Basel Committee
on Banking Supervision

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Via email: commentletters@ifrs.org / customerservices@ifrs.org

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Mr Andreas Barckow
Chairman
International Accounting Standards Board
Columbus Building, 7 Westferry Circus
Canary Wharf, London E14 4HD
United Kingdom

IASB Exposure Draft: *Financial Instruments with Characteristics of Equity*

Dear Mr Barckow

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the International Accounting Standards Board's (IASB's) Exposure Draft *Financial Instruments with Characteristics of Equity*.

Accounting standards generally form the starting point for the Committee's prudential capital framework. An appropriate accounting classification of financial instruments, and in particular a clear distinction between liabilities and equity, is essential, as it provides relevant information on a bank's solvency, leverage and liquidity. Further, under the Basel III capital framework, instruments that qualify as Common Equity Tier 1 (CET1) capital must meet, *inter alia*, the criteria for classification as equity under relevant accounting standards. Moreover, even though a similar condition is not established for Additional Tier 1 (AT1) instruments, certain jurisdictions have required that only equity instruments may qualify as AT1 instruments, while others have established that, regardless of their accounting classification as equity instruments or financial liabilities, all AT1 instruments must have a principal loss absorbency mechanism.

As such, the Committee welcomes the IASB proposal aimed at addressing some application issues related to *IAS 32: Financial Instruments: Presentation* without fundamentally changing the current framework for the accounting classification of financial instruments, and it supports the IASB's efforts to continuously develop high-quality accounting standards. However, the Committee believes that in the absence of further guidance from the IASB, certain aspects of the proposal may result in implementation challenges and could give rise to unwarranted diversity in practice.

Further, the Committee believes that it is important to have accounting standards that are consistently applied between preparers, jurisdictions and over time to prevent unintended consequences and form the basis of financial statements to prevent unintended consequences. For example, in cases where the proposed changes to IAS 32 result in the disqualification of certain instruments as AT1 capital, this could trigger an accelerated repayment of these instruments under Regulatory Disqualification Event clauses and potentially lead to pressures on issuers as well as financial stability concerns in the affected jurisdictions. To this extent, the Committee has identified areas where the IASB could refine the current proposal to support a higher-quality and more consistent application:

- *The effect of laws and regulations* – The Committee notes that the current proposal would follow a different approach than that used for prudential purposes, where the rights and obligations stemming from both laws and regulations and contractual terms are considered in a holistic

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manner in order to assess compliance with the regulatory eligibility criteria. Moreover, the Committee believes that the IASB proposal may not provide sufficient clarity on the accounting classification of financial instruments as either equity or liabilities, in particular in case of financial instruments with different combinations of contractual and regulatory features. Therefore, it would be important to include further guidance and illustrative examples on the type of rights and obligations to be considered in the assessment. Guidance would be especially useful in the case where the legal framework allows for different options upon discretion of the parties or where the Basel Framework has been implemented via guidance issued and enforced by prudential regulators, instead of by national laws and regulations. Indeed, many jurisdictions implement Basel standards through supervisory guidance that is recognised by the Committee and market participants as aligned with laws and regulations for the purpose of implementation of the Basel Framework.

- *The accounting treatment of financial instruments with contingent settlement provisions* – The Committee believes that it would be helpful to include further guidance on the measurement approach, including how to determine the discount rate that should be used in measuring the liability component in cases of contingent settlement provisions as well as the discounting period. In doing so, the IASB should consider the variety of different triggers and settlement mechanisms included in AT1 instruments.

Changes to the current classification of financial instruments could also have other unintended consequences. In response, the Committee proposes that, before finalising the standard, the IASB considers conducting a field test to ensure that the proposed clarifications would not result in any unintended consequences or undesired effects and additionally provides a reasonably sufficient time for implementation. The Committee notes the IASB proposal may affect banks' hedging policies or may have potential unintended implications considering, for instance, the prudential treatment established for non-controlling interests or the interpretation issues that could arise from the interplay between the proposed definition of liquidation and that established at a national level by the relevant legal framework.

Further details on the above are provided in the Annex.

Finally, given the above-mentioned interconnections between the Exposure Draft proposals and the regulatory framework, the Committee welcomes further engagement with the IASB on the finalisation of this project.

This letter has been prepared by the Committee's Accounting and Audit Expert Group, chaired by Katherine Tilghman Hill, Head of Supervisory Policy and Strategy, Federal Reserve Bank of New York.

If you have any questions regarding these comments, please contact Lushendren Pather at the Basel Committee Secretariat (Lushendren.pather@bis.org / +41 61 280 8268).

