



January 26, 2012

## WOCCU Summary and Request for Comment

### **Basel Committee “Definition of Capital Disclosure Requirements” Consultative Document**

The Basel Committee on Banking Supervision has released for public comment a new consultative document that will, when finalized, set forth the international standards for disclosures of financial institution regulatory capital components. The purpose of this new disclosure is to standardize the presentation of a financial institution’s capital position in order to “enable market participants to compare the capital adequacy of banks across jurisdictions . . .” using a standardized template that, if finalized as proposed, will break down a financial institution’s capital components into 82 individual line items. This is largely based on the template currently used to collect the [Basel III](#) capital and liquidity accords’ [implementation monitoring data](#).

Although the consultative document “is limited to the disclosure of capital and the capital ratios of banks,” credit unions are often subject to the same or similar prudential supervision requirements that banks are. It is likely that credit union supervisors in at least some jurisdictions will make credit unions subject to regulatory capital disclosures modeled on the proposed template and/or that credit unions’ bank counterparties will require capital disclosures based on the proposed template as a condition of doing business. For credit unions, the primary concern regarding such disclosures will be their treatment of credit union shares and other components of credit union regulatory capital allowed in some systems, such as subordinated debt.

The Basel Committee will be accepting comments on the consultative document until February 17, 2012. **Please provide any comments that you may have on this proposal to WOCCU Chief Counsel and VP for Advocacy & Government Affairs Michael Edwards ([medwards@woccu.org](mailto:medwards@woccu.org); fax: +1-202-638-3410) by February 10<sup>th</sup>.** If commenting directly to the Basel Committee, you can do so by email to: [baselcommittee@bis.org](mailto:baselcommittee@bis.org). Alternatively, comments may be sent by post to the Secretariat of the Basel Committee on Banking Supervision, Bank for International Settlements, CH-4002 Basel, Switzerland. You can access a copy of the Definition of Capital Disclosure Requirements consultative document [here](#) (the proposed template is in Annex 1 of the document, beginning on page 16 of the PDF, which is page number 10).

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#### **Detailed Summary**

The Basel III capital accord—[Basel III: A global regulatory framework for more resilient banks and banking systems](#)—recognizes that some forms of cooperative financial institution shares can be classified as “common shares” (which are a component of “Tier 1” capital—sometimes called “core” capital—as are retained earnings). Capital instruments that do not



meet the 11 requirements of “common shares” are treated as “Additional Tier 1 capital” or “Tier 2 capital,” which are further discussed below. Cooperative shares can qualify as “common shares” for regulatory capital purposes if:<sup>1</sup>

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).
3. The principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases 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 distributable items (retained earnings included). 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 distributable items).
6. There are no circumstances under which the distributions are obligatory. Non payment 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 (presumably after retained earnings and stock surplus, etc., are depleted). Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu*<sup>2</sup> 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.

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<sup>1</sup> Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, at 14 & n.12 (July 2011), available at <http://www.bis.org/publ/bcbs189.pdf>.

<sup>2</sup> *Pari passu* means: “Proportionally; at an equal pace; without preference.” *Black’s Law Dictionary* 1138 (7<sup>th</sup> ed. 1999).



In addition to “common shares,” Basel III also recognizes two additional classes of capital that meet less stringent requirements than “common shares.” These two additional classes of capital are: (1) “Additional Tier 1 capital;” and (2) “Tier 2 capital.” Section 1 of this summary, below, provides further details and references regarding Additional Tier 1 capital and Tier 2 capital. Under Basel III, institutions will generally 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 capital ratio requirements:<sup>3</sup>

- 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.

### **Section 1: Post 1 January 2018 Disclosure Template**

Beginning 1 January 2013 certain capital components are subject to phased-in deductions under Basel III, and these phased-in deductions should result in complete deductions of these instruments by 1 January 2018<sup>4</sup> (although the disclosure template contemplates disclosures related to these instruments until 2022). Examples of capital instruments to be phased-out are “innovative hybrid capital instruments with an incentive to redeem through features such as step-up clauses” and certain short-term subordinated debt that was considered “Tier 3” capital under Basel II (the concept of Tier 3 capital is eliminated in Basel III).<sup>5</sup> The proposed template is designed to capture the capital positions of financial institutions as though these phase-in deductions were already complete.

Although the Basel Committee created these phased-in deductions to address problems experienced during the last financial crisis involving relatively exotic capital instrument issued by some banks, it is possible that credit unions in some systems will be affected by these capital deductions. Such capital deduction phase-ins are likely to affect credit unions if the appropriate supervisory authority determines that shares or other credit union capital instruments that are currently included in regulatory capital are no longer permissible under Basel III.

