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Cooperative banks shares as Core Tier One Capital: Basel III impacts on the cooperative banking model

1. Background

The Basel Committee activity impact: a growing influence


The Basel Committee is an institution, created by central banks governors, with the intention **of enhancing the understanding of key supervisory issues and improving the quality of banking supervision worldwide.** The Committee uses this common understanding to develop **guidelines and supervisory standards** in areas where they are considered desirable.

The Basel Committee influence has grown significantly over the years increasingly acting as an international regulator in the banking sector. Therefore, **Basel Committee activities have to be under close scrutiny of cooperative banks** since they have direct impacts on their business.

One of the Basel Committee activity that more prickly concerns ICBA members is its regulatory work that defines the **banking prudential regulation**, notably the **banks solvability and liquidity.**

2. Basel III: strengthening the banking sector resilience

The financial crisis reveals **the excessive on- and off -balance sheet leverage.** The use and **abuse of innovative and highly complex financial instruments** to elude accounting and prudential standards came to light with the successive bankruptcy of prestigious investment banks. The **gradual erosion of the level and the quality of the bank capital base** combined with **insufficient liquidity buffers** lead the crisis to take the importance we know, compelling the public sector to step in with unprecedented injections of liquidity, capitals support and guarantees.

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To address the lessons of the crisis and the failures it revealed a reform of the financial sector has been endorsed by the Financial Stability Board¹, the G20 leaders at their Pittsburgh meeting and by the Basel Committee to **strengthen global capital and liquidity regulations with the goal of creating a more resilient banking sector.**

On December 2009 the Basel Committee published a consultative paper on a series of proposals aiming at “strengthening the resilience of the banking sector”². The Basel III reforms aims at two main objectives:

✚ *Enhancing the **banks solvability:***

- Raising the quality, the consistency and the transparency of the capital base by defining 14 criteria for the **Core Tier One Capital**. The restriction of the “core capital”- capital to be considered to be in better position to absorb losses- definition aims at ensuring that banks possess stable and “safe” capital.
- Increasing of the **capital requirement for counterparty credit risk exposures.**
- Modifying the existing **leverage ratio** in Basel II and move it to Pillar 1. The **leverage ratio is the ratio of debts to total assets of a bank**, today fixed at 2%, The Basel Committee reform would increase it and make it a part of the minimum capital requirement element (by migrating in into Pillar 1).
- Building up of **capital buffers** in good time that can be used in period of stress. A countercyclical framework would contribute to a more stable banking system to make it able to dampen, and not amplify, the economic and financial shocks.

b. Strengthening the banks liquidity

The second set of measures concern the **bank liquidity.**

- The Committee introduced a **30 days liquidity coverage ratio** requirement that compel internationally active banks to possess a set of liquid assets to meet its short term obligation in the case of a 30 days period of stress.

¹ <http://www.financialstabilityboard.org/>

² <http://www.bis.org/publ/bcbs164.pdf>

- The Committee introduced a “**net stable funding ratio**”, which aims at ensuring a minimum amount of funding that is expected to be stable over a one year time horizon, based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures.

3. The impact on cooperative banks: member shares in the Core Tier One Capital

Cooperatives member shares specificities

As define by the 14 criteria³, cooperative member shares, which constitute the main part of cooperative banks capital, could be excluded from Core Tier One Capital if the national laws transposing of this regulatory framework doesn't take into account the cooperative shares specificities.

In Europe, the Committee of European Banking Supervisors took into account in their implementation guidelines of the core capital renewed definition⁴ the cooperative member shares specificities thus allowing them to be classified as Tier 1 Capital.

National regulators thus need to be fully aware of the cooperative shares specificities to implement in a satisfactory ways for cooperative banks the Basel banking regulatory framework.

The cooperative banking model specificities:

Cooperative member shares are specific, they are not hold by profit-oriented stockholders but by its members, that are both its owners and customers.

First, cooperative business model relies on specific values, according to the ICA⁵, the seven international cooperative principles are:

Voluntary and open membership

³ See annex

⁴ http://www.c-eps.org/documents/Publications/Standards---Guidelines/2010/Guidelines_article57a/Guidelines_article57a.aspx

⁵ <http://www.ica.coop/coop/principles.html>

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*Democratic member control
Member economic participation
Autonomy and independence
Education, training and information
Co-operation among Co-operatives
Concern for Community*

It should therefore be kept in mind that a cooperative bank has **a different business model** that is based on a different logic than the “joint stock company”. A different business model but also a **full fledge actor of the financial system, representing, only in Europe, 4.2 billions in total assets and 123 millions clients⁶.**

The cooperative banking model is a total model, which means that we must not underestimate the risk that a seemingly specific reform could actually denature the foundation of the overall system.

