory capital rules for credit unions should consider seriously the EU's approach to cooperative shares as CET1 capital.

CET1 is a component of the numerator in all Basel III capital ratios including the 3 percent leverage ratio. Both the Basel III 14 point test for CET1 instruments and the CRD IV package's similar multi-point test for CET1 instruments are listed below. CET1 capital includes retained earnings, disclosed reserves, common shares issued by joint stock companies, other capital instruments that meet the criteria below for CET1 instruments (including credit union shares that meet these requirements), and what Basel III calls "stock surplus (share premium)" (which can also be called "capital surplus" and "additional paid-in capital") resulting from selling CET1 capital instruments at a premium above par value.[26]

Credit union shares issued before September 12, 2010, which do not meet the CET1 criteria but which are currently part of "Tier 1" capital under national banking law and which are accounted for as equity can be included initially in CET1 capital but must be written-off at a rate of 10% a year during the 10-year period between 2013 and 2022.[27] Credit union shares which are initially subject to being written-off in this manner can be immediately reclassified

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[25] For example, cash is assigned a risk-weight of 0% of face value (meaning that it is perceived as riskless either as an asset or as loan collateral), residential mortgages are assigned a risk-weight of 35% of face value, loans to or bonds issued by governments or business corporations can be weighted between 20% and 150% of face value depending on the creditworthiness of the obligor (e.g., sovereign or corporate bonds with AAA to AA- credit ratings are typically risk-weighted at 20% of face value), delinquent loans can be assigned values above 100% of face value, and most other types of assets (such as unsecured, non-delinquent loans to credit union members) are typically assigned 100% of face value risk-weights. *Id.* at 19-27 & n.32.

[26] *Basel III* at 13. For example, $4 of "stock surplus (share premium)" (i.e. capital surplus or additional paid-in capital) results when a joint stock company sells common shares with a par value of $1 for $5. *See generally* David E. Herwitz & Matthew J. Barrett, *Accounting for Lawyers* 46-50, 291-316 (4th ed. 2006) (discussing the various accounting and legal terms for equity contributed to a joint-stock company from stock sales, including "capital surplus" and "additional paid-in capital" resulting from selling stock for more than par value); Robert W. Hamilton, *The Law of Corporations* 171-76 (5th ed. 2000) ("The concepts of stated capital and capital surplus relate to how the common stock item is shown on the right hand side of the balance sheet. 'Stated capital' is defined to be the aggregate par value of all issues shares . . . while 'capital surplus' is defined to be the excess (if any) of capital contributed over the par value."); John Downes & Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* 98 (7th ed. 2006) (defining "capital surplus" as "equity" that is "not otherwise classifiable as 'capital stock' or 'retained earnings'" including the "surplus" resulting from "stock issued at a premium over par or state value").

[27] *Basel III* at 29.

as CET1 capital, however, if the credit union adjusts the terms and conditions of the shares so as to be CET1-compliant.[28]

A. Basel III's 14-Point Test for CET1 Capital Instruments

The Basel III 14-point test for CET1 capital instruments is essentially a description of the features of joint-stock company "common shares." Credit union shares can qualify as CET1 capital, however, if they are "equivalent" to "common shares" based on this test but "taking into account [cooperatives'] specific constitution and legal structure."[29]

Basel III's "Footnote 12" appears in reference to the Basel III's 14-point test for determining whether capital instruments qualify as CET1 capital, and it addresses the issue of CET1 instruments for cooperatives such as credit unions. Footnote 12 reads as follows:

> The [common equity Tier 1] criteria also apply to non joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure. The application of the criteria should preserve the quality of the instruments by requiring that they are **deemed fully equivalent** to common shares in terms of their capital quality **as regards loss absorption** and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress. Supervisors will exchange information on how they apply the criteria to non joint stock companies in order to ensure consistent implementation.[30]

The key passage of Footnote 12 is that CET1 standards for cooperative shares should "preserve the quality of the instruments by requiring that they are deemed fully ***equivalent*** to common shares in terms of their capital quality as regards loss absorption and do not possess features which could cause the condition of the bank to be weakened as a going concern during periods of market stress."[31] In this context "equivalent" is not intended to mean "identical."[32]

Basel III's 14-point test for CET1 capital instruments is as follows:[33]

1. The shares represent the most subordinated claim in liquidation of the credit union.

2. The shares are entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).

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[28] *See* Basel Committee on Banking Supervision, *Composition of Capital Disclosure Requirements* 2 (2012), *available at* http://www.bis.org/publ/bcbs221.pdf ("In the case of the main features template (Section 3) and provision of the full terms and conditions of capital instruments (Section 4), banks are required to update these disclosures whenever a new capital instrument is issued and included in capital and whenever there is a redemption, conversion/write-down or other material change in the nature of an existing capital instrument.")

[29] *Basel III* at 14 & n.12.

[30] *Id.* (emphases added).

[31] *Id.*

[32] *See Black's Law Dictionary* 561 (7th ed. 1999) (defining "equivalent" to mean "[c]orresponding in effect or function; nearly equal; virtually identical.").

[33] *Basel III* at 14 & n.12.

3. The principal is perpetual and never repaid (i.e. can never be withdrawn by the member) outside of liquidation (except for discretionary repurchases/redemptions at the option of the credit union or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).

4. The credit union does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled, nor do the statutory or contractual terms provide any feature which might give rise to such an expectation.

5. Distributions are paid out of retained earnings and/or capital contributed to the credit union by issuing shares. The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that a credit union is unable to pay distributions that exceed the level of retained earnings and/or contributed capital from share issuances).

6. There are no circumstances under which the distributions are obligatory. Nonpayment is therefore not an event of default.

7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.

8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur (i.e. the shares take these losses in the sense that shares "own" the credit union's retained earnings, disclosed reserves, any CET1 "stock surplus (share premium)," and other components of CET1 capital). Within the highest quality capital, after retained earnings and reserves are exhausted, each instrument absorbs losses on a going concern basis proportionately and *pari passu*[34] with all the others.

9. The paid-in amount is recognized as equity capital (i.e. not recognized as a liability) for determining balance sheet insolvency.

10. The paid-in amount is classified as equity under the relevant accounting standards.

11. The shares are directly issued and paid-in and the credit union cannot directly or indirectly have funded the purchase of the instrument.

12. The paid in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.

[34] *Pari passu* means: "Proportionally; at an equal pace; without preference." *Black's Law Dictionary* 1138 (7th ed. 1999).

13. It is only issued with the approval of the owners of the issuing credit union (i.e. the members), either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorized by the owners.

14. It is clearly and separately disclosed on the credit union's balance sheet.

Under this 14-point test and Basel III's Footnote 12, credit union shares should qualify as CET1 capital if their terms and conditions are "equivalent" to those of common stock issued by joint-stock companies. Notably, whether the shares are accounted for as equity under International Financial Reporting Standards generally depends on whether the credit union can refuse redemption of the shares, as further discussed in section 7 of the paper below.

