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International Accounting Standards Board

INFORMATION FOR OBSERVERS

Board Meeting:	**17 September 2008, London**
Project:	**Financial instruments with characteristics of equity**
Subject:	**Characteristics of cooperative shares in the EU (Agenda Paper 11A)**

[PORTIONS OF THE PAPER HAVE BEEN OMITTED FROM THE OBSERVER NOTE]

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

General

Co-operative entities are formed by groups of persons who view a co-operative as the best vehicle for meeting common financial needs. National laws define a co-operative using language like "a society endeavoring to promote its members' economic advancement by way of a joint business operation (principle of self-help)." The principle objectives of a co-operative are the satisfaction of members' economic and/or social goals.

Co-operative banks characterize themselves as *variable-capital entities*. However, they differ from other entities similarly labeled. The holder of equity in a variable-capital entity typically has a right to a proportionate share of the entity's net assets. For example, shares in a mutual fund are redeemed at an amount equal to the proportionate value of net assets. As outlined below, this is not true of some co-operative banks.

Co-operative entities operate under the principle of self-management. In some jurisdictions (notably Germany), co-operatives have both a Board and a Supervisory Board. In other jurisdictions, a single Board exercises responsibilities delegated to it by the members.

Co-operative entities also operate under a principle of personal responsibility. Accordingly, a member/shareholder's exposure to loss may exceed the amount paid to purchase shares. The governing charter sets the amount of exposure, referred to as the *reserve liability*. In some co-operatives, when the subscriber of shares leaves the cooperative (with variable capital), he or she remains committed to cover potential losses (arising from the period of his shareholding) for five years. This rule gives cooperative banks a legal basis for deferring up to five years the repayments of shares, in order to ensure deduction of any potential losses from the amount. However, in other cooperatives, members' exposure to loss is limited to the amount of their investment in shares (as would be the case in most other corporations).

In Europe, a bank must have at least €5,000,000 in *own funds* (equity). As a practical matter, this means that a newly formed co-operative must have member shares with a nominal value of €5,000,000 to begin operation as a co-operative bank.

While, most co-operatives only do business with their members, in most European co-operative banks, a customer need not become a member/shareholder to open an account or borrow. The member/shareholder, when acting as a customer, has the same rights and obligations as a customer who is not a member/shareholder. In the past, some co-operative banks required membership before making loans. However, this is no longer true of the large majority of banks. Competitive pressures as well as restrictive tax legislation make it difficult to offer special terms to members.

Co-operatives are of significant importance to the world economy: Co-operatives worldwide have 800 Million members and employ 100 Million people. Taken together, the world's top 300 co-operatives had in 2004 assets worth 30-40 Trillion US$ and revenues of 963 US $. As regards co-operative banks: Measured on banking capital, there are three (European) co-operatives that rank in the top 25 institutions of the world.

Shares and Purchase of Shares

Member shares are a cooperative's most subordinate financial instrument.

A member/shareholder purchases shares for a fixed amount (normally the face value), regardless of the amount of net assets in the co-operative before the purchase. The fixed amount is established in the entity's governing charter and cannot be changed without an amendment to the charter.

The co-operative charter or governing Board often establishes a maximum number of shares that a member/shareholder may purchase. The acquisition of shares begins with an agreement to contribute capital within a period defined by the entity's governing charter. It is then completed by payment from the member/shareholder and receipt of the shares.

A member/shareholder may own one share or many. However, a member/shareholder is entitled to only one vote in shareholders' meetings. While some jurisdictions allow voting based on shares owned, few co-operatives adopt voting based on shares owned.

Even when share voting is permitted, it is often limited to a fairly small proportion of the total votes (for example, 0.25%) or a fairly small number of votes (for example, 3 to 5). The voting rules apply to all matters, unless the governing charter provides otherwise.

Dividends

Dividends on shares are approved at the annual meeting and are not guaranteed. In most cases, dividends can be paid only from accumulated earnings. It is common practice (sometimes mandated by the entity's charter) to distribute only a portion of each year's earnings. In some jurisdictions, law or the entity's governing charter limits dividends.

Dividends are paid in cash. In most jurisdictions, dividends paid by a co-operative are taxed in the same manner as dividends paid by other entities.

In most jurisdictions co-operatives also have the possibility to pay the so-called "patronage dividends", which are a payment to the members based on the volume of business that a member/shareholder conducts with the entity. Due to their convergence with the purpose of a co-operative, i.e. the promotion of the members' economic interest, patronage dividends may be considered as probably the "most typical" kind of return of a cooperative. In many jurisdictions, depending on varying criteria, patronage dividends are exempted from taxation, since considered as a reimbursement to the member.

Most co-operative banks, however, do not pay "patronage dividends", not least due to the difficulty to establish meaningful data for the distribution of patronage dividends. Nevertheless, there are quite some cases where such a model is applied very successfully. Finally, in "commercial coops", dealing only with business people, there is also a tendency to avoid patronage dividends in favor of price reductions right from the start.

Retained Earnings

Undistributed profits are generally transferred to "retained earnings" or "reserves" of the co-operative.

Redemption of Shares

In general, a member/shareholder who presents shares for redemption in a going-concern-coop will receive the same amount paid to acquire the shares. While undistributed earnings generally do not increase the amount paid to redeem shares, accumulated losses reduce the amount paid by a proportionate share of the accumulated loss.

In many cases, the redemption of shares is executed only at the end of a business year. In some cases payments are done even after a longer period.

In the event of insolvency, member/shareholders and former member/shareholders can be assessed for a portion of any amounts necessary to pay creditors. In general, additional contributions are required only in the event of bankruptcy or liquidation. Most European jurisdictions have additional regulations or laws governing the time period during which a former member/shareholder is subject to call for additional contributions or refund of amounts paid to redeem shares.

Due to the aforementioned mechanisms, cooperatives have ensured the risk-absorbing character of their member shares.

A member/shareholder may transfer shares to another party rather than presenting the shares for redemption. However, all transfers are subject to approval by the governing board and the requirements of the entity's governing charter.

Depending on the entity's governing documents, a member/shareholder may be able to present a portion of shares for redemption.

A member/shareholder who wishes to redeem shares must obtain permission of the governing board. In some cases, permission cannot be granted until the annual meeting and approval of accounts.

The entity's ability to refuse a redemption request varies among jurisdictions and among entities with a jurisdiction. In some situations, the entity has an obligation to make payment, subject to solvency or other regulatory restrictions. In other situations, the co-operative or its board have the unconditional right to decline requests for redemption.

Representatives of the industry indicate that gross redemptions of member shares in any year average about 1% of outstanding shares.

Following the adoption of IFRIC 2, many jurisdictions have implemented changes to their co-operative laws and thus provided for possibilities for an unconditional refusal of the redemption of shares IFRIC 2 option 1), as well as for introducing a level below which capital must not fall due to redemption (IFRIC 2 option 2). Those co-operative (banks), which are subject to IFRS, have changed their charters accordingly. By consequence, the majority of shares of co-operatives that are subject to IFRS dispose of a feature that gives the entities board or management the unconditional right to refuse redemption.

Liquidation

The entity's governing charter describes the distribution of net assets on liquidation of the co-operative bank. In some jurisdictions, the net assets are distributed, either proportionately to the number of members/shareholders, or based on the number of shares owned.

In other jurisdictions, the member/shareholder receives only the amount paid for shares, and any remaining net assets are distributed to another cooperative organization, a charitable organization, a sponsoring organization (like a municipality or church), or to a guarantee fund. Such reserves/retained earnings are considered "indivisible". In some jurisdictions members/shareholders have the right to determine to whom the remaining funds will be allocated.