Cooperative shares specificities rely on the cooperative funding principles:

A customer owned...

Cooperative banks are **customer-owned businesses**: they belong to their customers that use their services. Cooperatives were historically created by customers and for them in a spirit of cooperation. As such, customers-owners hold shares not for speculation purposes but rather in order to invest in a real ownership instrument tinted with participation in a common economic endeavor.

...and customer driven entity

One of the purposes of cooperative banks is to encourage capital ownership amongst a large number of shareholders with the objective to include them in the decision process, notably during general meetings where the democratic principle of one person one vote rules: a totally different operating method from the other banks.

Three major member shares specificities, shared by many cooperative banks, need to be pinpointed here to understand the issue raised by Basel III definition of Core Tier One Capital:

⁶ According to the Association of European Cooperative Banks/ <http://www.eurocoopbanks.coop/>

1. Cooperative member shares are redeemable:

Hold by the cooperative shareholders (the members), cooperative shares are the main component of the cooperative capital. A capital which, by essence, evolves along with the actual number of members. **Accordingly to the free membership cooperative principle, members are free to join and leave the cooperative (under certain conditions to be developed below) and member shares are thus redeemable by the entity.** Cooperative banks are non joint market company, thus member shares cannot be traded on an organized market, and therefore the departure of a member isn't directly replaced by another member.

This principle is completed in the cooperative statutes, of many cooperatives, which states that cooperatives have an unconditional right to refuse the redemption of member shares in compliance with IAS 32 accounting standard.

2. Member shares are redeemable at their nominal value:

Cooperative banks, in many countries, redeem their shares at an amount that does not exceed the par value, that is to say the purchase value.

3. Access to net assets:

As the cooperative must operate, independently of the arrival or departures of members (cooperative shareholders), members usually don't have a right to the reserves, which therefore remain within the cooperative bank in order to cover its commitment. **This establishment of unavailable reserves, which aim is quite similar to the Basel Committee idea of a capital buffer, aims at creating an amount of capital available to develop the cooperative bank common business purpose.**

The **cooperative banking model has shown its resilience, and the relevance of these specificities, during the financial and economic crisis.** The International Organization of Labor⁷ notably published a report exposing that cooperative more risk-averse policy, cooperative non speculative capital and their customer centered business were the keys of the cooperative banks ability to resist the financial crisis and to limit the consequences of the economic one that followed, particularly in Europe where the

⁷ http://www.ilo.org/wcmsp5/groups/public/---ed_emp/---emp_ent/documents/publication/wcms_108416.pdf

cooperative financial institutions maintain, to a large extent, their lending activities towards companies. These distinctive cooperative characteristics have therefore to be expose, explain and promote to protect our model.

Cooperative member shares as Core Tier One Capital

For most cooperative banks, three criteria raise problem for their classification as Tier 1 capital.

The Core Tier One capital definition **criterion 2** states that “in case of liquidation, securities representing the capital must provide **a right to the net assets** in proportion with the capital that they represent” (= right to the liquidation surplus)

This criterion doesn't not always apply to cooperative banks since, as explained above, their reserves are not always available to members, neither during period of normal operation nor in case of liquidation.

This cooperative specificity, far from justifying the exclusion of member shares from core capital, enhances the cooperative bank financial solidity since no shareholders have an individual claim to its reserves. In view of the “permanency criterion” that defines core capital essence and bank stability, cooperative capital is stable.

Criterion 3 states that the “perpetual nature of securities issued in order to represent the capital: **absence of mechanisms for the repayment, redemption** or amortisation of **equity securities**”

This criterion goes along with **criterion 4** which specifies that “at the time of the issue, absence of an indication of the holders of any possibility for them to subsequently request **the redemption or repayment of their shares**”

As mentioned above, the cooperative shares, due to the free membership principle and their non-joint nature, are redeemable by the cooperative bank. Thus capital variability is linked to the deep nature of the cooperative banking model. Nevertheless **a set of measures exist in different national laws that limit the cooperative banks**

capital variability to ensure the permanence of the capital and the bank solvency.

For example, the shares are not immediately redeemable, the request has to be presented and validated by the general assembly.

Following the adoption of IAS 32 accounting standard⁸ many cooperative banks changed their status to include possibility for an unconditional right to refuse of the redemption of shares or/and for introducing a level below which capital must not fall due to redemption.