Yours sincerely

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Annex: Comments on the IASB Exposure Draft: *Financial Instruments with Characteristics of Equity* (ED)

Question 1 – The effects of relevant laws or regulations

1. The Committee welcomes the IASB's efforts to provide clarity on the effects of relevant laws and regulations for the classification of a financial instrument (or its component part) as a financial liability, financial asset or equity instrument. In particular, the Committee supports the IASB proposal to specify that relevant laws or regulations that prevent the enforceability of a contractual right or obligation shall be taken into consideration in assessing the accounting classification of a financial instrument (or its component part). The proposed approach aligns and clarifies the interaction with the principles established in *IFRIC 2: Members' Shares in Co-operative Entities*.

2. However, the Committee believes that some aspects of the current proposal may result in practical implementation challenges and would benefit from further clarification. In particular, it would be helpful to further specify the scope of what constitutes relevant laws and regulations. For example, clarifying whether guidance issued and enforced by a relevant competent authority, such as prudential regulators that have statutory authority, may be considered within "laws and regulations". Providing such clarity in the IAS 32 application guidance would enhance comparability for users of financial statements, especially given that some jurisdictions implement the Basel Framework via guidance issued by prudential regulators instead of through national laws and regulations. We further note that such supervisory guidance, while not enforceable by law but by the relevant competent authority, is recognised as assimilated to laws and regulations by the Committee and market participants for the purpose of the implementation of the Basel Framework.[1] Moreover, in other jurisdictions, whilst the Basel Framework has been implemented through laws or regulations, the latter explicitly require prudential regulators to provide additional specifications on certain aspects of the prudential framework. In this case, guidance issued by prudential regulators complements and shall be considered by supervised entities in a holistic manner with relevant laws and regulations. Further clarifications would also be helpful in explaining how the IASB proposal should be applied to financial products, the relevant terms and conditions of which are strongly regulated by applicable laws and regulations. Indeed, in this case it may be hard for issuers to define which is the most appropriate classification outcome under the current proposal.

3. Additional guidance would also be helpful to better understand the conceptual basis for not considering certain rights and obligations when classifying a financial instrument. Indeed, this aspect of the proposal may lead to financial instruments with identical features being classified in a different way across jurisdictions, depending on whether and according to which terms a certain requirement is established in the relevant laws and regulations or only within the contractual provisions of the instrument. This may jeopardise the transparency and comparability of financial statements across jurisdictions, and it may leave room for structuring issuances with the aim of achieving a more favourable accounting classification outcome. This may, in turn, hinder the comparability of regulatory capital across financial institutions and jurisdictions. Moreover, such an approach may introduce additional complexity in the case of cross-border groups with subsidiaries established in many different jurisdictions. In this

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[1] For example, according to the BCBS Regulatory Consistency Assessment Programme (RCAP) Handbook "[..] *the regulations being assessed should encompass all domestic laws, regulations, rules, guidelines or any other documents implementing the Basel standards and deemed by law or in practice as binding on banks and the supervisory authorities*".

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case, it may be difficult to assess whether the contractual terms introduce rights and obligations that are actually in addition to those established by law.

4. However, the Committee also notes that an approach based on a full consideration of the relevant laws and regulations might result in further unintended implications, especially in the case of bail-in instruments. To this extent, the Committee sees merits in the IASB proposal since it would address the practical issues of the effects of laws and regulations without resulting in a fundamental change in the IAS 32 accounting framework. However, the IASB is invited to provide more guidance and illustrative examples in the final standard in order to promote a consistent application of the proposed approach, keeping in mind that the interplay between contractual terms and the provisions established by the relevant law and regulations could give rise to different scenarios in practice.

5. Additional illustrative examples would be particularly helpful in cases where the legal or supervisory framework allows for different options at the discretion of the parties to the contract. For example, the prudential frameworks governing AT1 instruments generally provide a choice of contractual terms to establish the loss absorbency feature. This choice can be in the specific form of the loss absorbency mechanism (write-down or conversion into common shares) and the capital level that triggers the loss absorbency mechanism (a CET1 ratio of 5.125% is a minimum, but higher capital levels can be selected by the parties). In this case, while the contractual terms of the instruments stem from a legal or regulatory requirement and often refer to the relevant legal provisions, they integrate the applicable framework by establishing additional and more specific rights and obligations within the options allowed by laws and regulations. To this extent, pursuant to paragraph 15A of the ED, these clauses should not be disregarded but should affect the accounting classification of the instrument. However, at the same time, the rationale underlying BC25–26 of the ED may leave room for different interpretations.

