World Council

January 7, 2019

Filed Electronically
International Accounting Standards Board
IFRS Foundation
30 Cannon Street
London, EC4M 6XH
United Kingdom

Re: Discussion Paper: Financial Instruments with Characteristics of Equity (DP/2018/1)

Dear Sir or Madam:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the International Accounting Standards Board's discussion paper: *Financial Instruments with Characteristics of Equity*.[1] Credit unions are co-operative depository institutions and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are over 89,000 credit unions in 117 countries with USD 2.1 trillion in total assets serving 260 million physical person members.[2]

Question 3: The Board's preliminary view is that a non-derivative financial instrument should be classified as a financial liability if it contains: (a) an unavoidable contractual obligation to transfer cash or another financial asset at a specified time other than at liquidation; and/or (b) an unavoidable contractual obligation for an amount independent of the entity's available economic resources. This will also be the case if the financial instrument has at least one settlement outcome that has the features of a non-derivative financial liability. Do you agree? Why, or why not?

World Council strongly supports carrying forward the existing rules for accounting for co-operative shares as equity under IFRIC Interpretation Number 2,[3] as the Board proposes in paragraph IN19(c), paragraph 8.19 and note 103, and paragraph 8.34. We urge the Board to finalize these aspects of the discussion paper as proposed.

We believe that IFRIC Interpretation Number 2 represents an appropriate and reasonable approach to distinguishing whether co-operative shares held by members of credit unions and other co-operatives are equity or liabilities. Under IFRIC Interpretation Number 2, claims on co-operatives that function like

[1] International Accounting Standards Board, Discussion Paper: *Financial Instruments with Characteristics of Equity* (June 2018), *available at* https://www.ifrs.org/news-and-events/2018/06/iasb-consults-on-the-accounting-for-financial-instruments-with-characteristics-of-equity/.
[2] World Council, *Statistical Report* (2017), *available at* https://www.woccu.org/impact/global_reach/statreport.
[3] International Accounting Standards Board, International Financial Reporting Interpretations Committee (IFRIC) Interpretation No. 2, *Members' Shares in Co-operative Entities and Similar Instruments* (2004), *available at* https://www.ifrs.org/issued-standards/list-of-interpretations/ifric-2-members-shares-in-cooperative-entities-and-similar-instruments/.

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deposit accounts are liabilities but "[m]embers' shares are equity if the entity has an unconditional right to refuse redemption of the members' shares."[4]

Credit unions and other co-operative depository institutions typically have an unconditional right to refuse the redemption of co-operative shares that qualify as regulatory capital.

Under Basel III rules, such as those applicable to credit unions and other mutual deposit-taking institutions in Australia and Canada, co-operative shares that qualify as "common equity Tier 1" regulatory capital must also meet additional criteria such as absorbing losses that exceed retained earnings on a going-concern basis, being perpetual in duration, being uninsured, being non-withdrawable, and not being eligible to be pledged as security.[5] Credit union capital shares have successfully absorbed billions of dollars in losses in the past.[6]

The Rochdale Society of Equitable Pioneers, which formed the first co-operative in 1844, modeled co-operative shares on the terms and conditions of contemporary joint-stock company shares but with a "one-member-one-vote" voting rule. Even when credit unions issue shares that function like deposit accounts and are accounted for as liabilities under IFRIC Interpretation Number 2, these shares typically represent equity as a legal matter, confer corporate voting rights, and also have a claim on the residual assets of the credit union in liquidation in the same manner as joint-stock company shares.[7]

We strongly support the Board's proposal to carry forward the conclusions of IFRIC Number 2 for the equity classification of co-operative shares and urge the Board to finalize this aspect of the discussion paper as proposed.

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[4] *Id.* at ¶¶ 6-7.

[5] *See, e.g.*, Australian Prudential Regulation Authority (APRA), Prudential Standard APS 111, *Capital Adequacy* at 60-64 (2018) ("Attachment K—Mutual equity interests"), *available at* https://www.apra.gov.au/sites/default/files/aps-111-january-2018.pdf; Office of the Superintendent of Financial Institutions (OSFI) of Canada, *Capital Adequacy Requirement (CAR) Guideline* § 2.1.1.1(5) (2017) ("Common Equity Tier 1 instruments issued by a federal credit union"), *available at* http://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR18_chpt2.aspx. *See generally* Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems - revised version* at 14-15 & n.12 (2011) ("The [common equity Tier 1] criteria 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."), *available at* https://www.bis.org/publ/bcbs189.htm.

[6] *See, e.g.*, U.S. National Credit Union Administration, "Matters Related to 'Paid-In Capital' and 'Membership Capital' of Corporate Credit Unions," Letter to Credit Unions 09-CU-10 (May 2009), *available at* http://www.ncua.gov/Resources/Documents/LCU2009-10.pdf.