The Basel Committee intended for Footnote 12 to allow cooperative institutions like cooperative banks and credit unions — which performed better than many joint-stock banks during the recent financial crisis — to maintain the status quo ante with respect to cooperative shares as regulatory capital under Basel III if those shares are perpetual, accounted for as equity, redeemable only at the credit union's option, and available to absorb losses. According to the European Association of Co-operative Banks' (EACB) white paper on the Basel III negotiations which EACB issued in December 2009:

> The 14 criteria are a clear-cut description of the features of a share in a joint stock company. It is evident that due to some very fundamental differences between cooperatives and joint stock companies, the member shares of co-operatives would not fulfil all of those criteria, especially for two reasons:
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> > • All over the world, member-shareholders may receive dividends or other forms of remuneration during their membership. However the value of their shares will normally not increase. Thus, when they leave the co-operative or when the cooperative is liquidated the value of their shares will not have increased. They will receive the nominal value or the fair value, whichever is the lesser (i.e. that is the fair value when retained earnings and some capital have been "eaten up" by losses). This creates a conflict with criteria 2 and 8 relating to "loss-absorption".
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> > • As a general rule, Co-operatives are not listed although they have a wide base of members, each and every one of which holds a fairly limited amount of capital. Thus, shares are normally "given back" when leaving the co-operative. This is not in line with the Committee's "permanence criteria" (criteria number 3 and 4).
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> Apart from these very common elements, there may be other elements as well that may lead to conflicts with certain criteria (arrangements regarding fix payments, etc.). By consequence, co-operative shares would not fulfil the relevant criteria for core tier 1 capital.
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> . . . .
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> In Basel, many regulators from countries where co-operative banks play a relevant role (not only in Europe) saw the problem. They think that co-operative shares should be treated as core tier 1 capital and suggested adding a provision to the [Basel III] 14 criteria [for CET1 instruments] that would allow

> [regulators] to deviate from the 14 criteria when the specific constitution and legal structure of co-operative banks so require.[35]

One reason why CET1 capital instruments are significant for credit unions and other cooperative financial institutions is because the Basel Committee's rules for "Minimum requirements to ensure loss absorbency at the point of non-viability" under Basel III that were issued in January 2011 tie CET1 instruments to Additional Tier 1 (AT1) and Tier 2 instrument loss absorption. Under the Basel loss absorption rules, AT1 and Tier 2 capital instruments that must absorb a loss in order for the institutions to continue as a going concern must either be: (1) replaced with CET1 instruments; or (2) be permanently written off.[36] Please see section 7 of this paper, below, for more information on Basel III's loss absorbency requirements.

Credit unions that do not have legal authority to issue CET1 shares therefore have only one option vis-à-vis AT1 and Tier 2 capital instrument loss absorption: permanent write-off. Unless a CET1 share is available to replace the impaired AT1 or Tier 2 instrument, permanent write-off is the only option because the ability to replenish an impaired AT1 or Tier 2 capital instrument would create an off-the-books liability. This is because new net income of the institution would flow through the credit union's income statement and be accounted for as retained earnings.

The National Credit Union Administration's (NCUA) permanent write-down of the Paid-in-Capital (PIC) share and Membership Capital Share (MCS) accounts of U.S. Central Federal Credit Union (formerly the apex central credit union of the United States credit union system) and Western Corporate Federal Credit Union (formerly the largest second-tier central credit union in the U.S.) in March 2009 are a relatively recent example what would happen to AT1 and Tier 2 capital instruments which absorb losses at institutions that do not have authority to replace the impaired shares with CET1 instruments.[37]

B. The European Union Approach to CET1 Cooperative Shares in "CRD IV"

The EU's pending CRD IV Package is so far the most comprehensive governmental interpretation of the Basel III CET1 criteria in the context of cooperative shares. As of the time of this writing, the European Parliament, the EU Council, and the European Commission have all promulgated draft versions of the CRD IV Package, which is now in the

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[35] European Ass'n of Cooperative Banks, *The Basel Committee's future standards for core tier 1 capital and co-operative shares: Analysis, Arguments, Suggestions* 2-3 (Dec. 2009).

[36] *See* Basel Committee on Banking Supervision, *Basel Committee issues final elements of the reforms to raise the quality of regulatory capital* 3-4 (Jan. 2011), *available at* http://www.bis.org/press/p110113.pdf.

[37] *See, e.g.*, NCUA, Letter to Credit Unions No. 09-CU-10 ("Matters Related to 'Paid-in Capital' and 'Membership Capital' of Corporate Credit Unions") (Mar. 2009), *available at* http://www.ncua.gov/Resources/CUs/Pages/LTCU2009.aspx. NCUA later revised some of its original conclusions regarding the extent of U.S. Central FCU's and Western Corporate FCU's losses, but not while these institutions were going concerns.

EU's "Trilogue" process where these three EU institutions negotiate to reach a consensus version of the CRD IV.[38]

All three of these CRD IV Package drafts, however, would treat cooperative shares as CET1 capital so long as the shares are sufficiently permanent and able to absorb losses. This means that the EU will recognize that shares issued by credit unions and other financial cooperatives can qualify as CET1 capital no matter what combination of the three competing drafts of the CRD IV package emerges from the Trilogue negotiations.

The Trilogue process will likely be completed by the end of 2012, after which the European Parliament and the EU Council will vote on the compromise text and it will become law in the EU. The full title of CRD IV is:[39]

> PROPOSAL FOR A DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

As noted earlier, the CRD IV Package includes both the draft directive (called "CRD IV; "CRD" originally stood for "Capital Requirements Directive") and its proposed implementing regulation, the "CRR" ("CRR" originally stood for "Capital Requirements Regulation").[40] Both the CRD IV and the CRR will be adopted concurrently, and both are subject to negotiation in the Trilogue process. The draft CRD IV directive is more than150 pages with more than150 Articles and the draft CRR is more than 500 pages with approximately 500 Articles.

The CRR is the issuance in the CRD IV Package that addresses most Basel III requirements, and the draft CRD IV directive itself does not specifically address the issue of cooperative shares as capital. The sections of the CRR which address CET1 capital for both cooperatives and joint-stock companies are as follows (the European Parliament's Economic and

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[38] It should be noted that the current version of the CRD and the draft CRD IV do not apply to credit unions in Great Britain, Ireland, Latvia, Lithuania and Poland because those EU Member States requested exemptions from the CRD, primarily because of the CRD's requirement that any deposit-taking institution have at least €5 million in initial capital (which many credit unions in these countries could not comply with because of their relatively small size compared to European banks). *See, e.g.*, Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), Article 9 (2006), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0048:20100330:EN:PDF. The CRD IV's approach to cooperative shares as CET1 capital will apply therefore to cooperative banks primarily but remains highly relevant to the credit union movement because credit unions are cooperative financial institutions that are similar to cooperative banks in most respects.

[39] European Commission, *New proposals on capital requirements (CRD IV Package)*, http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm (last visited June 21, 2012).

[40] *E.g.*, European Commission, *PROPOSAL FOR A REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on prudential requirements for credit institutions and investment firms PART I* (July 2011), *available at* http://ec.europa.eu/internal_market/bank/regcapital/new_proposals_en.htm.

