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Dear Madam, dear Sir

Discussion Paper Financial Instruments with Characteristics of Equity

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the Discussion Paper Financial Instruments with Characteristics of Equity issued by the IASB.

Banking supervisory authorities and central banks have a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

CEBS has a particular interest in the definition of accounting equity, to the extent that it affects key elements of regulatory capital and in some countries has an influence on the regulatory classification of capital instruments.

Although we recognise the importance and interest of the paper, we are not convinced that there is a pressing need to modify IAS 32 at this stage. While it is true that IAS 32 has attracted a fair degree of criticism, some of the prior issues have been addressed in the current standard and its interpretations, and users and preparers are adapting to it. CEBS would therefore recommend that the IASB, in its considerations on taking this issue forward, carefully analyses the implications of the proposals not only from a cost/benefit perspective but also against the need for stability of accounting standards.

As concerns the substance of the discussion paper our main comments are as follows:

- We do not disagree with the objective of introducing a positive definition of equity. We would like to stress however the importance of ensuring that consistency is maintained with the conceptual framework, other existing standards or current projects of the IASB dealing for example with the positive definitions of assets and liabilities. This is discussed in more depth in the detailed comments put forward in the appendix to this letter.
- Rather than defining a narrow set of alternatives, we believe that a broader assessment of characteristics and principles that should apply to accounting equity, depending on its use in different contexts, will be

necessary¹. Our comments are based on CEBS' views on some fundamental characteristics that equity instruments should present, i.e. permanence, loss absorbency on a going concern basis (including the flexibility of payments) and in liquidation (i.e. subordination). We believe that these characteristics² would help to convey relevant information about the solvency of the preparer to a wider range of financial statements users.

- o CEBS does not express a preference at this stage for any of the approaches set out in the Boards' Discussion paper, pending a more in depth consideration by the Boards of the conceptual arguments that would justify the choice for one solution over the others. Such a decision requires a careful assessment and discussion of the different features of equity instruments. Rather our comments aim to raise issues and voice concerns or views on particular aspects or features of these approaches.
- o We do not comment on the *reassessed expected outcomes* approach, as we believe it would introduce too much complexity and unwarranted volatility in the definition and measurement of the most fundamental component of an entity's financial position. We therefore would like to recommend against the introduction of this approach

Rather than answering to the discussion paper question by question, we preferred to develop some key comments on what we consider to be the important items discussed in the paper.

The preceding comments have been coordinated by CEBS's Expert Group on Financial Information (EGFI) - in charge of monitoring any developments in the accounting area and of preparing related CEBS positions - and in particular by its Subgroup on Accounting under the direction of Mr. Patrick Amis of the French Commission Bancaire.

If you have any questions regarding our comments, please feel free to contact Mr. Didier Elbaum (+33.1.4292.5801), Chair of the EGFI, or Mr. Patrick Amis (+33.1.4292.6032).

Yours sincerely,



Kerstin af Jochnick
Chair, Committee of European Banking Supervisors

¹ For instance, the definition of equity has close links with solvency and company laws in a number of countries (definition of amounts distributable to shareholders, asset-liability tests for insolvency purposes...).

² These characteristics are in line with the principles set out by the Basel Committee on Banking Supervision for instruments to be considered of adequate quality to qualify for the highest tier of regulatory capital. They have been further explained in the CEBS proposal for a common EU definition of Tier 1 hybrids prepared in response to a request of the European Commission (<http://www.c-ebs.org/press/documents/hybrids.pdf>).

Appendix

Detailed comments

Positive definition of equity and link with other projects of the IASB (Question B1 / BOA Question 1)

As already stated in the cover letter, we do not disagree with the objective of introducing a positive definition of equity.

We noted however that, further to the already existing positive definitions included in the conceptual framework, the IASB is currently developing new positive definitions of assets and liabilities. Developing positive definitions for both assets and liabilities and equity might prove difficult and complex as it may lead not only to inconsistencies but also to overlapping or even loopholes. CEBS therefore recommends that the Boards, in going forward, take good care to avoid such problems.

We noted also that the discussion paper addresses the fundamental features of financial instruments with characteristics of equity but does not deal with other important components of equity, such as reserves and retained earnings, other comprehensive income and non-controlling interests. A clear understanding of the intended detailed treatment of these other components is essential in order to be able to form a definitive opinion on the proposal contained in the present discussion paper.

We would also expect that the general principles that are deemed relevant for the distinction between equity instruments and liabilities are also considered when discussing the presentation of these other components in the financial statements.

As such it is advisable that the IASB engages in a discussion of the practical and conceptual links between this proposal and other projects that are currently being developed, such as the definition of performance reporting and financial statements presentation.

Definition of basic ownership instruments (Question B1- BOA question 1)

We understand that the definition of *basic ownership instruments*, which reflects the definition proposed/favoured by the FASB, is based in particular on the notion of 'most subordinated' instrument. The definition of *basic ownership instruments* would thus be easy to implement and appropriate in most cases to capture the most basic form of instruments in an entity which are currently accounted for as equity. However it does not necessarily incorporate both the permanence as well as, in all instances, the loss absorbency feature which CEBS believes to be the cornerstones of the definition of equity and regulatory capital.

