



Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Via email: commentletters@ifrs.org

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

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Discussion Paper: Financial instruments with characteristics of equity

Dear Mr Hoogervorst

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the International Accounting Standard Board's (IASB) Discussion Paper (DP) *Financial instruments with characteristics of equity*.

The Committee supports the development of high-quality accounting standards as accounting information generally forms the starting point for the Committee's prudential capital framework. Financial information that is relevant and faithfully represents the substance of transactions or other events helps to promote the safety and soundness of the financial system. The distinction between liabilities and equity is essential as it provides relevant information on an entity's solvency, leverage and liquidity. Further, under the Basel III capital framework, instruments that qualify as Common Equity Tier 1 (CET1) capital must meet, among other things, the criteria for classification as equity under relevant accounting standards. As such, the Committee appreciates the substantial work undertaken by the IASB to address the existing application issues in *IAS 32: Financial Instruments: Presentation* that result in inconsistent accounting classification of instruments as either liabilities or equity.

In the Committee's view, the IASB's preferred approach provides a strong foundation for discussion. In particular, we commend the IASB for retaining the binary distinction between liabilities and equity by positively defining liability and defining equity as a residual interest in assets after deduction of all liabilities. This is consistent with the treatment of equity in the IFRS *Conceptual Framework for Financial Reporting*. We further appreciate that the IASB developed its proposal with the underlying objective of ensuring that classification outcomes remain largely unchanged under the preferred approach, as compared with IAS 32. This helps to reduce the burden that could result from unnecessary changes to classification outcomes that are currently well understood.

The Committee recognises the significant challenges associated with clearly distinguishing the categorisation of financial instruments that have characteristics of both equity and liabilities. Considering the degree of complexity of the changes, we

recommend further discussion and clarification to avoid any unintended consequences. In particular, as the IASB continues developing its approach, we encourage it to further consider the following aspects:

- *Interaction between the DP proposals and the IFRS Conceptual Framework and other IFRS standards:* The Committee understands that the IASB will consider whether changes to the Conceptual Framework are needed as a result of this project, as outlined in Appendix B of the DP. In our view, all new or revised standards should state whether they are consistent with the Conceptual Framework and, if they are not, should explain how they are inconsistent and why the IASB thinks the inconsistency is necessary. We also believe it is important that a draft explanation of these matters be included in any exposure draft resulting from this DP, so it is important that the IASB consider the need for changes as part of the next stage of this work. We also agree that it is important that any final approach strive for consistency with other relevant IFRS standards to further minimise the application issues that currently exist under IAS 32. In particular, clarifications are welcome on the interaction between the IASB's proposals and the Conceptual Framework with respect to:
 - share-settled outcomes and obligations to transfer economic resources. With reference to an obligation to issue an entity's own shares, it is important that the IASB clarify the inconsistency, if any, between the DP and the Conceptual Framework and explain the way in which they would be addressed (eg modifying the Conceptual Framework or explaining in the Exposure Draft why the misalignment is necessary); and
 - whether the DP's presentation proposals around the use of other comprehensive income (OCI) and non-recycling meet the criteria set out in the Conceptual Framework (see also the comments below under "Presentation").

In addition, clarifications are welcome on the relationship (eg differences and/or similarities) between the DP's proposals and *IAS 37 Provisions, Contingent Liabilities and Contingent Assets* and the Conceptual Framework (in particular, with regard to the concepts of probability and constructive obligation).

