ISDA Safe, Efficient Markets

International Accounting Standards Board
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3rd January 2019

Dear Sir/Madam,

**Ref.: Financial Instruments with Characteristics of Equity DP/2018/1**

The International Swaps and Derivatives Association ("ISDA")[1] is pleased for the opportunity to respond to the above referenced Public Consultation on the Discussion Paper ('DP') issued by the International Accounting Standards Board ("IASB").

The members of ISDA who are banks are not only preparers of financial information but also users. Financial statements are an important source of information for making credit assessments and lending decisions. Accordingly, this response reflects the views of ISDA members who are lenders as well as preparers.

Key Messages:

Our members accept that IAS 32 has a number of areas where it can be improved but do not believe the standard is "broken" and necessitates the introduction of the new principles and terms which the DP proposes. IAS 32 is widely understood and changes could be introduced to resolve the specific issues with IAS 32 rather than introducing a new model with new terms and untested principles, which may have unintended consequences.

In particular, our members are concerned about the 'amount' feature. These concerns are discussed more fully under our responses to Question 2, but in summary:

i) It is unclear how the DP's proposals would apply to most cumulative preference shares;

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[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 70 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA

ii) Distinguishing between cumulative and non-cumulative preference shares based on what would happen on a theoretical liquidation has little technical merit and does not reflect the economic substance of the instruments;
iii) The DP does not specifically address the treatment of non-cumulative preference shares where there is a call feature, but applying an IFRS 9 approach to measure the liability would result in a (mostly) liability classification for certain instruments that are currently classified as equity under IAS 32. This would have the same effect as applying an economic compulsion principle, even though the Board chose not to introduce one. This approach would also be divorced from the economic fundamentals of the instrument and so could give rise to structuring opportunities, such that the accounting outcome could be at the choice of the issuer;
iv) A number of the terms used in the amount feature such as 'amount' and 'liquidation' are also unclear and would need to be more clearly defined.

Our members do not support the increased use of other comprehensive income (OCI). We believe that the increased use of OCI for liabilities, which do not meet the amount feature, is contrary to the conceptual framework and should not be necessary if the principles of the DP were sufficiently robust. Our members believe that if the Board wishes to tackle 'counter-intuitive' accounting there are other ways that this can be done either through separate presentation within profit or loss or through disclosure.

Our members believe that the attribution of profits is too complicated and does not provide users with sufficiently useful information to justify the cost. Our members believe that most of the information required by users could be provided more usefully by improving IAS 33 together with additional disclosure on the impact on cashflows of the various settlement alternatives of the equity instruments. Information on cash flows (rather than an attribution of total comprehensive income) could provide simpler and more relevant information for users.

Our members, who do not believe that the DP as a whole represents an improvement on IAS 32, believe that there are parts of the DP that could be used to improve IAS 32 and resolve some of the long standing issues with the standard, including:

1. Clarification of the IAS 32 'fixed for fixed' principle to reflect the ideas set out in paragraphs 4.53 to 4.61 of the DP, so that changes in the terms of an instrument due to the passage of time, or the effect of dilution or missed distributions, would not prevent an instrument from being classified as equity (but see our response to Question 5);

2. Amendment of the IAS 32 treatment of foreign currency denominated instruments (see our response to Question 5);

3. Clarification of the treatment of NCI puts (but see our response to Question 6);

4. Clarification that statutory requirements are not relevant in classifying financial instruments (but see our response to Question 11).

The disclosure requirements of IFRS 7 should also be re-examined, particularly to help users of financial statements to understand the expected cashflows of equity instruments. However, our members do not support the introduction of further disaggregation of line items on the face of the financial statements and are opposed to additional disclosure if it overloads the financial statements without being commensurate with the value to users.

Overall, our members would not support the DP and its new principles, as currently drafted.

Yours faithfully,

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Appendices: I Responses to specific questions raised by the IASB
II Typical terms of AT1 instruments

**Appendix I– Responses to specific questions raised by the IASB**

**Section 1: Objectives and Challenges**

| Question 1<br><br>Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes.<br><br>(a) Do you agree with this description of the challenges and their causes?<br>Why or why not? Do you think there are other factors contributing to the challenges?<br><br>(b) Do you agree that the challenges identified are important to users of financial statements and are pervasive enough to require standard-setting activity? Why or why not? |
|---|

Our members agree with the list of challenges and their causes. We believe however that there are other challenges the Board should consider.