[7] *See, e.g.*, 12 U.S.C. § 1757(6) ("To receive from its members . . . payments, representing equity, on shares which may be issued at varying dividend rates . . ."), *available at* https://www.law.cornell.edu/uscode/text/12/1757; 12 C.F.R. § 710.6(b) ("After all assets of the Federal credit union have been converted to cash or found to be worthless and all loans and debts owing to it have been collected or found to be uncollectible and all obligations of the Federal credit union have been paid, with the exception of shares due its members, the books shall be closed and the pro rata distribution to the members shall be computed. The computation shall be based on the total amount in each share account as of the liquidation date or the date on which all share drafts have cleared, whichever is later."), *available at* https://www.law.cornell.edu/cfr/text/12/710.6.

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Question 10(a): Do you agree with the Board's preliminary view that: (a) economic incentives that might influence the issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a financial liability or an equity instrument? . . . Why, or why not?

World Council supports the Board's proposed view in paragraph 8.19 and note 103 that economic incentives that may influence an issuer's decision to exercise its rights should not be considered when classifying a financial instrument as a liability or equity. The parties' rights and obligations should be considered instead.

We agree with the Board in paragraph 8.19 and note 103 that institutions having a history of making dividend distributions at regular intervals or stating an intention to make such distributions should not create a liability. Market expectations should not take precedence when an institution has discretion over whether or not to make a distribution.

We agree that rights and obligations, not incentives, should be the focus of analyzing whether or not a claim is equity or a liability, as discussed in greater depth in response to Question 11, below. We urge the Committee to finalize paragraph 8.19 and note 103 as proposed.

Question 11: The Board's preliminary view is that an entity shall apply the Board's preferred approach to the contractual terms of a financial instrument consistently with the existing scope of IAS 32. Do you agree? Why, or why not?

World Council does not agree that there is a practical difference between whether "rights and obligations arise from a contract or from the law" in terms of distinguishing equity from liabilities as the Board argues in proposed paragraphs 8.27 to 8.36. Contractual rights and obligations are legal rights and obligations that arise from "the law" like other enforceable rights and obligations do. We believe that both contractual and non-contractual sources of rights and obligations should be considered in distinguishing equity from liabilities because both are enforceable rights and obligations that can result in the same or similar economic consequences.

We are concerned that statements implying that contractual rights and obligations operate independently of the law, if finalized, would be confusing to users of this standard because it would create an arbitrary distinction between one set of enforceable rules and a different set of equally enforceable rules, both of which are rooted in law and can affect the economic substance of the equity-liability distinction. While we support looking to co-operative laws as a source of the rights and obligations of co-operative societies and their member-shareholders, we believe that IFRIC Interpretation No. 2's references to co-operative laws discussed in paragraph 8.34 should not be viewed as an exception to a general rule. The economic consequences of exercising a right or obligation should be essentially the same on an accounting basis whether or not the right or obligation is based in contract or on non-contract legal provisions, even in the case of a retroactive law.

We believe that the conceptual distinction from an economic substance standpoint is whether a contingent right or obligation that can convert a claim from a liability to equity, or from equity to a liability, has been exercised or not. Whether the contingent right or obligation arose from a contractual provision under contract law or arose from another source of law would not generally affect the economic consequences of the transaction so long as it was enforceable.

One example given by the Board in proposed paragraph 8.29(a) is a bond that can legally be converted to equity under specific circumstances pursuant to "legal or regulatory requirements" but the bond does

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not include that conversion provision in its contractual terms. As proposed, users of the standard would analyze this instrument for expected credit losses under International Financial Reporting Standard 9 (IFRS 9).[8] A similar convertible bond, however, would presumably be accounted for differently if its conversion feature was based on its contractual terms.

This proposed approach, if finalized, would likely create an artificial distinction between rights and obligations arising in contract law and rights and obligations stemming from other sources of law. Creating a distinction on an accounting basis between whether the conversion from a liability to equity occurs under contract law or under another applicable legal authority does not seem consistent with the Board's stated intention to have similar accounting treatment for similar economic consequences.

A less confusing way to analyze this scenario, at least in the context of distinguishing equity from liabilities, would be to treat enforceable "legal or regulatory requirements" as equivalent to enforceable contractual provisions and analyze whether or not the contingency requiring the instrument to convert from a liability to equity has occurred or not. It makes little economic difference whether the rules governing a financial instrument spring from the law of contract (such as being set by the provisions of a contract) or spring from another source of law, such as banking regulations or legislation governing the operations of co-operatives.

We urge the Board to clarify that enforceable rights and obligations arising from "legal or regulatory requirements" are equivalent to enforceable rights and obligations arising from contractual provisions, at least for purposes of distinguishing equity instruments from liabilities. We believe that the relevant question from an economic-consequences standpoint is whether a contingent right or obligation that can convert a claim from a liability to equity, or from equity to a liability, has been exercised or not.

World Council appreciates the opportunity to comment on the International Accounting Standards Board's discussion paper: *Financial Instruments with Characteristics of Equity*. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1.202.843.0702.

Sincerely,

Michael S. Edwards
SVP and General Counsel
World Council of Credit Unions

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[8] International Accounting Standards Board, IFRS 9 *Financial Instruments* (2014), *available at* https://www.ifrs.org/issued-standards/list-of-standards/ifrs-9-financial-instruments/.