6. Against this backdrop, the Committee invites the IASB to clarify that, in accordance with paragraph 15A of the ED, in the case illustrated above, the contractual terms related to the loss absorbency mechanism of AT1 instruments are deemed to be relevant in assessing the accounting classification, while the provisions of BC25–26 are applicable only for assessing whether an element of the instrument shall be accounted for separately or not. Such an interpretation would contribute to mitigating differences in the accounting classification of AT1 instruments across jurisdictions. This would also be consistent with the rationale underlying BC20–21 of the ED, given that, as a difference compared to the general bail-in power of the resolution authorities, the contractual terms related to the loss absorbency feature of AT1 instruments are specific to the instrument itself, since they are negotiated and may be amended by the contractual parties. The Committee believes it would also be valuable for the IASB to include an example illustrating how the standard should be applied in the case of the general bail-in power. The Committee believes it would be useful to have such an example in contrast to the example of an AT1 instrument (see paragraph 5).

7. We also note that instruments may have a variety of contractual triggers, including PONV triggers.[2] In this regard, it should be noted that PONV triggers may be required by laws or regulations to be stipulated in instruments' contractual terms, but such triggers can only be activated by authorities' decisions (ie neither the issuer nor the investor influences the trigger). For these instruments, it is unclear whether the ED intends to treat instruments with contractual PONV triggers differently than other bail-in instruments and, if so, the rationale for its approach. In the light of this, the IASB is invited to clarify

[2] The baseline requirement under the BCBS's point of non-viability (PONV) requirements is that the contractual terms and conditions of all AT1 and Tier 2 instruments issued by an internationally active bank must include a provision that requires such instruments to be written off or converted into common equity at the option of the relevant authority upon a PONV trigger event. The standard permits an exception to the contractual approach where jurisdictions have equivalent statutory resolution regimes in place and subject to other conditions.

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that the contractual terms dealing with the general bail-in power and the PONV triggers (including the related contingent settlement mechanism – ie write-down or conversion terms) are not to be considered for the purpose of the accounting classification assessment and corresponding measurement, to the extent that they do not give rise to additional or more specific contractual rights and obligations beyond the relevant legal requirements. It would be useful for the IASB to provide application guidance on determining whether a feature would create contractual rights and obligations that are in addition to or more specific than the legal rights and obligations.

Question 2 – Settlement in an entity's own equity instruments

8. The Committee supports the IASB's clarifications to determine when the "fixed-for-fixed" condition in paragraph 16(b)(ii) of IAS 32 is met. In particular, the Committee welcomes the clarifications provided on the types of adjustments that are consistent with the principles of the fixed-for fixed condition (ie preservation and passage-of-time adjustments), as this will reduce diversity in practice and improve consistency across entities.

9. With specific reference to the effect of foreign currency, the Committee welcomes the certainty for foreign currency rights, options and warrants (for which the clarification made by the IASB will not change the application of the requirements in paragraph 16(b)(ii) of IAS 32), as the current exception is perceived as useful.

10. The Committee notes that the IASB is proposing in the new paragraph 22C(b)(iii) that a passage-of-time adjustment must represent compensation proportional to the passage of time. The Committee further notes that the IASB has clarified in new Illustrative Example 20 (paragraphs IE82–IE86) that a strike price that varies with an interest rate benchmark or an inflation index does not meet the fixed-for-fixed condition, as it cannot be considered as a preservation or passage-of-time adjustment. However, the rationale for these not meeting the passage-of-time definition is not sufficiently clear. The Committee believes that the IASB should clarify whether such adjustment is not compliant with the fixed-for-fixed definition simply for being a rate that varies with the time – ie because it is not fixed at initial recognition – or rather because it is a variable interest rate. The Committee also notes that the IASB has not provided any illustrative examples of adjustments that comply with the passage-of-time requirements in new paragraph 22C(b), and the IASB has not provided any guidance on how an issuing entity should make the assessment described in paragraph IE79 of new Illustrative Example 19. In the Committee's view, providing additional guidance and examples on these aspects would contribute to reducing diversity in practice in the implementation of the IASB proposal.

Question 3 – Obligations to purchase an entity's own equity instruments

11. The Committee welcomes the IASB's efforts to reduce the diversity in the practices observed in the accounting treatment of contracts that contain an obligation to purchase its own equity instruments. However, the Committee believes that the approach proposed by the IASB may lead to questions and implementation issues on how to determine the present value of the redemption amount (see also Question 4 below) and, most importantly, it may have unintended consequences for banks.

