EACB Comments

IASB Discussion Paper

Financial Instruments with Characteristics of Equity (DP/2018/1)

Brussels, 19th December 2018

Contact:

For further information or questions on this paper, please contact:

- Mr. Volker Heegemann, Head of Department (v.heegemann@eacb.coop)

- Mr. Marco Mancino, Deputy head of Department, Banking Regulation (m.mancino@eacb.coop)

General comments

The European Association of Cooperative Banks (EACB) gladly takes the opportunity to comment on the Discussion Paper Financial Instruments with Characteristics of Equity ('FICE'), issued by the IASB on 28th June 2018 (the DP).

The EACB welcomes the IASB's efforts to address the current application issues and other challenges related to IAS 32 Financial Instruments: Presentation.

In relation to the DP, the EACB welcomes in particular that the IASB's preferred approach:

- retains the use of a binary split between liabilities and claims on equity;
- defines equity as 'the residual interest in the assets of the entity after deducting all of its liabilities';
- makes a shift to analyse the classification of financial liabilities and equity instruments from the perspective of the issuer.

On the other hand, EACB notes that the approach in the DP introduces completely new terminology. Such new terminology would require preparers and auditors to reconsider a wide range of past classification decisions. Accordingly, this approach, while addressing various interpretative issues, will also cause some disruption, create additional costs for preparers and bears risks for the emergence of new issues and uncertainties. In our view a careful weighing of the potential benefits of a better articulation of the principles in IAS 32 against the potential risks of unnecessary disruption and unintended consequences is essential.

The members of the EACB have doubts regarding the advantages of a move to a new approach. To address the need for information on hybrid financial instruments, we believe that it would be appropriate to supplement the existing requirements of IAS 32, for example to provide information on ranking, dependency on the payment of business factors or write-down (bail-in instruments). However, an extension of the identification and presentation rules should be done with extreme care. Finally, it should be underlined that IFRIC 2 does not cover the second new criteria of the preferred approach.

The preferred approach

Unavoidable Obligation

Under 2.1 the discussion paper states:

The Board's preferred approach would classify a claim as a liability if it contains:

(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or
(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

While the DP then elaborates on the "timing feature" and the "amount feature", there is no further reference to when an obligation is "avoidable" and which role the element of "unavoidability" plays in the overall context of the approach.

The Amount Feature

Moreover, we see that the IASB's preferred approach would require total equity, and changes in equity, to be disaggregated between ordinary shares and equity instruments other than ordinary shares.

The DP states that an ordinary share is the class of equity that is the most subordinate claim and requires the entity to transfer economic resources only at liquidation; the amount of economic resources to be transferred at liquidation is equal to a pro-rata share of the entity's net assets on liquidation that remain after all higher priority claims have been satisfied.

The members of the EACB believe that if the IASB is to differentiate equity instruments, then it would be useful to have additional guidance on how the IASB's preferred approach would fit in cooperatives' instruments and how it would be made sure that the current classification is not questioned. The capital structure of cooperatives is one of their major distinctive features when compared to standard commercial-type entities. Because of this unique structure, the definitions of elements of liability and equity remain a major concern.

When applying the IASB's preferred approach to members' shares in co-operative entities the 'timing' feature does not seem to be an issue (due to the clarifications of IFRIC 2). However, further clarification regarding the 'amount' feature, due to a specific feature of most cooperative member shares (see also Annex) would be urgently required:

- In fact, cooperative shares are normally issued at face value and reimbursed at face value. The members have access to retained earnings only via dividends distributed during going concern. Only if losses go beyond retained earnings, a value lower than the face value would be redeemed. While that case is not the rule, it nevertheless happens from time to time that cooperatives come to this point. Thus, while in most going concern cases the amount of the claim would not change (face value), it is nevertheless excluded that the amount of the claim could exceed the resources of the entity (para. 3.18) under any possible scenario. Since the redemption amount depends only partially on available economic resources, this seems a problematic aspect introduced in the DP.
- Moreover, cooperative laws and company charters do not stipulate always that net assets are distributed pro rata in case of liquidation. While cooperative shares seem to not perfectly match the features of ordinary shares that are illustrated in para. 2.9 of the DP, the fact that cooperative shares/certificates are the most subordinated claim in a cooperative capital structure is unquestionable and so should be their classification as equity.