Monetary Affairs (ECON) Committee draft of these and other Articles regarding CET1 capital requirements are reprinted as Annex 1 to this white paper):

- Article 24 ("Common Equity Tier 1 items")
- Article 25 ("Capital instruments of mutuals, cooperative societies, saving banks or similar institutions in Common Equity Tier 1 items")
- Article 26 ("Common Equity Tier 1 instruments")
- Article 27 ("Capital instruments issued by mutuals, cooperative societies, savings banks and similar institutions")

Although the European Parliament, EU Council and European Commission drafts of the CRR all agree that CET1 shares can qualify as CET1 capital, the draft issued by the European Parliament's ECON committee is the most favorable version vis-à-vis credit unions because it contains special rules for central credit unions and cooperative federations and authority for governmental capital injections that are not present in the other CRR drafts.

All three CRR drafts would allow European cooperative banks and other cooperative organizations (such as credit unions) to maintain the status quo ante regarding cooperative shares as regulatory capital even under Basel III. The CRR therefore includes several specific rules for cooperative shares that are intended to clarify exactly under what circumstances cooperative shares are "equivalent" to joint-stock company common stock within the meaning of Basel III's Footnote 12.

Article 27 is the most significant provision of the CRR in terms of setting special CET1 requirements for shares issued by cooperatives and other credit unions. Article 27 requires cooperative shares to follow the requirements of Article 26 for joint-stock company shares (see Annex 1 for the text of Article 26) but with special exceptions for cooperatives that would permit cooperative CET1 shares to have preset share redemption values and predetermined dividend rates and caps. Further, Article 27 would allow CET1 shares to be redeemable to a limited extent if national law includes a right to redemption of the cooperative shares.

More specifically, the key features of CRR Article 27clarify that national and provincial regulators can validly interpret the Basel III CET1 requirements so that cooperative shares with these features can be deemed to be CET1 instruments even when joint-stock company instruments with preset redemption values, dividend caps, etc., would not likely qualify as CET1 instruments (since joint-stock company "common shares" do not have such features). For example:

- **Redemption Rights:** Draft CRR Article 27(2) would — when applicable law prohibits a credit union from being able to refuse the redemption of members' shares — nonetheless allow shares to still qualify as CET1 instruments if "the provisions governing the instruments shall give the institution the ability to limit their redemption." Under this approach, if shares could be only redeemed up to a certain threshold (such as if the shares could only be redeemed if the credit union would

remain above the minimum regulatory capital requirement after the redemption), shares up to that limitation would qualify as equity under IFRIC Interpretation number 2 (see section 7 of this white paper, below) and likely also as CET1 capital. Shares that could be redeemed at the member's option without any "limitations" would not qualify. Credit union share redemption rights under local law, especially in credit union systems which traditionally have their members redeem shares upon retirement may be able to qualify as CET1 capital under the CRR Article 27(2) approach.

- **Dividend Distribution Caps:** Draft CRR Article 27(3) reads: "The capital instruments may include a cap or restriction on the maximum level of distributions only where that cap or restriction is set out under applicable national law or the statute of the institution."

- **Claims on Reserves:** Draft CRR Article 27(4) reads: "Where the capital instruments provide the owner with rights to the reserves of the institution in the event of insolvency or liquidation that are limited to the nominal value of the instruments, such a limitation shall apply to the same degree to the holders of all other Common Equity Tier 1 instruments issued by that institution."

- **Claims on Assets:** Draft CRR Article 27(5) reads: "Where the capital instruments entitle their owners to a claim on the assets of the institution in the event of its insolvency or liquidation that is fixed or subject to a cap, such a limitation shall apply to the same degree to all holders of all Common Equity Tier 1 instruments issued by the institution."

- **Special Rule for Federations and Central Coops:** The May 21, 2012, ECON committee draft CRR Article 27(5a) would allow a special rule for CET1 instruments issued by federations and centrals regarding voting rights and dividend levels. It states that "Central bodies which carry out the necessary central operations of a network of affiliated institutions" may pay "higher distributions" on one class of CET1 shares than on other CET1 classes if "according to the by-laws of the central bodies, Core Equity Tier I instruments with preferential voting rights can be issued to ensure that the affiliated undertakings maintain a dominant influence in their central body."

- **EBA Technical Standards for Coop CET1 Share Redemption Limits:** Draft CRR Article 27(6) would require the European Banking Authority (EBA) to deliver "draft regulatory technical standards to specify the nature of the limitations on redemption necessary where the refusal by the institution of the redemption of its own funds instruments is prohibited under applicable national law" to the European Commission by January 1, 2013.

The full May 21, 2012, ECON committee draft of CRR Article 27 reads as follows, with that draft's changes from the European Commission's original proposal in italicized, bold typeface:

Article 27

*Capital instruments issued by mutuals, cooperative societies, **savings banks** and similar institutions*

1. Capital instruments issued by mutuals, cooperative societies***, savings banks*** and similar institutions shall qualify as Common Equity Tier 1 instruments only if the conditions laid down in Article 26 and ***amended by*** this Article are met.

2. The following conditions shall be met as regards redemption of the capital instruments:

   (a) except where prohibited under applicable national law, the institution shall be able to refuse the redemption of the instruments;

   (b) where the refusal by the institution of the redemption of instruments is prohibited under applicable national law, the provisions governing the instruments shall give the institution the ability to limit their redemption;

   (c) refusal to redeem the instruments, or the limitation of the redemption of the instruments where applicable, may not constitute an event of default of the institution.

3. The capital instruments may include a cap or restriction on the maximum level of distributions only where that cap or restriction is set out under applicable national law or the statute of the institution.

4. Where the capital instruments provide the owner with rights to the reserves of the institution in the event of insolvency or liquidation that are limited to the nominal value of the instruments, such a limitation shall apply to the same degree to the holders of all other Common Equity Tier 1 instruments issued by that institution.

   The condition laid down in the first sub-paragraph is without prejudice of the possibility for a mutual, cooperative society or a similar institution to recognize within CET1 capital instruments that do not afford voting rights to the holder and that meet both the following conditions:

   (a) the claim of the holders of the non-voting instruments in the insolvency or liquidation of the institution is proportionate to the share of the total Common Equity Tier 1 instruments that those non-voting instruments represent;

   (b) the instruments otherwise qualify as a Common Equity Tier 1 instruments.

5. Where the capital instruments entitle their owners to a claim on the assets of the institution in the event of its insolvency or liquidation that is fixed or subject to a cap, such a limitation shall apply to the same degree to all holders of all Common Equity Tier 1 instruments issued by the institution.

5a. Central bodies which carry out the necessary central operations of a network of affiliated institutions referred to in Article 9 may, notwithstanding Article 26(1) (h), pay higher distributions on the Core Equity Tier I instruments referred to in point (c) below than on the Core Equity Tier I instruments referred to in point (a), if the following conditions are met:

   a) according to the by-laws of the central bodies, Core Equity Tier I instruments with preferential voting rights can be issued to ensure that the affiliated undertakings maintain a dominant influence in their central body;

   b) the instruments referred to in point (a) are not traded in a regulated market;

   c) there is no preferential treatment between any other Core Equity Tier 1 instruments issued by the body

6. EBA shall develop draft regulatory technical standards to specify the nature of the limitations on redemption necessary where the refusal by the institution of the redemption of own funds instruments is prohibited under applicable national law.

   EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2013.

> Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.