- *Conceptual elements underpinning the preferred approach:* While the Committee agrees that the preferred approach seems to be more coherent than the requirements in the current IAS 32, it is our view that aspects of the two elements of the preferred approach (ie the *timing* and *amount* features) need further clarification to ensure that together they form a strong conceptual basis for understanding the resulting definitions of liabilities and equity. With respect to the amount feature, paragraph IN11 of the DP states that an obligation for an amount independent of the entity's available economic resources, such as an amount based on an interest rate or other financial variable, is a liability. Here, the meaning of "independence" is unclear. For instance, if the variable that influences the amount is a bank's CET1 ratio, there is uncertainty as to whether the DP regards this as independent of a bank's available economic resources, as a bank's CET1 ratio is affected by various factors, including changes in regulatory risk weights. Another example stems from the DP's explanation

that the amount feature is relevant to an assessment of solvency. The preferred approach requires some financial instruments to be classified as liabilities where the amount is independent of the entity's available economic resources, even though a transfer of cash or another financial asset is required only upon liquidation. We believe the DP needs to clearly explain why such obligations are relevant to solvency assessments, as instruments that do not have to be settled unless and until the entity goes into liquidation are not usually relevant to a solvency assessment because they would not result in an entity becoming insolvent.

- *Application of the preferred approach to complex instruments:* In July 2013, the IFRS Interpretations Committee (IFRIC) considered how an issuer would classify a particular mandatorily convertible financial instrument under IAS 32. The IFRIC's analysis showed that different readings of the current standard could be made and that those readings would result in different classifications. We appreciate the fact that the IASB has developed an approach for financial instruments with alternative settlement outcomes that it believes will reduce the diversity in the accounting classification (as liabilities and/or equity) of complex instruments such as contingent convertible bonds. Nevertheless, the Committee encourages the IASB to further clarify how its approach applies to such instruments by, for instance, including examples of how the preferred approach interacts with such instruments to help ensure consistent classification.

The Committee's further comments on specific aspects of the IASB proposal are set out below.

Whether the challenges merit developing a standards-level solution

The Committee supports the IASB's view that a standards-level solution is needed. The alternative (eg issuing non-mandatory guidance) would be insufficient to achieve the DP's objective of developing a pervasive high-quality principles-based approach for classification of liabilities and equity.

The Committee further recognises that a standards-level solution could involve either replacing IAS 32 or making targeted amendments to the current IAS 32, with the aim of providing a strong and consistent conceptual basis for the liability-equity distinction. Substantial changes of text may create new issues and uncertainties that could require further interpretation. As such, and taking also into account that the IASB's objective is to not fundamentally change the existing classification outcomes of the extant standard, we suggest that before deciding to replace the standard the IASB look once again and in detail at whether targeted enhancements to IAS 32 would be sufficient to achieve the DP's objective. If they would not be, we agree that IAS 32 should be replaced in its entirety. Specifically, an assessment should be made to determine whether the benefits of replacing IAS 32 (eg introducing a clearer and more consistent rationale for distinguishing financial liabilities from equity instruments) justify the costs that changes of this kind impose on financial statement preparers. In addition, unintended consequences resulting from unexpected reclassifications should be evaluated against the benefits. Nevertheless, we recommend that the IASB incorporate the criteria for mutual banks, currently addressed in IFRIC 2, in the standard (see also the comments below under "Puttable exception and members' shares in cooperative entities").

Economic incentives

The DP asks whether economic incentives that might influence the issuer's decision to exercise its rights should be considered when classifying a financial instrument as a financial liability or an equity instrument. Consistent with the current IAS 32, the IASB's preliminary view is that classification should be based on the rights and obligations established by the contractual terms of the instrument, including obligations that are established indirectly through the terms of the contract. As per the DP, economic incentives other than those established by the contractual terms or "indirect obligations" that might influence the issuer's decision to exercise its rights would not be considered when classifying a financial instrument.

In the Committee's view, depending on the structure of the issuing entity's rights and other facts and circumstances, there may be economic incentives for the entity to exercise a liability settlement option even though it has the right to the equity settlement outcome. In some circumstances, those incentives may be so economically strong that the entity becomes "economically compelled" to exercise a liability settlement outcome. Nevertheless, the Committee understands the IASB's view that considering economic incentives or compulsion in the classification between equity and liability *for accounting purposes* is very challenging and difficult to operationalise. However, we emphasise that for banking regulatory purposes, considering economic incentives is important as these can affect and even compromise the capital instrument's ability to absorb losses.