As noted above, the common template is included in Annex 1 of the consultative document (see pages 16-21 of the [PDF version of the document](#), which are the pages numbered 10- 15, to view all 82 line items and a detailed explanation of each row). The general categories that the common template’s 82 line items fall into are:

- Common Equity Tier 1 capital: instruments and reserves (such as retained earnings and common shares);
- Common Equity Tier 1 capital: regulatory adjustments;

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<sup>3</sup> Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, at 12, 61 (July 2011), available at <http://www.bis.org/publ/bcbs189.pdf>.

<sup>4</sup> *Id.* at 2, 27-29.

<sup>5</sup> *See id.*



- Additional Tier 1 capital: instruments (i.e. capital instruments that are considered Tier 1 capital under Basel III but not “common equity,” such as shares or stock surplus that do not meet all of the 11 requirements listed above on page 2 of this document for “common shares,” but that meet a less stringent 14-point test included in Basel III);<sup>6</sup>
- Additional Tier 1 capital: regulatory adjustments;
- Tier 2 capital: instruments and provisions (e.g., subordinated debt and similar capital instruments, undisclosed reserves, etc.);<sup>7</sup>
- Tier 2 capital: regulatory adjustments;
- Capital ratios and buffers;
- National minima (if different from Basel III);
- Amounts below the threshold for deduction;
- Applicable caps on the inclusion of provisions in Tier 2; and
- Capital instruments subject to phase-out arrangements (only applicable between 1 January 2018 and 1 January 2022).

## Section 2: Reconciliation Requirements

Basel III also requires financial institutions to disclose “a full recognition of all regulatory capital requirements back to the balance sheet in the audited financial statement.”<sup>8</sup>

According to the consultative document, the purpose of this requirement is “to address the problem that at present there is a disconnect in many banks’ disclosure between the numbers used for the calculation of regulatory capital and the numbers used in the published financial statements.” This is because the balance sheet consolidation requirement (i.e. consolidation with the institution’s subsidiaries) for regulatory capital purposes is often not the same as the applicable accounting regime’s balance sheet consolidation requirements.

The consultative document proposes achieving this “full recognition of all regulatory capital requirements back to the balance sheet” using a three step process, as follows:

1. Step 1: Disclose the reported balance sheet under the regulatory scope of consolidation. Step 1 is required only when the scope of consolidation with subsidiaries is different for regulatory capital purposes than under the applicable accounting regime.
2. Step 2: Expand the lines of the regulatory-scope balance sheet to display all of the components that are used in the definition of the capital disclosure template.
3. Step 3: Map each of the components that are disclosed in Step 2.

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<sup>6</sup> See *id.* at 15-17.

<sup>7</sup> See *id.* at 17-19.

<sup>8</sup> *Id.* at 27.



Annex 2 of the consultative document includes a detailed illustration of this three step reconciliation process (see pages 22-24 of the [PDF version of the consultative document](#), i.e. page numbers 16-18).

### Section 3: Main Features Template

The purposes of the proposed “main features template” is to “disclose the main features of capital instruments in a consistent and comparable way . . . .” This template, if adopted as proposed, would represent the minimum level of capital instrument features that a financial institution must disclose regarding each type of capital instrument issued. Bank and credit union supervisory authorities would be encouraged to add additional disclosure criteria to this minimum list. The minimum requirements are detailed in Annex 3 of the consultative document (see pages 25-27 of the [PDF version of the document](#), i.e. page numbers 19-21). Although all of the required components are too lengthy to be listed here, the general categories of features to be disclosed are:

- Name of the issuer;
- A unique identifier (such as a Committee on Uniform Security Identification Procedures (CUSIP) identifying number);
- Regulatory treatment of the capital instrument;
- Amount recognized in regulatory capital;
- Par value of instrument;
- Accounting classification;
- Original date of issuance;
- Perpetual or dated;
- Issuer call subject to prior supervisory approval;
- Coupons<sup>9</sup>/dividends;
- Convertible or non-convertible;
- Write-down feature;
- Position in subordination hierarchy in liquidation; and
- Non-compliant transitioned features (if yes, specify the non-compliant features).

Although not included in the minimum disclosure template, additional criteria that the Basel Committee suggests supervisory authorities contemplate adding to the template include:

- Whether the issuer is a cooperative, a mutual, a bank, a bank holding company, a special purpose vehicle, etc.;
- The governing laws of the instrument (e.g., the applicable credit union act and/or securities laws);
- Coupon features (e.g., whether a fixed or floating coupon, the coupon rate, etc.);
- Events of default;

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<sup>9</sup> “Coupon” means the “interest rate on a debt security the issuer promises to pay to the holder until maturity, expressed as an annual percentage of face value.” John Downes & Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms*, at 149 (7<sup>th</sup> ed. 2006).