As noted above, the European Union has not yet finalized the CRD IV Package and it is unlikely that the above ECON draft will become final law without at least some changes in the Trilogue negotiations process with the EU Council and European Commission. Both the EU Council and European Commission's versions of Article 27, however, are very similar to the above quoted ECON draft in most material respects. This means that the final version of the CRR is virtually certain to contain rules for cooperative shares as CET1 capital that are reasonably similar to the ECON May 21st draft.

We believe that the CRD IV Package's approach to cooperative shares as CET1 capital is consistent with the Basel Committee's intent regarding cooperative shares as expressed in Footnote 12 of Basel III. We also believe that national and provincial credit union regulatory agencies which decide to apply Basel III's principles to credit unions should consider seriously the European Union's response to the Basel III CET1 criteria as expressed in the CRD IV Package.

4. Additional Tier 1 Capital and Credit Unions

Credit union capital components that do not meet the CET1 definition may be eligible to meet the less stringent requirements for AT1 capital. AT1 capital can include instruments that are accounted for as equity, such as preferred shares issued by joint-stock companies, as well as some types of instruments that are accounted for as liabilities. "Stock surplus (share premium)" resulting from selling AT1 shares or other AT1 instruments for above par value can generally be included in AT1 regulatory capital.[41]

AT1 capital is a component of the Basel III leverage ratio as well as the Total Tier 1 Capital risk-based capital ratio and the Total Capital risk-based capital ratio, but is not an element of the Common Equity Tier 1 risk-based capital ratio. In order to meet the AT1 definition, credit union shares or other capital instruments would need to meet these requirements:[42]

1. The instrument must be issued and paid-in.
2. The instrument must be subordinated to depositors, general creditors and subordinated debt of the credit union.
3. The instrument must be neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis credit union creditors.
4. The instrument must be perpetual, i.e. there is no maturity date and there are no step-ups or other incentives to redeem.

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[41] *Basel III* at 17. *See generally supra* note 26.
[42] *Basel III* at 15-17.

5. The instrument must be callable at the initiative of the issuer only after a minimum of five years and with the following conditions:

    a. To exercise a call option a credit union must receive prior supervisory approval; and

    b. A credit union must not do anything which creates an expectation that the call will be exercised; and

    c. Credit unions must not exercise a call unless:

        i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done under conditions which are sustainable for the income capacity of the credit union; or

        ii. The credit union demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

6. Any repayment of principal (e.g., through repurchase or redemption) must be with prior supervisory approval and credit unions should not assume or create market expectations that supervisory approval will be given.

7. The credit union must have discretion over dividends/coupons:

    a. the credit union must have full discretion at all times to cancel distributions/payments;

    b. cancellation of discretionary payments must not be an event of default;

    c. credit unions must have full access to cancelled payments to meet obligations as they fall due; and

    d. cancellation of distributions/payments must not impose restrictions on the credit union except in relation to distributions to common stockholders.

8. Dividends/coupons must be paid out of distributable items (such as retained earnings).

9. The instrument cannot have a credit sensitive dividend feature, that is a dividend/coupon that is reset periodically based in whole or in part on the credit union's credit standing.

10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.

11. Instruments classified as liabilities for accounting purposes must have principal loss absorption through either (i) conversion to CET1 shares at an objective pre-specified trigger point or (ii) a write-down mechanism which allocates losses to the instrument at a pre-specified trigger point. The write-down will have the following effects:

    a. Reduce the claim of the instrument in liquidation;

    b. Reduce the amount re-paid when a call is exercised; and

    c. Partially or fully reduce coupon/dividend payments on the instrument.

12. Neither the credit union nor a related party over which the credit union exercises control or significant influence can have purchased the instrument, nor can the credit union directly or indirectly have funded the purchase of the instrument.

13. The instrument cannot have any features that hinder recapitalization, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.

14. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g., a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.

The primary differences between CET1 and AT1 instruments is that CET1 instruments take losses before AT1 and also must be accounted for as equity, whereas AT1 instrument can be accounted for as either equity or as a liability. AT1 instruments are similar to CET1 instruments in most respects, and both CET1 and AT1 are included in the Basel III leverage ratio (although only CET1 can be used to meet Basel III's Countercyclical Capital Buffer and Capital Conservation Buffers requirements). In addition, as noted above, AT1 capital is a component of the Basel III leverage ratio as well as the Total Tier 1 Capital risk-based capital ratio and the Total Capital risk-based capital ratio, but is not an element of the CET1 risk-based capital ratio.

5. Tier 2 Capital and Credit Unions

Tier 2 capital is the most permissive capital category under Basel III, and it includes instruments such as subordinated debt (so long as the instruments meet all of Basel III's 9 requirements for Tier 2 capital, which are discussed below). Tier 2 capital is also called "gone concern capital" (as opposed to "going concern") or "capital de liquidación" because it does not generally prevent an institution from failing but reduces the losses from a failure for the credit union's savers and/or the applicable share or deposit guarantee scheme.

More specifically, a credit union that depletes all CET1 and AT1 capital would register "zeros" on the Basel III leverage ratio as well as on the CET1 and Total Tier 1 risk-based capital ratios, and would presumably be subject to governmental seizure and likely liquidation. This is because Tier 2 capital is a component of the Basel III "Total Capital" risk-based capital ratio but is not a component of the Basel III leverage ratio or the CET1 or Total Tier 1 risk-based capital ratios.

Under Basel III, Tier 2 capital consists of the sum of the following elements: [43]

- Instruments issued by the credit union that meet the criteria for inclusion in Tier 2 capital (and are not included in Tier 1 capital)

[43] *Id.* at 17-19

- "Stock surplus (share premium)" (i.e. capital surplus, additional paid-in capital) resulting from the issue of instruments included in Tier 2 capital for above par value
- Instruments issued by consolidated subsidiaries of the credit union and held by third parties that meet the criteria for inclusion in Tier 2 capital and are not included in Tier 1 capital
- General provisions or general loan-loss reserves "held against future, presently unidentified losses" in an amount up to 1.25% of risk-based assets
- Regulatory adjustments applied in the calculation of Tier 2 Capital

Basel III's criteria for inclusion in Tier 2 capital require the capital instrument to meet these conditions:[44]

1. The instrument must be issued and paid-in.

2. The instrument must be subordinated to depositors and general creditors of the credit union.

3. The instrument must be neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis depositors and general credit union creditors.

4. The instrument must satisfy the following levels of maturity:

    a. minimum original maturity of at least five years;

    b. recognition in regulatory capital in the remaining five years before maturity will be amortized on a straight line basis; and

    c. there are no step-ups or other incentives to redeem.

5. The instrument must be callable at the initiative of the issuer only after a minimum of five years:

    a. To exercise a call option a credit union must receive prior supervisory approval;

    b. A credit union must not do anything that creates an expectation that the call will be exercised; and

    c. Credit unions must not exercise a call unless:

        i. They replace the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the credit union; or

        ii. The credit union demonstrates that its capital position is well above the minimum capital requirements after the call option is exercised.

6. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.

[44] *Id.*

7. The instrument cannot have a credit-sensitive dividend feature, such as a dividend/coupon that is reset periodically based in whole or in part on the credit union's credit standing.

