European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

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Mr. Andreas Barckow
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EACB Comments on EFRAG Discussion Paper "Distinguishing between Equity and Liability"

Dear Mr. Barckow,

The European Association of Cooperative Banks (EACB)[1] gladly takes the opportunity to comment on EFRAG Discussion Paper – "Distinguishing between Liabilities and Equity". As you know, the matter of equity/liability distinction is a matter of major importance for cooperative banks. Please find our answers to your questions expanded on the following pages

In general terms, we warmly welcome the discussion paper as the outcome of the PAAinE project and strongly support its "loss-absorption approach".

We strongly appreciate the focus on loss-absorption, i.e. the risk-bearing character of capital. For good reasons, it is also this element that is decisive for the prudential approach to this matter.

The biggest advantage of loss-absorption approach is that it is "neutral" and therefore reflects that there is a large variety of businesses beyond listed companies. This universality allows to properly consider the particularities of all companies, including cooperatives (see (IE10).

[1] The European Association of Co-operative Banks (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. With 4,500 locally operating banks and 60,000 outlets co-operative banks are widely represented throughout the enlarged European Union. They play a major role in the financial and economic system, serve 130 million customers. The co-operative banks in Europe represent million members and 700,000 employees and have a total average market share of about 20%.

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Since the EACB strongly supports the loss-absorption approach, we explicitly encourage EFRAG and the drafting team to carry on the work on this project and to come up with an even more robust paper. There are still parts that may appear a bit theoretical. In particular, a mapping of many kinds of financial instruments will need to be done at some stage.

We welcome any question regarding our comments

Yours sincerely,

Hervé GUIDER
General Manager

Volker Heegemann
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RESPONSES TO QUESTIONS

1. *Do you believe that defining two different classes of capital on the balance sheet does provide decision-useful information, even if the entity´s capital structure is in fact multi-dimensional (the so-called "list claims"-approach, pars. 13 ff.) If not, why?*

EACB believes that the distinction between equity and liability as a conceptual basic principle is highly adequate. It allows presenting a complete picture of the financial situation of a company, including its liquidity position and claims against the company.

A more multidimensional approach would not bring more advantages. To the contrary, it would make the reading more difficult. While under the two-dimensional approach only a limited number of notes is required for a proper picture. A multidimensional approach would require much more detailed notes.

2. *Do you believe that listing all claims to the entity's assets, ranking those claims by a certain criterion and providing additional information on all other characteristics of the claims in the Notes to the financial statements would have merit (pars. 1.3 ff)? Why? If not, why?*

In our opinion the distinction between equity and liabilities on the balance sheet provides creditors and investors with the information they need to take their relevant decisions. At a first glance readers will gain at least at first overview on the equity and liability situation. Details of the equity or liability positions could be explained in notes.

3. *Do you agree with the analysis of the different characteristics of capital as the basis for distinguishing between equity and liabilities (pars. 1.14 ff.)? If not, why? Do you think that any other characteristics should be considered? If yes, which?*

We agree in principle, in particular with the participation in losses. The participation in losses should be the main distinguishing element when looking at equity instruments.

However, while the paper itself is generally formulated in a neutral manner, we see many passages from which it is clear that the paper is oriented towards shares of listed companies as the "basic" form of equity.

Focusing only on one type of equity instrument often leads to problems of interpretation and application. Therefore, we suggest to improve the document in order to avoid allegations to certain forms of company. This would also help to avoid that the analysis in the paper is biased but ensure that it is impartial.

4. *Do you agree with the analysis in the paper on whether to base a capital distinction on one or more than one criterion (pars. 1.33 ff.)?*

   We are not definitely convinced that a priori it is the better way to define capital on the basis of one criterion. There could also be definitions based on several criteria. Nevertheless, the concept of using one single criterion is very interesting, since it seems to simplify the distinction considerably.

   The key question, however, is whether an approach is practical and provides for appropriate results.

   In so far, we definitely see the advantage of loss-absorption as the general principle. Saying this, we think that it will be important to determine clearly from which perspective loss-absorption is defined. The most crucial aspect will be a test of loss-absorption as the single criterion for loss-absorption on a wider range of existing instruments, as it has been done by the FASB.

5. *Do you agree with the analysis in this paper that, in order to classify capital, either an entity view or a proprietary view has to be applied (pars. 1.40 ff.)? If not, why not? Do you agree with the paper's description of the implications of each approach (pars. 2.35 ff., 3.22 ff.)? If not, why?*

   The proprietary perspective and the entity view can lead to diverging results. In this respect we think that the entity view is the relevant, since according to the conceptual framework financial information is to be provided for investors, but also for creditors. For creditors, in particular, only the entity perspective is relevant. Since this perspective will tend to deliver more information, it may also deliver all relevant insight to investors.

6. *Do you agree with the analysis of the needs of the users of financial statements in the context of classifying capital (pars. 3.1 ff.)?*

   The users of financial information are mainly investors and creditors, but also public authorities and finally the wide public. Financial information should cover the needs of all of them, even when accounting standards mainly focus on investors and creditors.