- Covenants;
- Guarantees or enhancements (to assess subordination);
- Voting rights; and/or
- Whether the instrument was issued to a parent or affiliate of the issuer.

#### **Section 4: Other Disclosure Requirements**

Under Basel III, financial institutions must disclose how any “non-regulatory ratio” (e.g., “tangible common equity”) it makes public is calculated, and must also place the full terms and conditions of all instruments included in regulatory capital on its website.<sup>10</sup>

Related to these Basel III requirements, the consultative document proposes to:

1. Prohibit financial institutions from using the terms “Common Equity Tier 1,” “Additional Tier 1,” “Tier 1,” “Tier 2,” and “Total Capital” if these ratios are not calculated in accordance with Basel III’s requirements; and
2. Require all financial institutions subject to Basel III to maintain a section of their websites entitled “Regulatory Disclosures” where all information related to regulatory capital disclosures is made available to market participants (ideally also including the institution’s published financial reports).

#### **Section 5: Template During the Transitional Period**

During the 1 January 2013 to 1 January 2018 Basel III transitional period, financial institutions must “disclose the specific components of capital, including capital instruments and regulatory adjustments that are benefitting from the transitional provisions.”<sup>11</sup> The consultative document describes this requirement as follows:

The transitional arrangements for Basel III phase in the regulatory adjustments between 1 January 2014 and 1 January 2018. They require 20% of the adjustments to be made according to Basel III in 2014, with the residual subject to existing national treatment. In 2015 this increases to 40%, and so on, until the full amount of the Basel III adjustments are applied from 1 January 2018.

The consultative document proposes to ensure consistent and comparable disclosures of these requirements by modifying the disclosure template discussed in Section 1, above, “in a way that captures existing national treatments for the regulatory adjustments.” As proposed, the disclosure template would be modified in two ways:

1. Adding an additional column that indicates the amounts of the regulatory adjustments that will be subject to the applicable national treatment; and
2. Each “jurisdiction would insert additional rows in four separate places to indicate where the adjustment amounts reported in the added column actually affect capital during the transition period.”

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<sup>10</sup> See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, at 27 (July 2011), available at <http://www.bis.org/publ/bcbs189.pdf> .

<sup>11</sup> *Id.*



Annex 4 of the consultative document sets forth the modifications to the template and provides examples of how this would work in practice (see pages 28-31 of the [PDF version of the document](#), i.e. page numbers 22-25). As proposed, this template would be required as soon as Basel III comes into effect on 1 January 2013 and would be required to be disclosed with the same frequency as the institution's public financial statements (i.e. usually quarterly or semi-annually).

### **Questions**

1. Assuming that Basel III will apply to your credit union system, what specific comments or concerns do you have regarding the proposed disclosure templates included in the consultative document?

2. Do you believe that any of the proposed disclosure requirements could result in a misleading picture of your credit unions' capital positions? Why or why not?

The Basel Committee also has included specific requests for comment in the consultative document. These are as follows:

3. "Market participants . . . are asked to provide feedback on whether the use of templates across jurisdictions, with consistency in format and information disclosed, is necessary to achieve an appropriate level of comparability in disclosure, or whether the focus should be only on the consistency of the information disclosed, with the formats varying between jurisdictions."

4. "In addition to Step 1 [of the reconciliation requirements outlined in Section 2, above], the Basel Committee is considering requiring banking groups to disclose the list the [sic] legal entities that are included within the accounting scope of consolidation but excluded from the regulatory scope of consolidation . . . . Similarly, banking groups could be required to list the legal entities included in the regulatory consolidation. Banks responding to this consultative document are asked to give an indication of how extensive such a requirement would be in practice, eg [sic] through indicating the number of legal entities that would be required to be identified through these disclosure requirements."

5. "Market participants responding to this consultative document, in particular the users of information on regulatory capital reported by banks, are asked to consider whether the current list of items included in the main features template represents the most useful set of minimum summary disclosures on the key feature of capital instruments that banks could be required to make. They are also asked to provide feedback on whether, and if so how, they would use the information provided."

6. "The main features template is designed to be completed for every capital instrument the bank has issued. The Basel Committee would also welcome feedback on whether this should also include the common shares issued by the bank. For example, this may help provide useful information in cases where the issuing banks has more than one class of common share."