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**E-MAIL**

**EFRAG Discussion Paper: "Classification of Claims"**

Dear Ms Flores,

The European Association of Co-operative Banks (EACB) appreciates EFRAG's initiative for a Discussion Paper (DP) on Classification of Claims. The Members of the EACB see this DP as a good basis for further reflections on the classification of equity and liability and gladly take the opportunity to comment on it.

Equity and liability distinction is an extremely important topic for all co-operatives in Europe and, in particular, for co-operative banks. As you know, the introduction in Europe of IAS 32 – *Financial Instruments: Disclosure and Presentation* (which was introduced by Regulation (EC) No 1126/2008 and amended by Regulation (EU) No 1256/2012) raised concerns about the treatment of co-operative shares. IFRIC Interpretation 2 – *Members' Shares in Cooperative Entities and Similar Instruments*, solved this problem by providing consensus on the classification of such instruments as equity, due to the imposition of restrictions regarding the redemption of member's shares. This modification required significant changes in local law, regulations and entities' governing charters. The Basel III regulatory framework and its European implementation –through the CRR- also modeled the treatment of co-operative shares as equity on the basis of IFRIC 2 (cf. Art. 27 CRR).

A lot of effort has been undertaken in order to achieve this "acquis", which provides for a fair treatment of cooperative shares. Therefore, it is our concern that any review of the conceptual framework and, in particular, its elements on equity and liability distinction will not lead to any change in this respect.

- ***Objectives of the classification requirements***

We believe that EFRAG has identified the right **objectives** to be pursued when assessing the classification of claims. However, we are not sure whether the ponderation of the objectives, as described in the DP, is appropriate.

Both liquidity and solvency give important information about the soundness and financial strengths of an entity. The DP seems to grant liquidity a greater or, at least, the same importance as solvency. We are concerned that this could lead discussions in a wrong direction. We are not sure if liquidity is more substantive for the classification of claims.


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We therefore do not consider it essential to focus the discussion on a ranking of those objectives.

Solvency shows the ability of the economic resources of the entity to meet its obligations. The relation between these economic resources and its obligations is also related to the current prudential provisions, which have a focus on the ability of own funds to absorb losses. In this light, the degree of solvency is also a sound indicator of the resilience and financial strength of the company and provides the useful information that readers need to make decisions.

The DP itself defines liquidity as the *"degree to which an entity has the economic resources required to meet its obligations as they fall due, or is able to meet them by selling its economic resources or issuing new claims without affecting the value of its economic resources or its claims"*. Thus, a first decisive aspect for liquidity is whether an entity has the (right) economic resources that it can sell or simply use (deposits or other balances) to meet its obligations as they fall due. Secondly, we believe that the categorization of liabilities along maturities plays a highly important role for liquidity. When it comes to the ability to meet obligations as they come due, long term liabilities and own funds do not make much of a difference. The "degree to which an entity is able to issue new claims" is equally a question of liquidity and solvency.

Thus, even if liquidity and solvency may be inextricably linked in the real world as indicated in the paper, we nevertheless think that they are not identical and, therefore, can be distinguished to some degree. We fear that, in the context of this fundamental discussion, the differences between liquidity and solvency should not be blurred from the outset. It might therefore be appropriate to reconsider the drafting of the relevant passages of the paper.

- ***The choices to be taken in developing an approach to the classification of claims***

We think that the **choices** identified in the DP are appropriate as a departing point for discussion. However, from a banking perspective, we believe that the current choices, reflected in IAS 32 are the right ones: a *binary split* where equity is calculated as the residual interest after deducting all liabilities. This classification provides for a realistic representation of a bank's activities and better reflects prudential aspects. Furthermore, most of the indicators on the current regulatory framework are built around an equity/liability distinction on the claims side of the balance sheet.