Criterion 5 specifies that “compensation of the securities drawn on the distributable items (earning or reserves) with no link with the redemption value or issue price of these securities and **not subject to a ceiling**”

In line with the spirit of cooperation for economical and not financial interest of the adhesion to cooperative capital, in many national cooperative laws, the remuneration of cooperative shares is limited to a certain amount or percentage.

Moreover, there is a paradox here by forbidding the existence of a remuneration cap, thereby encouraging the distribution of profits to the detriment of retained earnings, while nonetheless defending the establishment of buffers. The cooperative limited remuneration of member shares is rather an **example of good practice for ensuring the consistency, quality and stability of capital** own funds than a reason for excluding cooperative shares for Core Tier One.

4. What's next?

The Basel Committee September 12th 2010 press release⁹ announced that the group of governors and head of supervision, the oversight body of the Basel Committee on Banking Supervision, decided a substantial strengthening of existing capital requirement and published the Basel III reform implementation calendar.

National implementation by member countries will begin on 1 January 2013. Member countries must translate the rules into national laws and regulation before this date.

⁸ See ICBA paper on International Accounting Standards for Cooperative Banks

⁹ <http://www.bis.org/press/p100912.htm>

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The topic is thus at the top of cooperative banks agenda, all the more so since **capital instruments that do not meet the criteria for inclusion in common equity 1**, will be excluded from common equity Tier 1 as of 1 January 2013.

Cooperative banks have a 10 years delay for their member shares to be excluded for tier 1 if their member shares meet the three conditions that the Basel Committee set: the instrument are "1. issued by a non joint stock company, 2. they are treated as equity under the prevailing accounting standards and 3. they receive unlimited recognition as part of Tier 1 capital under national banking law".

Nevertheless, these transition arrangements can only be applied to financial instruments **issued before 12 September 2010**, thus all cooperative banks member shares that are issued after the 12 September 2010 will be excluded for common equity Tier 1 on January 1st 2013.

To summarize three possible situations:

- 1.** The national laws implementing Basel III reforms recognize cooperative banks member shares as Tier 1 capital
- 2.** If the national laws don't recognize cooperative member shares as Tier 1 capital:
 - if the shares have been issued before September 12th 2010 and meet the three above mentioned conditions, they will be excluded from common equity Tier 1 on January 1st 2023
 - if the shares have been issued after September 12th 2010, they will be excluded from common equity Tier 1 on January 1st 2013

Understanding the cooperative banks interest in this process is central here. Cooperative banks business model relevance has been proven and recognized during the financial and economic crisis. If ignored, the cooperative specificities that are the funding element of their resilience can be threatened by the ongoing reform.

Poorly informed on the different functioning but also on the economic importance of cooperative banks, national regulators must be fully aware of the necessity to adapt the Basel reform to cooperative structures and ICBA members must be mobilized on this issue.