The *basic ownership instruments* approach further raises two specific issues that relate to the treatment of co-operative shares and to instruments puttable at fair value.

In addition to the requirement to be the most subordinated form of instrument on liquidation the basic ownership instrument definition also requires that the holder is entitled to a percentage of the net assets of the entity. This feature would preclude in many jurisdictions the classification of co-operative shares as equity, even though these instruments – classified as equity under current IAS 32 - are the most junior /subordinated instruments issued by an entity. CEBS

recommends that the Boards address this problem. One way this could be done is by modifying the 'percentage of net assets' component by stating that the holder of a *basic ownership instrument* would be entitled to a fixed or variable portion of the issuer's net assets. This is one of the characteristics of "other perpetual instruments" as foreseen in the *ownership settlement* approach. Moreover, in some jurisdictions, the holder is entitled to an amount at redemption that is not the same as the amount that he would be entitled to if the issuer were to liquidate. This could be addressed by deleting the requirement that the redemption amount for redeemable instruments should be the same as the amount to be received in the event of liquidation, and by requiring the redemption amount to also be a 'fixed or variable portion' of the issuer's net assets.

As regards instruments puttable at fair value CEBS is concerned that these instruments do not meet the permanence criteria that we recommend for consideration by the Boards. While we understand that for practical reasons, these instruments could represent equity for some entities on an individual basis - as is already the case under IAS 32-, we have concerns in particular about their potential treatment in consolidated financial statements. We understand that *basic ownership instruments* classified as equity in the individual financial statements would retain this status in consolidated financial statements. As such, minority interests could be created simply by purchasing the majority of shares in a mutual fund.

Treatment of other perpetual instruments (BOA questions 2-3)

While CEBS fully agrees with the permanence criterion embedded in the definition of other perpetual instruments, there are concerns about the fact that this feature is used on a stand alone basis to determine/characterise a financial instrument as equity. Indeed, it seems that under the proposed definition an unsubordinated perpetual instrument would for instance be classified as equity whereas a dated subordinated instrument would be classified as liability³.

On a different issue we understand that the 'fixed or variable portion' criterion foreseen in the discussion paper could be read to entitle the holder to a fixed amount of cash in liquidation, thus allowing for co-operative shares to be classified as equity. The proposed definition remains unclear however and more guidance is needed to clarify this point.

Finally, in its preliminary views document, the FASB mentioned that it had not yet decided whether or how to remeasure a perpetual instrument that would be classified as a liability. For purposes of achieving consistency with other liability instruments under current accounting standards, CEBS favours option a in paragraph 34 of the FASB document. Of course, this does not preclude the classification of such instruments into the trading category or the use of the fair value option, if the requirements for doing so are met.

Treatment of derivative instruments (BOA questions 2-3)

For an instrument to be classified as an "indirect ownership instrument" under the *ownership settlement approach*, the fair value of a derivative shall change in

³ Provided that the legal form of the instrument does not influence its accounting treatment. It is unclear in the FASB document whether instruments would need to be in the legal form of equity instruments in order to qualify as equity for accounting purposes. In any case, we believe that the classification of instruments for accounting purposes should be based primarily on their economic characteristics.

the same direction as the fair value of a basic ownership instrument. However, the final value of such a derivative, e.g. a call option, could be either positive or negative. At this stage in the discussion, the proposed criterion does not seem very useful. A clear understanding of the rationale of this approach is needed.

Irrespective of a clarification need, CEBS recommends that the Boards explore whether derivatives would meet the characteristics we have put forward in order to classify as equity instruments.

Substance (BOA question 5)

While the inclusion of the substance principle is welcomed, CEBS believes at the same time that it needs to be supplemented with clarifications as to how it would apply. Notably, it should be clarified whether this principle is applied only to the contractual features of an instrument. It could also be useful to clarify that economic compulsion⁴ can be viewed as one component of the substance principle in the sense that it could imply the existence of an implicit obligation to exercise the option, transforming the instrument, by this implicit obligation, into a liability.

The same applies for the reassessment principle, which CEBS considers to be a subset of the substance principle. Here it should be clarified that – in line with the approach for embedded derivatives - such a reassessment should only be triggered by contractual changes alone and not by external changes to economic or financial conditions.

Separation (BOA question 6)

CEBS suggests that the Boards clarify how this feature would apply in practice. For instance, what would be the value of the equity component of a perpetual share with mandatory dividends (i.e. we understand that the discounted cash flows that go to liability would amount to the entire principal amount of the instruments)?

Linkage (BOA question 7)

Also in this context CEBS recommends that the Boards further clarify with more examples how this feature would apply in practice.

⁴ This could be due for instance to important step-ups at a call date, that would make the exercise of the call almost compulsory from the point of view of the issuer, in a situation where the economic compulsion issue would be more important than the reputation issue.