- ***Positive or negative definitions of elements***

We also appreciate the dissertation about the consequences of choosing which elements should be defined positively. We consider that the IAS 32 approach is the best, i.e. a **liability to be defined positively** as a present obligation of the entity to transfer an economic resource as a result of past events. We understand the challenges arising from such approach, especially when it comes to obligations that under some circumstances do not derive in a transfer of economic resources, but in an obligation to issue equity instruments. For the seek of clarity and faithful representation, we believe that the definition of liability should take a baseline scenario as reference where the principle of substance over forms prevails.

On the other hand, we are skeptical regarding a positive definition of equity: due to the enormous varieties of equity, a positive definition would have to be very complicated. This effect is amplified by the diversity of legislations in different jurisdictions. Moreover, due to the existing varieties, we doubt that it is possible to develop a definition that provides for strong and practical criteria for segregation. We would like to recall that even the latest attempt of the IASB for such a positive definition was a failure due to these reasons. A good example for possible difficulties would be the accounting treatment of retained earnings in co-operative banks, which are available for the cooperative as long as it exists and fulfils its activities, but would in some jurisdictions not be available for members in case of liquidation. A negative definition bearing in mind the most important characteristics of equity, i.e. lack of obligation to transfer economic resources, would therefore be the best option in terms of feasibility and simplicity. In this light, we support the IAS 32 approach that defines equity as the residual interest after deducting all liabilities.

In our opinion, the proprietary perspective presented in the DP as an approach to positively define equity has its merit. Even if we do not support a positive definition of equity, we believe that **ownership** could be better reflected by depicting the close relationship between company law (which is not internationally harmonized) and the legal forms derived from this on the one hand, and recognition in the balance sheet on the other hand. Generally speaking, limited-liability companies in Europe must have a minimum amount of equity at the time of their establishment (equity required under company law). This also applies to co-operatives. We are of the opinion that this kind of capital which represents owner rights and is liable in relation to all other creditors must in any case be recognized in the balance sheet as equity. Additionally, defining equity as "the most residual instrument" is not appropriate.

We hence believe that despite all perfectly correct definition considerations, the equity examination process must end with the control question: is the equity class which was contributed by the founding shareholders for liability purposes and to exercise ownership rights recorded as equity? If not, then the balance sheet would be perceived to be counter-intuitive by parties participating in economic activities. We are of the opinion that this kind of final control question is the only way to define an internationally accepted term for equity.

Having said this, the advantages of IFRIC 2 prove that it is a good approach to be taken into account when considering the equity-liability distinction and, more broadly, the accounting conceptual framework. As we stated in our response to the 2013 IASB DP "A Review of the Conceptual Framework for Financial Reporting", we believe that the underlying principle of IFRIC 2 should be included in the conceptual framework since it adequately introduces the notion of control of an entity over its capital .

- ***Contractually bail-inable instruments***

Regarding **bail-inable instruments**, we do not consider adequate its inclusion as a third additional element. We understand that the logic underpinning this initiative is that some liabilities may at some times not meet the definition, i.e. being an obligation to transfer economic resources, and that therefore they should be classified in a different category. However, we believe that such a view is not appropriate.

First of all, it has to be pointed out that bail-inable liabilities, along with some other instruments, are liabilities, have to be served as liabilities and should therefore be accounted as liabilities. In most cases, conversion or write-downs are very remote events that will never happen.

Moreover, the treatment of those liabilities may vary:

- Some instruments will be converted at a certain trigger-point into equity, generally into share capital.
- Contractual bail-in instruments will be written down or converted into share capital at the discretion of a resolution authority.
- Other bail-inable liabilities, especially liabilities to all kinds of creditors, can, at the discretion of the resolution authority, also be written down or converted into share capital. Even deposits above the amount covered by a Deposit Guarantee Scheme could be potentially subject to bail-in.

Especially in the case of the latter category, the identification may be very difficult. We therefore have doubts about introducing a new category of bail-inable instruments between equity and liability.

Should you have any questions or wish to discuss our comments with us, we would be available for you at any time.

Yours sincerely,

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