12. Given the lack of specific guidance in IAS 32, different approaches have been observed in practice. However, at least in some jurisdictions, the accounting treatment generally followed by banks in their consolidated financial statements involves the recognition of the liability related to the obligation to purchase own equity instruments against non-controlling interests (NCIs) instead of against a component of their own equity. The rationale provided for this accounting treatment is that the

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settlement of the liability recognised for the obligation to acquire own equity instruments would result in the derecognition of NCIs. In addition, such an approach would also have the merit of avoiding any potential negative effect on banks' solvency ratios due to the different prudential treatment established for NCIs.[3] The Committee recommends that the IASB conduct a field test on this point in order to ensure that the proposal would not result in any unintended implications for banks.

Question 4 – Contingent settlement provisions

13. The Committee supports the proposed clarifications on the treatment of financial instruments with contingent settlement provisions. The IASB proposal would improve consistency in the accounting treatment of these instruments, avoiding any differences in the recognition and measurement that could arise from the high degree of judgment involved in the estimation of the likelihood of the contingent event. Moreover, requiring issuers to measure the liability component of financial instruments with contingent settlement provisions at the present value of the expected settlement amount would result in a more prudent outcome than a measurement based on a probability weighted amount.

14. However, the Committee notes that the IASB proposal would introduce a new measurement basis into IAS 32. This could be seen as inconsistent with IFRS 9 requirements, according to which financial liabilities shall be initially recognised at their fair value and subsequently measured either at fair value or at amortised cost. To this extent, in order to reduce application challenges for preparers, the Committee would appreciate the IASB including additional guidance and illustrative examples in the final standard. In particular, the IASB is encouraged to include more guidance on how to determine the discount rate and the discounting period that should be used in calculating the present value of the settlement amount. Additional examples would also be helpful for clarifying the application of the IASB proposal, where at the estimated earliest settlement date, the related contingent event has not yet occurred. As well, examples could illustrate the case of those perpetual AT1 instruments with clauses involving either:

i. the conversion into a variable number of shares of the issuer (subject to a cap/floor mechanism in the number of shares); or

ii. the conversion into a fixed or a variable number of shares, depending on whether the share price falls below a certain pre-determined amount ("floor share price").

In these cases, measuring the liability component under the proposed approach may require significant judgment and may result in some operational challenges or, depending on the circumstances, even in a carrying amount that is higher than the consideration received for the instrument. It would also be helpful to include further examples in order to clarify the treatment of instruments with different or multiple triggers (ie contractual or statutory PONV, capital-based triggers, or combinations of both).

15. The Committee also notes that excluding probability in the measurement basis may be considered a fundamental change for some instruments and in some jurisdictions and may be perceived as inconsistent with the IASB's intention to resolve issues efficiently and effectively without fundamentally changing IAS 32. In the light of this, the Committee invites the IASB to conduct a field

[3] According to the Basel III capital framework (see CAP10.20–CAP10.26), non-controlling or minority interests receive limited recognition in regulatory capital, which is different when compared to retained earnings and reserves that – apart from some exceptions – are generally included within banks' CET1 capital. To this extent, the IASB proposal involving the recognition of the liability for the obligation to purchase own equity instruments against a component of own equity (instead of against NCIs) may result in further negative implications for prudential purposes, considering the prudential treatment established for NCIs.

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test in order to ensure that the proposed approach would not result in potential unintended consequences, especially in those jurisdictions where the proposed clarifications would lead to a change in banks' accounting classification and measurement of financial instruments with contingent settlement provisions.

16. Further consideration is suggested for the proposal in new paragraph 32A that discretionary payments are recognised in equity even if, at initial recognition, an entity allocates the entire carrying amount of a compound instrument to the liability component. The Committee supports the IASB clarification but notes that such an approach may affect banks' hedging policies (eg banks may no longer be able to apply hedge accounting to an instrument for which the discretionary payments are in a foreign currency or to hedge the related interest rate risk). This would introduce volatility to banks' income statements. The Committee therefore believes it is paramount that the IASB provides a sufficient period of time for the implementation of the new requirements in order to allow banks to adapt their hedging practices to the proposed changes.