  In conclusion, when applying the IASB's preferred approach to members' shares in cooperative entities, the "amount" feature challenges fundamentally the existing classification outcome of IAS 32 as the current guidance illustrated in the DP does not take into account the very specific elements of cooperative shares. We believe that this is not in line with the board stated intention and expectation not fundamentally change the classification outcome of IAS 32.

The very specific features of cooperative shares should be taken into account by the IASB, and appropriately reflected so that the general definition of the "amount feature" is compatible with such instruments.
In order to avoid any misunderstandings, we would urge the IASB to reflect and elaborate these aspects of "Further guidance on an amount independent of the entity's available economic resources" already in the wording of the preferred approach or ensure that the substance of the guidance is adequately taken up eventually in a future standard. Ideally the example of a cooperative share could also be added under 3.24 (or a corresponding number).

It should also be said that the relevance of the amount feature to define a liability is generally questionable. Focusing on remote event and cash flows upon liquidation is not the best criterion to define a liability under going concern assumption. We rather consider that the loss absorption capacity, combined with the right to avoid/refuse payment at any time (except liquidation), are much more relevant.

Moreover, we would like to recall that not all cooperative laws and company charters stipulate that net assets are distributed pro rata in case of liquidation. The distribution may also be done per capita or the residual after redemption of shares may be mandated to a third (charitable/public) entity. We believe it is not an essential element for equity instruments whether in liquidation assets are distributed pro rata or per capita or whether any amount remaining is distributed in another way. We therefore urge to clarify that this practice is not harmful under the preferred approach.

IFRIC 2 Members' Shares in Co-operative Entities and Similar Instruments

The DP states that the IASB does not intend to reconsider the requirements in IFRIC 2 given that IFRIC 2 was developed for a very specific fact pattern with limited effect in practice and that it is not aware of any challenges to its application.

The members of the EACB highly appreciate that the IASB shall not reconsider the guidance in IFRIC 2. However, this is only under the condition that no other elements are introduced, be it in IFRIC 2 or the underlying equity definition as referred to in our above statements. In particular, no elements from the puttable instruments exception should be inserted.

As mentioned above, we believe that IFRIC 2 provides some guidance regarding the "avoidability" of an obligation and should accordingly be referenced.

We fully agree that IFRIC 2 was developed for a specific fact pattern and that we as well are not aware of any challenges to its application. However, we would like to remind that today the recognition of members' shares in cooperatives as equity under IFRS Standards is governed by IAS 32 and the related Interpretation IFRIC 2 issued in 2004. Since 2004 IFRIC 2 has become the blueprint for the design for members' shares for the majority of cooperatives which have to prepare financial statements under IFRS Standards.

In fact, the Interpretation builds upon the very specific features of members' shares and determines the condition for their treatment as equity. While we are not able to count the global number of IFRS preparers in the cooperative sector, we would nevertheless like to remind that the 300 biggest cooperative groups stand for a turnover of 2.400 billion US-$ and therefore have doubts that IFRIC 2 has only limited effects

The approach of IFRIC 2 for the distinction between equity and liabilities is also the basis for the recognition of members' shares as of cooperatives banks as Common Equity in the European Union's Banking Supervisory Law (Regulation (EU) 575/2013 and Commission Delegated Regulation (EU) 241/2014). Moreover, the recognition of cooperative shares as accounting equity is the basis for their recognition as Tier 1 capital under the current Basel Accord[1]. A deletion of IFRIC 2 would therefore wipe out cooperative banks' core capital by the billions and would most probably trigger a financial crisis.

[1] Footnote 12, Basel III agreement December 2010: "*The criteria [for classification as common shares for regulatory capital purposes] 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.*"

Finally, we consider that the IASB should take the opportunity to integrate IFRIC 2 in a revised IAS 32.