8. Neither the credit union nor a related party over which the credit union exercises control or significant influence can have purchased the instrument, nor can the credit union directly or indirectly have funded the purchase of the instrument

9. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g., a special purpose vehicle – "SPV"), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 Capital.

Many existing credit union capital instruments likely already meet Basel III's 9-point test for inclusion in Tier 2 capital. For example, credit union shares which are perpetual and available to absorb losses but which members have an absolute right to redeem at their own option under certain circumstances (such as upon retirement) would likely qualify as Tier 2 capital. By way of comparison, however, such shares would likely be considered CET1 or AT1 capital if the credit union had the unconditional right to refuse a members' redemption request.

For shares that do not meet the Tier 2 test, conforming shares' terms and conditions to the Tier 2 capital rules should be less demanding than would making these shares CET1- or AT1-compliant. In addition, subordinated debt of at least 5-years duration should qualify as Tier 2 capital in most cases.

6. Capital Instrument Loss Absorbency

The Basel III rules for capital instrument loss absorbency are included as an annex to Basel III. As noted above in section 3(A) of this white paper, capital instruments that have a face value must be immediately converted to CET1 shares or written down to absorb losses that exceed retained earnings, reserves, and all other more senior capital classes, and cannot be written up again for any reason.[45]

Permanent accounting write-off of impaired AT1 and Tier 2 capital instruments is the only option when an institution does not have authority for CET1 shares because a commitment to replenish an impaired AT1 or Tier 2 capital instrument would create an off-the-books liability, which would be an unsafe and unsound practice. As stated by the Committee:[46]

> 1. The terms and conditions of all non-common Tier 1 and Tier 2 instruments issued by an internationally active bank must have a provision that requires such instruments, at the option of the relevant authority, to either be written off or converted into common equity upon the occurrence of the trigger event unless:

[45] Basel Committee on Banking Supervision, *Basel Committee issues final elements of the reforms to raise the quality of regulatory capital* 3-4 (Jan. 2011), *available at* http://www.bis.org/press/p110113.pdf.
[46] *Id.*

> (a) the governing jurisdiction of the bank has in place laws that (i) require such Tier 1 and Tier 2 instruments to be written off upon such event, or (ii) otherwise require such instruments to fully absorb losses before tax payers are exposed to loss;
>
> (b) a peer group review confirms that the jurisdiction conforms with clause (a); and
>
> (c) it is disclosed by the relevant regulator and by the issuing bank, in issuance documents going forward, that such instruments are subject to loss under clause (a) in this paragraph.

2. Any compensation paid to the instrument holders as a result of the write-off must be paid immediately in the form of common stock (or its equivalent in the case of non-joint stock companies).

3. The issuing bank must maintain at all times all prior authorisation necessary to immediately issue the relevant number of shares specified in the instrument's terms and conditions should the trigger event occur.

Events that would trigger recognition of these write-downs include "the earlier of: (1) a decision that a write-off, without which the firm would become non-viable, is necessary, as determined by the relevant authority; and (2) the decision to make a public sector injection of capital, or equivalent support, without which the firm would have become non-viable, as determined by the relevant authority."[47]

Writing off the value of a capital instrument for accounting and regulatory capital purposes may be subject to judicial review depending on terms and conditions of the instrument and the legal traditions of the jurisdiction in question. In many legal systems procedural due-process requirements or similar rule-of-law notions of fairness and justice allow courts to review regulators' determinations for abuses of discretion.[48] It seems likely, however, that most courts would defer to a credit union regulator's reasoned judgment regarding regulatory capital accounting and impairment, especially during periods of economic stress.

As noted earlier, in the United States, the National Credit Union Administration's (NCUA) write-down on an accounting and regulatory capital basis of the Paid-in-Capital (PIC) share and Membership Capital Share (MCS) accounts of U.S. Central Federal Credit Union and Western Corporate Federal Credit Union in March 2009 are a recent example of what would happen to AT1 and Tier 2 capital instruments that absorb losses if the institution does not have authority to replace the impaired shares with a CET1 instrument.[49] Another recent example is Spanish and European authorities' attempt to write-off the value of "preferred shares" and bonds held by members of Spanish cajas which receive governmental capital injections, although this process has not been concluded as of the time of this writing.[50]

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[47] *Id.*

[48] *See, e.g.*, *ICURN Guiding Principles* 1 (stating in ICURN Guiding Principle Number 1 that it is "essential" for a credit union regulatory authority "to be accountable in its discharge of duties.")

[49] *See* NCUA, Letter to Credit Unions No. 09-CU-10 (Mar. 2009), *available at* http://www.ncua.gov/Resources/CUs/Pages/LTCU2009.aspx.

[50] *See, e.g.*, Christopher Bjork, *Europe Bailout Conditions Pinch Spain's Small Savers*, WALL ST. J., July 11, 2012, *available at* http://professional.wsj.com/article/SB10001424052702304373804577521072516539692.html ("Spanish prosecutors are mounting lawsuits on behalf of small savers who hold preferred stock in local banks, as the European Union is set to require ailing lenders to impose losses on holders of junior bonds and preferred shares as a condition of its bailout. Prosecutors claim banks misrepresented these securities as safe deposits

In the case of U.S. Central Federal Credit Union and Western Corporate Federal Credit Union, these central or "corporate" credit unions' PIC and MCS were permanently written-off on an accounting and regulatory capital basis by NCUA because their asset-backed securities experienced significant "Other-Than-Temporary Impairment" (or "OTTI") of their value. After NCUA determined that the PIC and MCS no longer had value for accounting or regulatory capital purposes, the PIC and MCS holders' recourse for determining whether their legal rights to these instruments continued to have any value was to submit claims to NCUA as part of the agency's administrative claims determination process for creditors of liquidated credit unions.[51]

Some recoupment of PIC and MCS value by the members of U.S. Central Federal Credit Union and Western Corporate Federal Credit Union may be possible, however, once the liquidation process is completed at the end of NCUA's corporate credit union resolution efforts.[52] NCUA is tracking the actual losses from the failed institutions' portfolios compared to the projected losses as part of this process.[53]

Alternatively, the procedural due-process provisions of the United States' Administrative Procedure Act[54] would have also allowed NCUA's actions to be reviewed by a court (even if the agency had never liquidated U.S. Central Federal Credit Union and Western Corporate Federal Credit Union).[55] A reviewing court, however, would have been required to grant deference to NCUA's factual determination that the PIC and MCS were impaired so long as the agency's accounting analysis was not "arbitrary and capricious."[56] This standard grants

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when they sold them. If courts rule in favor of clients, sales contracts would be annulled and banks forced to pay back investors . . . About 120,000 small Spanish savers are exposed to the country's nationalized banks."); Miles Johnson, Peter Spiegel & Joshua Chaffin, *Spain pressed to inflict losses on small investors*. FIN. TIMES, July 10, 2012, *available at* http://www.ft.com/intl/cms/s/0/c4810fd6-caa8-11e1-8872-00144feabdc0.h#axzz233qJPhj6 ("The bailout conditions for Spain's banks would force any lender taking aid fully to write off their preferred shares and subordinated bonds, according to a draft memorandum of understanding seen by the Financial Times.").

[51] *See* 12 C.F.R. pt. 709 ("Involuntary Liquidation of Federal Credit Unions and Adjudication of Creditor Claims Involving Federally-Insured Credit Unions in Liquidation.").