Meaning of "not genuine"

17. The Committee welcomes the IASB's efforts to provide clarity on the meaning of "not genuine" for the purpose of the assessment of contingent settlement provisions. In particular, the Committee shares the IASB's view that in assessing whether a contingent settlement provision is not genuine, consideration should not be given only on the likelihood of occurrence of the related contingent event. Nevertheless, the Committee invites the IASB to provide additional guidance in the standard on the concepts of "extremely rare" and "highly abnormal", with the aim of limiting the degree of judgment involved in assessing the genuineness of contingent clauses and contributing to a consistent application of the ED proposal. In this sense, the IASB might consider providing more practical examples of contractual provisions that are deemed to be neither extremely rare nor highly abnormal, apart from the case of those clauses related to regulatory changes.

Question 7 – Disclosure

18. The Committee has focused on the proposals in paragraphs 30A–30F of IFRS 7, as they are the most relevant to banks. The Committee believes that the disclosures will generally provide useful information to users of financial statements, with appropriate cross-referencing to avoid duplication (as permitted by paragraph 21B of IFRS 7) and to ensure that users have a sufficiently complete picture. The Committee notes that banks already provide disclosures about financing and capital in their Pillar 3 reports and as part of their financial statements. Nevertheless, the proposed IFRS 7 requirements are not all specifically required by Pillar 3 rules.

19. While the Committee understands that a balance is to be struck on the volume of disclosures, we believe that limiting information about priority on liquidation as proposed in paragraph 30E of IFRS 7 to only those instruments with both financial liability and equity characteristics would not be helpful for users. For example, for banks there will most likely be instruments ranking both ahead and behind qualifying AT1s with respect to priority on liquidation. The IASB may consider whether some information should be required that would set this disclosure requirement in context, which does not necessarily involve giving all the information for all financial liabilities and equity instruments. Alternatively, banks may need to cross-reference in their IFRS 7 disclosures other documents that give more information about regulatory capital and other capital instruments.

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20. The Committee does not believe there are requirements in IFRS to make disclosures about risks in an entity's capital structure, eg how an entity's capital may change because of exchange rates or interest rates. This does not seem to be specifically captured by the new proposed objective in IFRS 7 about how an entity is financed (IFRS 7 paragraph 1(c)), by the disclosures supporting the existing objective about the nature and extent of risks arising from financial instruments (IFRS 7 paragraph 1(b)), or by the required disclosures in IAS 1 (paragraphs 134–136) about what an entity manages as capital and how it is meeting its objectives for managing capital. The Committee recommends that the IASB consider whether such a disclosure requirement would be helpful to users; such disclosure could be decision-relevant, and it would vary over time depending on capital instruments and risks.

21. There is another area where the Committee believes the IASB may wish to consider its proposal further: it is not clear what the IASB intends by the proposal in paragraph 30E(c) of IFRS 7: "information about any significant uncertainty about how laws or regulations applicable to financial instruments could affect their priority on liquidation — an entity would not be required to predict what the legal outcomes might be when providing this disclosure". While it seems relevant for users to understand that laws and regulations may affect instruments' priority on liquidation, or that laws and regulations may affect what happens to an instrument on liquidation (eg a resolution authority may have powers to write down or convert an instrument on liquidation or at a point of non-viability), for the Committee it is less clear how entities might assess whether there is "significant uncertainty" as to how laws and regulations might affect priority on liquidation and whether any such disclosure would be operable by banks or useful to readers of financial statements.

Question 9 – Transition

22. The Committee shares the IASB's view that a retrospective application of the standard would result in greater comparability and more relevant information for users of financial statements. However, the Committee also notes that, depending on the relevant impact of the proposed amendments on the current classification of financial instruments, a retrospective application may give rise to potential implementation challenges, especially for instruments that could be disqualified from capital recognition due to changes in their accounting classification, as well as in the case of financial liabilities subject to a hedging relationship. Indeed, if the current classification of the hedged item changes as a result of the proposed amendments, banks might need to discontinue the related hedging relationship retrospectively, with additional burdens and operational challenges. Similar considerations are applicable when the hedged item is represented by a compound instrument currently classified as a financial liability and for which, following the proposed amendments, related discretionary payments shall be accounted for within equity instead of in the income statement.

23. Given the potential implementation challenges stemming from certain aspects of the IASB proposal, the Committee welcomes the transitional relief provided in new paragraphs 97W and 97X, aimed at alleviating operational burdens for preparers when applying the standard retrospectively. Moreover, the Committee encourages the IASB to consider providing specific transitional arrangements related to hedge accounting and a reasonably sufficient time period for the implementation of the standard in order to allow preparers to perform an in-depth analysis of the impacts stemming from the IASB proposal. In addition, the IASB is invited to consider conducting a field test before finalising the standard in order to ensure that the proposal would not result in potential unintended consequences or in undesired effects.