Disclosure

With regard to the disclosure elements tentatively put forward, we see that the proposals would represent a significant extension of current disclosures on financial instruments. Moreover, financial institutions with a variety of debt instruments with different seniority and subordination levels and a range of and equity items already have to fulfil Pillar 3 disclosure requirements, making the proposals for including such information in the financial statements redundant.

In addition, any additional element should avoid the risk of diluting financial information and should be seen in light of its relevance and materiality.

ANNEX: Factual elements on cooperative shares

Brussels, 19th December 2018

Background

Cooperatives and other similar entities are formed by groups of persons to meet common economic or social needs. National laws typically define a cooperative as a society endeavoring to promote its members' economic advancement by way of a joint business operation (the principle of self-help).

Members' interests in a cooperative are often characterized as members' shares, units or the like, and are referred to below as 'members' shares'. Some cooperatives dispose of instruments which are made available to "outside" investors and not only to members. They shall therefore be referred to as "other shares/certificates"

These financial instruments, i.e. members' shares and other shares/certificates, have characteristics of equity, e.g. rights to participate in dividend distributions and voting rights (member shares).

Face Value

Member shares and other shares/certificates normally have a face value. Members/Investors acquire one or several of those instruments. In most cases member shares and other shares are issued when a member subscribes them. The price usually is the face value. Other shares/instruments, which are traded and acquired on a market, may be acquired at prices higher or lower than the face value.

Dividends

Members/Investors, who hold cooperative member shares or other shares/certificates participate in the economic life of the cooperative via the distribution of dividends. The amount of dividends fully depends of the economic success of the cooperative. There are no minimum payments. Dividend payments can be fully skipped, when there is not profit to be distributed.

It should be noted, however, that usually the biggest part of annual profits is transferred into retained earnings, in many cases with minimum percentages fixed by law. Thus, cooperative members participate in the economic development of the cooperative.

Redemption

Some of these instruments give the holder the right to request redemption for cash or another financial asset, but may include or be subject to limits on whether the financial instruments will be redeemed. In particular, all European cooperative banks as well as most cooperatives under IFRS today dispose of mechanism that correspond to the requirements of IFRIC 2, and have a right to refuse redemption. Certificates are not redeemable. The entity's available economic resources are thus preserved.

Indivisible Reserves during Going Concern and Loss Absorption

While a cooperative is going concern the retained earnings, i.e. the "reserves", are indivisible. The member/owner of the instruments does not have an entitlement to these retained earnings, however they do have a "limited" access during going concern by receiving dividends.

By consequence, in the case of a redemption of shares for cash, the member shares only receive the face value. In the case of losses, the retained earnings are reduced in the first place and not the subscribed capital.

Should however, losses result in a complete depletion of retained earnings, any consecutive losses would affect the subscribed capital as well and the shares would only be redeemed at an amount corresponding to the book value[2] given the available resources.

Indivisible Reserves in Liquidation

Member shares and other shares/certificates are the most subordinate claims in liquidation. Only after the fulfillment of all liabilities and obligations the member shares and other shares/certificates are paid back at face value.

Since unfortunately also cooperatives can fail, it may happen that the member shares and other shares/certificates are not fully paid back or that they are not paid back at all. All depends on the residual resources.

As regards the distribution of any residual remaining after the fulfillment of all liabilities and obligations and the repayment of member shares and/or other shares/certificates, jurisdictions envisage different approaches (*please note that this is intended to illustrate some existing factual elements, i.e. examples of some cases, to provide a wide angle overview on cooperative shares*):

- Such residual may be distributed among members according to the amount of shares they hold or according to the number of members (per capita);
- It may be transferred to the church or charitable institutions, or a cooperative fund;
- It could even be put on an interest-bearing bank account and administered by the national bank until the cooperative can be re-established.

[2] This case is rather hypothetical in the case of cooperative banks, where retained earnings normally form by far the biggest amount of regulatory capital. Supervisory measures or, in the worst case resolution measures, would intervene at an earlier stage.