[52] *See* NCUA, "NCUA Guaranteed Notes (NGN) Program," http://www.ncua.gov/Resources/Corps/NGN/Pages/default.aspx (last visited Aug. 8, 2012).

[53] *See* NCUA, "Projected Legacy Asset Losses," http://www.ncua.gov/Resources/Corps/NGN/Pages/TimelineLegacy.aspx (last visited Aug. 8, 2012); *see also* NCUA, "Estimated Range of Future Stabilization Fund Assessments Narrows," (June 29, 2012), http://www.ncua.gov/News/Press/NW20120629StabilizaationFund.pdf ("The estimated range of losses is now between $2.7 billion and $6.0 billion. The narrower range of projected remaining assessments reflects the actual performance of the legacy assets to date and BlackRock's updated assessment of the macroeconomic factors used in projecting future performance.")

[54] 5 U.S.C. §§ 551-706.

[55] *See* 5 U.S.C. § 704 ("Agency action made reviewable by statute and final agency action for which there is no other adequate remedy in a court are subject to judicial review. A preliminary, procedural, or intermediate agency action or ruling not directly reviewable is subject to review on the review of the final agency action."); *cf.* 12 U.S.C. §§ 1786(h)(3), 1787(a)(1)(B) (providing only a ten day window for a credit union to request judicial review of NCUA Board "conservatorship" orders and liquidation orders).

[56] *See* 5 U.S.C. § 706(2) ("[T]he reviewing court shall . . . hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law

U.S. regulatory agencies a high degree of judicial deference and most U.S. courts have deferred to credit union regulators' judgment regarding the conditions of troubled credit unions in order to maintain better the safety and stability of the U.S. credit union system.[57]

7. Capital Instrument Accounting

The accounting treatment of credit union capital instruments plays an integral part in those instruments' Basel III classification. Most significantly, the Basel III CET1 rules require CET1-compliant instruments to be accounted for as equity.[58] The Basel III AT1 and Tier 2 criteria similarly require that instruments either be accounted for as equity or, if accounted for as a liability, absorb losses on a going concern basis (i.e. as the losses occur rather than during liquidation), as discussed in section 6 above.[59]

The International Financial Reporting Interpretations Committee (IFRIC) of the International Accounting Standard Board (IASB) in 2004 issued an interpretation entitled *Members' Shares in Co-operative Entities and Similar Instruments* which concluded that whether cooperative shares are classified as equity or liabilities depends on the terms and conditions of the shares.[60] Specifically, IFRIC Interpretation No. 2, items 5-9, concluded:[61]

> 5. The contractual right of the holder of a financial instrument (including members' shares in co-operative entities) to request redemption does not, in itself, require that financial instrument to be classified as a financial liability. Rather, the entity must consider all of the terms and conditions of the financial instrument in determining its classification as a financial liability or equity. Those terms and conditions include relevant local laws, regulation and the entity's governing charter in effect at the date of the classification, but not expected future amendments to those laws, regulations or charter.
>
> 6. Members' shares that would be classified as equity if the members did not have a right of redemption are equity if either of the conditions described in paragraphs 7 or 8 are present. Demand

. . ."); *e.g.*, *Motor Vehicle Mfrs. Ass'n of the U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) ("The scope of review under the 'arbitrary and capricious' standard is narrow, and a court is not to substitute its judgment for that of the agency. Nevertheless, the agency must examine the relevant data and articulate a satisfactory explanation for its action, including a 'rational connection between the facts found and the choice made.'") (citations omitted).

[57] *See, e.g.*, *Polish and Slavic Federal Credit Union v. NCUA Bd.*, 2000 U.S. App. LEXIS 9527 (2d Cir. 2000) (affirming an NCUA Board conservatorship order because the factual record supported the agency's conclusion that the credit union had violated anti-money laundering rules); *Bingham v. NCUA Bd.*, 927 F.2d 282, 286 (6th Cir. 1991) ("Petitioners do not challenge the district court's findings regarding the financial condition of the credit union . . . Based on these undisputed findings, we hold that a statutory ground existed for the NCUA to impose the conservatorship . . ."); *Lafayette Federal Credit Union v. United States (Lafayette II)*, 76 F. Supp. 2d 645 (D. Md. 1999) (dismissing a challenge to the NCUA Board's decision to place Capital Corporation Federal Credit Union ("CapCorp") into conservatorship and subsequently liquidate it, which depleted the value of CapCorp's Preferred Capital Shares ("PCS")); *Lafayette Federal Credit Union v. NCUA Bd. (Lafayette I)*, 960 F. Supp. 999 (E.D. Va. 1997), *aff'd*, 133 F.3d 915 (4th Cir. 1998) ("Since neither Plaintiffs nor CapCorp availed themselves of [the Financial Institutions Reform, Recovery, and Enforcement Act's] administrative processes, this Court lacks subject matter jurisdiction over their claims.").

[58] *Basel III* at 14.

[59] *Id.* at 15-19; *see also* Basel Committee on Banking Supervision, *Basel Committee issues final elements of the reforms to raise the quality of regulatory capital* 3-4 (Jan. 2011), *available at* http://www.bis.org/press/p110113.pdf.

[60] International Financial Reporting Interpretations Committee, *Members' Shares in Co-operative Entities and Similar Instruments*, IFRIC Interpretation 2 (Nov. 2004).

[61] *Id.* at 2-3.

> deposits, including current accounts, deposit accounts and similar contracts that arise when members act as customers are financial liabilities of the entity.
>
> 7. Members' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares.
>
> 8. Local law, regulation or the entity's governing charter can impose various types of prohibitions on the redemption of members' shares, eg unconditional prohibitions or prohibitions based on liquidity criteria. If redemption is unconditionally prohibited by local law, regulation or the entity's governing charter, members' shares are equity. However, provisions in local law, regulation or the entity's governing charter that prohibit redemption only if conditions—such as liquidity constraints—are met (or are not met) do not result in members' shares being equity.
>
> 9. An unconditional prohibition may be absolute, in that all redemptions are prohibited. An unconditional prohibition may be partial, in that it prohibits redemption of members' shares if redemption would cause the number of members' shares or amount of paid-in capital from members' shares to fall below a specified level. Members' shares in excess of the prohibition against redemption are liabilities, unless the entity has the unconditional right to refuse redemption as described in paragraph 7. In some cases, the number of shares or the amount of paid-in capital subject to a redemption prohibition may change from time to time. Such a change in the redemption prohibition leads to a transfer between financial liabilities and equity.

As noted earlier, most of the above requirements for cooperative shares to be accounted for as equity will be met if the shares are sufficiently permanent — such as if the credit union can unilaterally refuse to redeem the shares — and are available to absorb losses on a going concern basis. The limitations on credit union shares as equity in IFRIC Interpretation No. 2 regarding share redemption limits will be especially significant in terms of deciding when credit union shares qualify as CET1 capital.