7. *Do you agree that basing the distinction between equity and liabilities on risk capital would provide decision-useful information to a wide range of*

users of financial statements about entities in different legal forms (pars. 3.5 ff.)? If not, why? Is there any other basis for the distinction that you would consider providing more useful information? If yes, which and why?

It seems that the distinction between capital and equity is a question on whether capital is "at risk". Risk capital provided by the entrepreneur is capital that is available to ensure that claims of creditors are not at risk.

8. *Do you agree with the analysis of losses as either economic losses or accounting losses in the context of classifying capital as equity or liabilities (pars. 4.1 ff.)? If not, why? Would you agree that the Loss Absorption Approach should focus on accounting losses?*

For the classification of equity and liability distinction the criterion of participation of losses delivers relevant information. In this respect, the definition of losses is crucial.

In our opinion, the focus should be on accounting losses, not on economic losses. In fact, we think that an approach based on accounting losses will provide comparable results more easily. However, such approach should avoid restrictions that are not relevant for the definition of capital as "at risk" (e.g. business year, etc). This being said, it will certainly be important to refine this approach in the detail, in order to deal with a number of "special situations".

9. *Do you think that the Loss Absorption Approach is explained sufficiently clear in this paper (Section 4)? Do you agree with the definition of loss-absorbing capital in par. 4.16? If not, why? How could this definition be improved?*

While EACB strongly supports the concept of the loss-absorption approach, there can be no doubt that the approach requires more explanation, in particular explanation beyond the very principles. Otherwise it will not be possible to achieve clarification regarding all financial instruments. The illustrative examples are certainly helpful, but not sufficient.

10. *Do you agree that classification of an instrument as equity or liability should be based on the terms and conditions inherent in the instrument? Do you agree that the passage of time should not be the trigger for reclassification of an instrument (pars. 4.22 ff)? If not, why?*

Insofar as the terms of the instruments define its loss-absorbing capacity, we think that the terms are relevant, if not decisive.

Any classification should be done once, when the instrument is issued or acquired and such decision should not be reviewed for the purpose of any subsequent financial statement.

11. *Do you agree with the discussion on linkage (pars. 4.13 ff.)?*

The issue of several products at the same moment in time is normally not done for reasons of structuring opportunities, but in order to correspond to the demand of the market. Such issues should therefore be analyzed instrument by instrument.

12. *Do you agree with the discussion on split accounting (pars. 4.36 ff.)?*

The issue of complex financial instruments is not a matter of structuring opportunities. Split accounting allows an economic analysis of an instrument and to reflect the reality of an operation as the issuer wants it.

13. *Do you agree with the discussion of the different approaches to distinguish equity from liabilities within a group context in general and with regard to the Loss Absorption Approach in particular (section 5)? If not, why? Would you prefer the approach set out in par 5.1(a) or the approach in par. 5.1 (b)? Why?*

From our perspective it is crucial that the definition of equity does not differ from entity to group level. An instrument, that is an equity instrument on entity level should not lose its equity classification on group level. With this in mind we would encourage EFRAG to continue and even increase it work on this matter and to come up with additional information on this topic.

14. *Do the examples in section 6 illustrate the loss-absorption principle well? Would you have reached a different conclusion (or classification)? Why? Are there any other aspects of the Loss Absorption Approach that need to be illustrated?*

These examples are very useful. Unfortunately, they are quite limited in number and accordingly can only illustrate, but not draw a very clear picture.

15. *Do you believe that the Loss Absorption Approach is sufficiently robust to be prescribed in an accounting standard? If not, why? If you are concerned about structuring opportunities what would be your suggestion to limit the structuring opportunities?*

We are strongly positive about the approach and its principles:

a. Due to the focus on loss-absorption, i.e. the risk-bearing character of capital. For good reasons, it is also this element that is decisive for the prudential approach to this matter.

b. The biggest advantage of loss-absorption approach is that it is "neutral" and therefore reflects that there is a large variety of businesses beyond listed companies. This universality allows to properly consider the particularities of all companies, including cooperatives (see (IE10).

For these reasons we strongly encourage EFRAG and the authors of the paper to carry on and to come up with a concrete approach.

16. *Do you think the Loss Absorption Approach should be simplified? If yes, how could the Loss Absorption Approach be simplified?*

At the moment, we don't see any possibility of significantly simplifying the loss-absorption approach.

17. *This Discussion Paper is based on the view that the current IFRS approach to distinguish equity from liabilities has shortcomings. Do you agree with the analysis of the current IFRS approach to distinguish equity from liabilities (section 2)? Do you agree that the current approach has shortcomings as identified in this paper (pars. 2.17 ff.)? If not, why? Do you see any other shortcomings? Do you see advantages of the current approach?*

18. *Do you believe that the Loss Absorption Approach would represent an improvement in financial reporting over the current IFRS approach? Do you think that the distinction based on this approach provides decision-useful information? If not, why? Do you have any other comments?*

While there may be shortcomings of the current approach, we think that from the perspective of co-operatives it is liveable, more for some co-operative banks than for others. The biggest advantage of IAS 32 and IFRIC 2 certainly is that it is simply there and “in force”.

The loss-absorption approach, due to its undeniable advantages (universality and focus on “risk capital”), once properly developed, would become the better solution.