Annex: *Basel Committee definition of Tier 1*

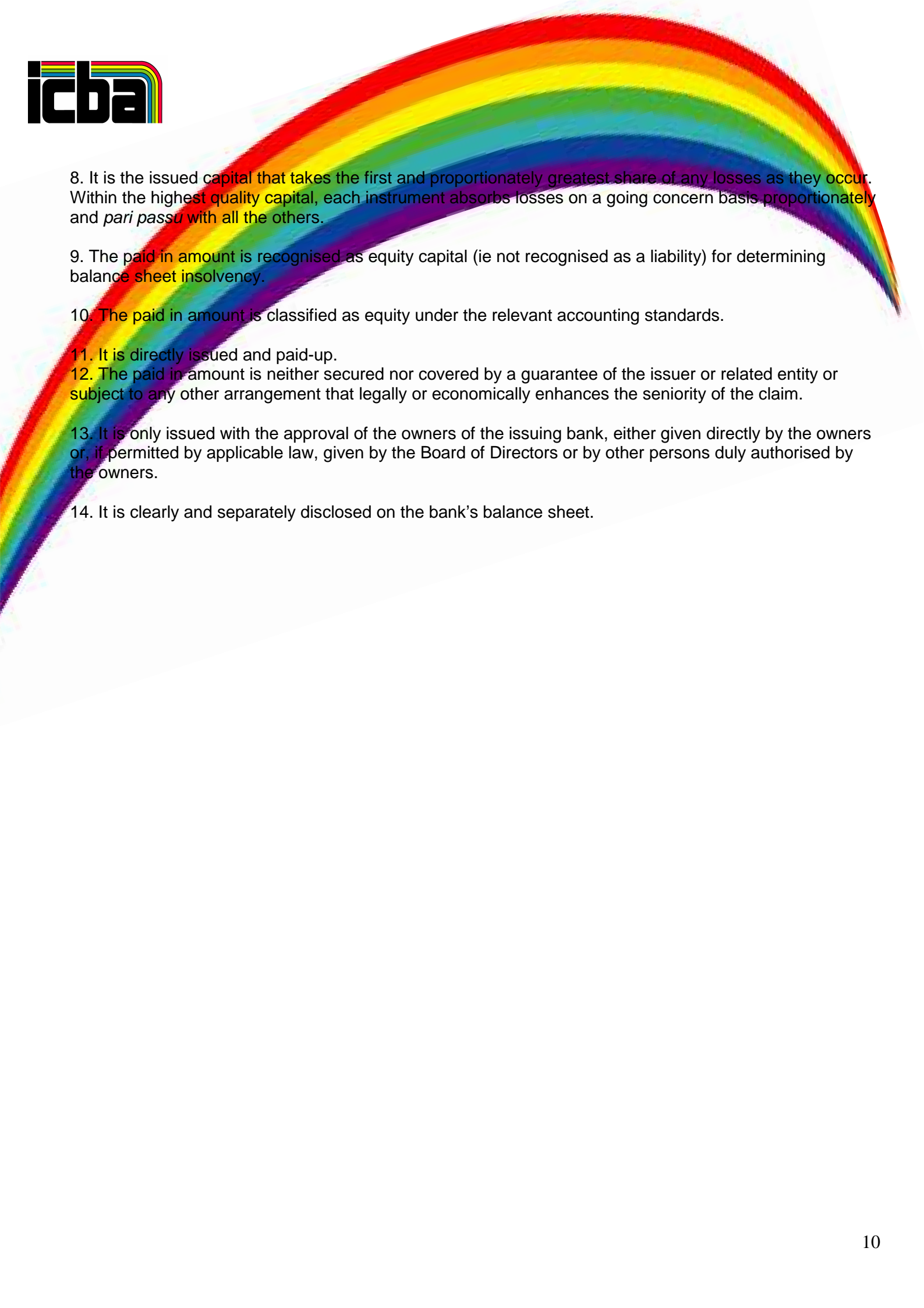
(e) *Criteria governing inclusion in the Common Equity component of Tier 1*

87. For an instrument to be included in the predominant form of Tier 1 capital it must meet all of the criteria which follow. The vast majority of internationally active banks are structured as joint stock companies¹⁸ and for these banks the criteria must be met solely with common shares. In the rare cases where banks need to issue non-voting common shares as part of the predominant form of Tier 1, they must be identical to voting common shares of the issuing bank in all respects except the absence of voting rights.

Criteria for classification as common shares for regulatory capital purposes¹⁹

1. Represents the most subordinated claim in liquidation of the bank.¹⁰
2. Entitled to a claim of the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (ie has an unlimited and variable claim, not a fixed or capped claim).
3. 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 national law).
4. The bank 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 are not in any way tied or linked to the amount paid in at issuance and are not subject to a cap (except to the extent that a bank 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 obligation 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.

¹⁰ Throughout the criteria the term “bank” is used to mean bank, banking group or other entity (eg holding company) whose capital is being measured

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8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur. Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and *pari passu* with all the others.
 9. The paid in amount is recognised as equity capital (ie not recognised as a liability) for determining balance sheet insolvency.
 10. The paid in amount is classified as equity under the relevant accounting standards.
 11. It is directly issued and paid-up.
 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.
 13. It is only issued with the approval of the owners of the issuing bank, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.
 14. It is clearly and separately disclosed on the bank's balance sheet.

International Cooperative Banking Association:

The International Co-operative Banking Association (ICBA) is a sectoral organization of the International Co-operative Alliance (ICA). Founded in 1895, the International Co-operative Alliance is an independent, non-governmental organization which unites, represents and serves co-operatives worldwide.

*The ICBA mission is to **contribute to the sound development, growth and competitiveness of co-operative banks in the marketplace by defending their interests and by promoting worldwide their important contribution to the economic and social well-being of the population and their communities.***

Objectives of ICBA :

- *to facilitate the promotion at the international and regional levels of the distinctive co-operative values of co-operative banks and of the advantages of using them over other banks*
- *to facilitate and encourage the exchange of information amongst members on key co-operative banking issues and foster inter-cooperation in the finding of solutions*
- *to support regional committees and their members, individually or collectively with specific challenges*
- *to encourage inter-cooperation with other types of co-operatives and various bodies of the ICA*