8. Capital Instruments and Securities Laws

National and provincial securities laws must also be considered by credit unions that plan to issue shares which qualify as regulatory capital under Basel III. This is because, even if credit union shares are not currently regulated as securities, conforming the terms of those shares or other instruments to the Basel III rules may make them into "securities" as defined by national or provincial laws. In many jurisdictions, capital instruments that resemble joint-stock company shares or debt securities like bonds must register with appropriate securities regulators and meet other securities law compliance requirements. On the other hand, some jurisdictions may allow a lighter securities laws compliance regime, or an exemption, for credit union capital instruments.

The question of when credit union capital instruments qualify as "securities" under national or provincial law is outside the scope of this paper. Credit union stakeholders, however, must keep in mind that issuing capital instruments to members or other investors will, at a minimum, entail determining whether the instruments are securities under national or provincial laws and, if so, also entail complying with those legal requirements. Failure to do so could result in significant legal liabilities if a court or government agency were to later conclude that the credit union had issued instruments that were legally considered securities but did not have the necessary legal authorization to do so.

9. Conclusion: Next Steps for the Credit Union Movement

World Council remains committed to working with the international credit union movement to help credit unions worldwide continue to have the option to issue shares that qualify as regulatory capital, as credit unions have done since the earliest days of the credit union movement. Credit unions have always issued shares and in many systems these shares continue to qualify as regulatory capital under non-Basel III regimes. The Basel Committee intended to allow cooperative shares with a high degree of permanence and the ability to absorb losses to qualify as CET1 capital, but did not provide many details about how this would work in practice other than in Basel III's Footnote 12 regarding cooperative shares as CET1 capital.

Fortunately, the EU's CRD IV Package gives credit union stakeholders detailed direction regarding when credit union shares should qualify as CET1 capital or other regulatory capital under Basel III. The CRD IV Package also provides credit union regulators outside the EU with a good example of how they can interpret the meaning of the term "equivalent" as used in Basel III's Footnote 12.

The future of credit union shares as capital therefore remains bright, especially if jurisdictions outside of Europe follow the EU's approach to Basel III implementation. Following the European approach to Basel III for credit unions would preserve credit union's cooperative structure and also allow cooperative institutions to have the flexibility to use member shares and other capital instruments to supplement retained earnings as forms of regulatory capital. We believe that credit union regulators worldwide should consider seriously implementing Basel III in a manner that is the same as or similar to the EU's approach.

Annex 1:
Articles 23-28a of the European Parliament's ECON Draft of the CRD IV Package's Proposed Regulation ("CRR")

Amendments made by the ECON committee to its May 21, 2012 CRR draft to the European Commission's CRR proposal appear in ***bold and italicized type***. As of the date of this writing, the ECON and other (highly similar) draft versions of the CRR are is in the Trilogue negotiation process during which the Parliament, the EU Council, and the European Commission reconcile the differences between their respected draft versions of the CRD IV Package.

CRR Title II
Elements of own funds

Chapter 1
Tier 1 capital

Article 23
Tier 1 capital

The Tier 1 capital of an institution consists of the sum of the Common Equity Tier 1 capital and Additional Tier 1 capital of the institution.

Chapter 2
Common Equity Tier 1 capital

SECTION 1
COMMON EQUITY TIER 1 ITEMS AND INSTRUMENTS

Article 24
Common Equity Tier 1 items

1. Common Equity Tier 1 items of institutions consist of the following:

   (a) capital instruments, provided the conditions laid down in Article 26 ***or in Article 27*** are met;

   (b) share premium accounts related to the instruments referred to in point (a);

   (c) retained earnings;

   (d) accumulated other comprehensive income;

(e) other reserves;

(f) funds for general banking risk.

2. For the purposes of point (c) of paragraph 1, institutions may include interim or year-end profits in Common Equity Tier 1 capital before the institution has taken a formal decision confirming the final profit or loss of the institution for the year only with the prior consent of the competent authority. The competent authority shall consent where the following conditions are met:

(a) those profits have been reviewed by persons independent of the institution that are responsible for the auditing of the accounts of that institution;

(b) the institution has demonstrated to the satisfaction of the competent authority that any foreseeable charge or dividend has been deducted from the amount of those profits.

A review of the interim or year-end profits of the institution shall provide an adequate level of assurance that those profits have been evaluated in accordance with the principles set out in the applicable accounting standard.

3. EBA shall develop draft regulatory technical standards to specify the meaning of foreseeable when determining whether any foreseeable charge or dividend has been deducted.

EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2013.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.

4. EBA ***shall evaluate and then*** establish, maintain and publish a list of the forms of capital instrument in each Member State that ***meet the requirements of this Regulation to*** qualify as Common Equity Tier 1 instruments. EBA shall establish and publish this list by 1 January 2013.

Article 25

*Capital instruments of mutuals, cooperative societies, **saving banks** or similar institutions in Common Equity Tier 1 items*

1. Common Equity Tier 1 items shall include any capital instrument issued by an institution under its statutory terms provided the following conditions are met:

(a) the institution is of a type that is defined under applicable national law and which competent authorities consider to qualify as a mutual, cooperative society, ***saving banks*** or a similar institution for the purposes of this Part; ***or (ii) the institution is wholly owned by an institution as described in point (i), it has approval from the competent authorities to make use of the provisions in this Article and provided that, and for as long as, 100% of the ordinary shares in issue in the institution are held directly or indirectly by an institution described in point (i);***

(b) the conditions laid down in Articles 26 and ***the amending conditions in Article*** 27 are met;

(c) the instrument does not possess features that could cause the condition of the institution to be weakened as a going concern during periods of market stress.

2. EBA shall develop ***a*** draft regulatory technical standard ***with a view to encouraging the development of a robust and diverse banking sector in the EU with a variety of different liability structures*** to specify the ***conditions in accordance with which competent authorities may determine that a type of undertaking recognised under applicable national law qualifies as a mutual, cooperative society or similar institution for the purposes of this Part.***

EBA shall submit ***that*** draft regulatory technical standard to the Commission by ***1 January 2016***.

Power is delegated to the Commission to adopt the regulatory technical standard referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.

Article 26
Common Equity Tier 1 instruments

1. Capital instruments shall qualify as Common Equity Tier 1 instruments only if all the following conditions are met:

(a) the instruments are issued directly by the institution with the prior approval of the owners of the institution or, where permitted under applicable national law, the management body of the institution;

(b) the instruments are paid up and their purchase is not funded directly or indirectly by the institution;

(c) the instruments meet all the following conditions as regards their classification:

(i) they qualify as capital within the meaning of Article 22 of Directive 86/635/EEC;

(ii) they are classified as equity within the meaning of the applicable accounting standard;

(iii) they are classified as equity capital for the purposes of determining balance sheet insolvency, where applicable under national insolvency law;

(d) the instruments are clearly and separately disclosed on the balance sheet in the financial statements of the institution;

(e) the instruments are perpetual;

(f) the principal amount of the instruments may not be reduced or repaid, except in either of the following cases:

(i) the liquidation of the institution ***or administration by a resolution authority***;

(ii) discretionary repurchases of the instruments or other discretionary means of reducing capital, where the institution has received the prior consent of the competent authority in accordance with Article72;

(g) the provisions governing the instruments do not indicate expressly or implicitly that the principal amount of the instruments would or might be reduced or repaid other than in the liquidation of the institution ***or administration by a resolution authority***, and the institution does not otherwise provide such an indication prior to or at issuance of the instruments, except in the case of instruments referred to in Article 25 where the refusal by the institution to redeem such instruments is prohibited under applicable national law;