We suggest that the IASB analyse whether and how the concept of economic incentives as set out in the DP could be analogised to the notion of "no practical ability to avoid" that forms part of the definition of a liability in the IFRS Conceptual Framework. We also support the IASB's proposal to retain the requirement for indirect obligations in paragraph 20 of IAS 32.

Furthermore, we observe that providing in the notes to the financial statements a complete description of the incentives related to all relevant financial instruments could overburden preparers and contribute to excessive disclosures.

Presentation

The DP proposes specific presentation requirements for instruments that are to be classified as liabilities but have certain features of equity. In particular, the DP proposes to recognise re-measurements of certain classes of financial liabilities in OCI, without subsequent reclassification ("recycling") to profit or loss. The statement of profit or loss is the primary source of information about an entity's financial performance for the reporting period. Before departing from this presentation it is important that the IASB clarify what exceptional circumstances would justify the re-measurement of certain classes of financial liabilities in OCI.

The DP further recommends that amounts presented in OCI should not be recycled to profit or loss on the basis that including these items in profit or loss does not have predictive value. If the OCI classification is confirmed, the Committee suggests that the IASB further explore the merits of the DP's rationale and consider the interaction with the Conceptual Framework.

On presentation within the different classes of equity, comprehensive income is currently attributed to owners of the parent and non-controlling interest. The DP proposes to expand the attribution of comprehensive income to equity instruments other than ordinary shares. The attribution of comprehensive income to all equity

instruments (including derivative equity instruments) would result in the updating of the carrying amount of each class of equity. We believe that this proposal is complex and costly, and is not justified by the benefits of such a treatment. In particular, it would require the fair value of every equity instrument issued by the entity to be estimated. Moreover, many derivative equity instruments have inputs that are not directly observable.

Furthermore, we are not convinced of the benefits of either introducing variability in the carrying amounts of the components of equity or of expanding attribution to derivative equity instruments that reflect only potential ownership rights (to be converted at a future date). Therefore, we do not support the expansion of the attribution requirements to equity instruments other than ordinary shares. Instead, we suggest that the IASB explore an alternative solution via enhanced disclosures to meet the information needs of the users of financial statements.

Puttable exception and members' shares in cooperative entities

The Committee believes that the IASB's final approach for equity and liability classification should continue to accommodate the treatment that currently exists under IAS 32 for puttable instruments. In addition to the reasoning presented in the DP in paragraphs 3.31 through 3.38, we suggest emphasising that the puttable exception is very restrictive. Considering this, and the fact that puttable instruments represent the most residual interest in the entity's net assets, we urge the IASB to retain the exemption. Moreover, the IASB should ensure that the preferred approach (in particular, the amount feature) does not have unintended consequences on the effects of the current treatment of the puttable exception.

At the same time, the Committee emphasises the importance of retaining in IFRS the material in IFRIC 2 on cooperative entities. The interpretation allowed by IFRIC 2 is of the utmost relevance for instruments that are redeemed at nominal value and therefore do not meet the puttable exception condition that stipulates a "pro rata share of the entity's net assets in the event of the entity's liquidation".¹ In accordance with IFRIC 2, if local regulation or the entity's governing charter imposes prohibitions on redemption, these instruments can still be classified as equity and, as such, may qualify as CET1 instruments due to the direct link in prudential regulation with the accounting classification. For this reason, the Committee urges the IASB to retain the accounting treatment currently envisaged in IFRIC 2, as suggested in the DP in paragraph 8.34.

We hope you find our comments constructive and helpful. This letter has been prepared by the Committee's Accounting Experts Group, chaired by Fernando Vargas Bahamonde, Associate Director General of the Bank of Spain. If you have any questions regarding these comments, please contact Mr Vargas (+34 913 38 61 04), Antonio Renzi, chair of the FICE Drafting Team (+39 06 47924374) or Ruby Garg at the Basel Committee Secretariat (+41 61 280 8463).

¹ IAS 32, paragraph 16A(a).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Stefan Ingves', with a stylized, cursive script.

Stefan Ingves