(h) the instruments meet the following conditions as regards distributions:

(i) there are no preferential ***distribution treatment regarding the order of distribution payments,*** including in relation to other Common Equity Tier 1 instruments, and the terms governing the instruments do not provide preferential rights to payment of distributions;

(ii) distributions to holders of the instruments may be paid only out of distributable items;

(iii) the conditions governing the instruments do not include a cap or other restriction on the maximum level of distributions, except in the case of the instruments referred to in Article 25 ***and a multiple of the dividend paid on ordinary shares or instruments referred to in Article 25 does not constitute preferential distribution, a cap or other restrictions on the maximum level of distributions; however, multiples of dividends which result in a disproportionate drag on capital shall not be allowed***;

(iv) the level of distributions is not determined on the basis of the amount for which the instruments were purchased at issuance, and is not otherwise determined on this basis, except in the case of the instruments referred to in Article 25;

(v) the conditions governing the instruments do not include any obligation for the institution to make distributions to their holders and the institution is not otherwise subject to such an obligation;

(vi) non-payment of distributions does not constitute an event of default of the institution;

(i) compared to all the capital instruments issued by the institution, the instruments absorb the first and proportionately greatest share of losses as they occur, and each instrument absorbs losses to the same degree as all other Common Equity Tier 1 instruments;

(j) the instruments rank below all other claims in the event of insolvency or liquidation of the institution;

(k) the instruments entitle their owners to a claim on the residual assets of the institution, which, in the event of its liquidation and after the payment of all senior claims, is proportionate to the amount of such instruments issued and is not fixed or subject to a cap, except in the case of the capital instruments referred to in Article 25;

(l) the instruments are not secured, or guaranteed by any of the following:

(i) the institution or its subsidiaries;

(ii) the parent institution or its subsidiaries;

(iii) the parent financial holding company or its subsidiaries;

(iv) the mixed activity holding company or its subsidiaries;

(v) the mixed financial holding company and its subsidiaries;

(vi) any undertaking that has close links with the entities referred to in points (i) to (v);

(m) the instruments are not subject to any arrangement, contractual or otherwise, that enhances the seniority of claims under the instruments in insolvency or liquidation.

The condition set out in point (j) of the first subparagraph shall be deemed to be met, notwithstanding the instrument ranking pari passu with capital referred to in Article 463(3), for instruments which have been issued before 20 July 2011 and are included in Additional Tier 1 or Tier 2 in accordance with this Regulation.

2. The conditions laid down in point (i) of paragraph 1 shall be met notwithstanding a write down on a permanent basis of the principal amount of Additional Tier 1 instruments.

3. EBA shall develop draft regulatory technical standards to specify the following:

(a) the applicable forms and nature of indirect funding of capital instruments;

(b) the meaning of distributable items for the purposes of determining the amount available to be distributed to the holders of own funds instruments of an institution.

(ba) Whether and when multiple distributions would constitute a disproportionate drag on Common Equity Tier 1 capital;

(bb) the meaning of preferential distributions;

(bc) the definition and implications of 'absorbing the first and proportionately greatest share of losses as they occur';

(bd) the nature of a cap or other restriction on the maximum level of distributable items.

EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2013.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.

Article 27

Capital instruments issued by mutuals, cooperative societies, ***savings banks*** *and similar institutions*

1. Capital instruments issued by mutuals, cooperative societies***, savings banks*** and similar institutions shall qualify as Common Equity Tier 1 instruments only if the conditions laid down in Article 26 and ***amended by*** this Article are met.

2. The following conditions shall be met as regards redemption of the capital instruments:

(a) except where prohibited under applicable national law, the institution shall be able to refuse the redemption of the instruments;

(b) where the refusal by the institution of the redemption of instruments is prohibited under applicable national law, the provisions governing the instruments shall give the institution the ability to limit their redemption;

(c) refusal to redeem the instruments, or the limitation of the redemption of the instruments where applicable, may not constitute an event of default of the institution.

3. The capital instruments may include a cap or restriction on the maximum level of distributions only where that cap or restriction is set out under applicable national law or the statute of the institution.

4. Where the capital instruments provide the owner with rights to the reserves of the institution in the event of insolvency or liquidation that are limited to the nominal value of the instruments, such a limitation shall apply to the same degree to the holders of all other Common Equity Tier 1 instruments issued by that institution.

The condition laid down in the first sub-paragraph is without prejudice of the possibility for a mutual, cooperative society or a similar institution to recognize within CET1 capital instruments that do not afford voting rights to the holder and that meet both the following conditions:

(a) the claim of the holders of the non-voting instruments in the insolvency or liquidation of the institution is proportionate to the share of the total Common Equity Tier 1 instruments that those non-voting instruments represent;

(b) the instruments otherwise qualify as a Common Equity Tier 1 instruments.

5. Where the capital instruments entitle their owners to a claim on the assets of the institution in the event of its insolvency or liquidation that is fixed or subject to a cap, such a limitation shall apply to the same degree to all holders of all Common Equity Tier 1 instruments issued by the institution.

5a. Central bodies which carry out the necessary central operations of a network of affiliated institutions referred to in Article 9 may, notwithstanding Article 26(1) (h), pay higher distributions on the Core Equity Tier I instruments referred to in point (c) below than on the Core Equity Tier I instruments referred to in point (a), if the following conditions are met:

a) according to the by-laws of the central bodies, Core Equity Tier I instruments with preferential voting rights can be issued to ensure that the affiliated undertakings maintain a dominant influence in their central body;

b) the instruments referred to in point (a) are not traded in a regulated market;

c) there is no preferential treatment between any other Core Equity Tier 1 instruments issued by the body

6. EBA shall develop draft regulatory technical standards to specify the nature of the limitations on redemption necessary where the refusal by the institution of the redemption of own funds instruments is prohibited under applicable national law.

EBA shall submit those draft regulatory technical standards to the Commission by 1 January 2013.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with the procedure laid down in Articles 10 to 14 of Regulation (EU) No 1093/2010.

Article 28

Consequences of the conditions for Common Equity Tier 1 instruments ceasing to be met

The following shall apply where, in the case of a Common Equity Tier 1 instrument, the conditions laid down in Article 26, and Article 27 where applicable, cease to be met:

(a) that instrument shall cease to qualify as a Common Equity Tier 1 instrument;

(b) the share premium accounts that relate to that instrument shall cease to qualify as Common Equity Tier 1 items.

Article 28a

Capital instruments used by public authorities in crisis situations

In crisis situations and if deemed necessary for the stability of financial markets Member States may decide to inject capital into individual or a group of credit institutions. Under the particular economic and political conditions of a crisis situation, it may be appropriate for the capital instruments used for this kind of operation only to fulfil most or substantially all of the criteria set out in Articles 26 and 27, including at least Article 26, points (a) to (e) and that the instruments are able to absorb losses in a suitable way. This shall apply where the instruments are issued between 20 July 2011 and 31 July 2016 and the capital injection complies with the state aid rules.

Upon reasoned request by and in cooperation with the relevant competent authority, EBA shall consider these capital instruments equivalent to Common Equity Tier 1 instruments for the purpose of this Regulation.