1. ***Linkage.*** Our members believe that the issue of linkage should be considered. The DP states that "for a standalone derivative to extinguish an equity instrument, consider the package of contractual rights and obligations arising from the derivative and the underlying non-derivative equity instrument that will or may be extinguished together" (DP 5.8). However beyond this specific requirement, the DP does not propose any principle whereby instruments should be linked or propose any wider application of the concept of package or linkage similar to the principle underlying the guidance in IFRS 9.IGB.6. We also note that the reference to 'package' in the DP does not require the instruments to be entered into at the same time, so the application proposed in the DP would appear to be much broader than that expressed in IFRS 9 IGB.6. The absence of a linkage principle means that there is the potential for confusion and could lead to structuring opportunities.

2. ***Foreign currency.*** Our members believe that the impact of foreign currency on classification under IAS 32 is also a challenge. Under IFRS 9 the holder of an asset assesses and accounts for the instrument in its currency of denomination and it is unclear why a similar principle should not apply under IAS 32 for the issuer.

3. ***Reclassification.*** If factors in the assessment change, such as where a call feature, which at origination was expected to be called and so required recognition of a liability, expires without being exercised, would such an instrument be reclassified from liability to equity or would it remain as a liability and be remeasured?

Our members believe that standard setting activity is required to resolve the problems that have been identified with IAS 32 but, as discussed above, do not believe that the challenges identified are so great or IAS 32 so broken, that the scale of rewrite envisaged by the DP is necessary.

**Section 2: the Board's preferred approach**

<table><tr><td>
Question 2<br><br>
The Board's preferred approach to classification would classify a claim as a liability if it contains:<br><br>
(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or<br><br>
(b) an unavoidable obligation for an amount independent of the entity's available economic resources.<br><br>
This is because, in the Board's view, information about both of these features is relevant to assessments of the entity's financial position and financial performance, as summarised in paragraph 2.50.<br><br>
The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.<br>
Do you agree? Why, or why not?
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Our members believe that the 'timing' feature has merit but that the 'amount' feature is flawed. The timing feature is close to the approach currently applied by IAS 32. However, the amount feature does not seem to contain a principle that is easily understood and may instead cause confusion in its application and have unexpected consequences.

The DP proposes that an irredeemable fixed-rate cumulative preference share should be classified as a liability as there is an obligation independent of the entity's available economic resources. However, we note that the DP gives the example of where, if the preference shares are non-cumulative but a fixed amount would be payable on liquidation, the NPV can be assumed to be nil. This raises a number of questions:

- If the entity is a going concern, can the period to liquidation always be deemed to be near infinite?
- Would the assessment of the instrument's life have to be reassessed after the instrument has been issued?
- What discount rate should be used to discount the liability?
- How would this principle apply to limited life entities, particularly entities whose life is limited by statute (see Question 11)?
- If, the coupon is cumulative but there is no obligation to pay interest on the arrears, assuming a near infinite life, would the NPV still be nil so there would again be no liability?
- If the instrument required that any arrears of coupon are waived on liquidation of the entity, would that mean that a cumulative preference share would be analysed in a similar manner to a non-cumulative preference share?

Our members also have a number of concerns:

1. If it can be assumed that the entity's life is infinite while it prepares its financial statements under the going concern principal, but not as soon as this is no longer valid, there will be a significant increase in liabilities as soon as the entity ceases to be a going concern. This is unlikely to be helpful to users of the accounts in this

circumstance, as the only amount that will ever be payable to preference shareholders will be limited to value of the net assets. In reality, preference shares behave much like debt when the entity is a going concern but absorb losses and so behave most like equity when it is not. Hence, what is proposed in the DP would portray the opposite of the substance of the instrument.

2. Given that cumulative preference shares sometimes do not pay interest on deferred coupons, the simple cumulative/non-cumulative distinction made by the DP will often be too simple. Applying the proposals in the DP, many cumulative preference shares may have no liability component or be hybrid instruments.

3. The distinction that the DP seeks to make between cumulative and non-cumulative preference shares is too stark, given that they differ little in substance. In practice:

    i) The key risks for the investors are, in both cases, extension risk (the risk that the borrowers will not redeem the securities at the next call date) and subordination risk (the increased risk of non-recovery vs. senior debt), rather than simply credit or deferral risk on the coupons and principal like a debt instrument (the risk of non-payment or deferral of coupons);
    ii) The remedies available to the investors in the event of financial difficulty of the issuer are the same: they cannot request repayment of principal;
    iii) The distinction has largely been driven by regulatory requirements (requiring non-cumulative instruments) rather than the market;
    iv) Certain rating agencies tend not to differentiate the equity credit assigned to cumulative and non-cumulative instruments, as consideration is given to the ability of issuers to defer payments before reaching liquidation. This means that, by certain rating agencies, these instruments are treated similarly, as part debt and part equity, in the same proportion regardless of whether they are cumulative or non-cumulative (all else being equal);
    v) On both a going concern and liquidation basis, cumulative and non-cumulative securities have similar recovery rates.

4. In addition, classifying cumulative preferred shares as a liability would raise level playing field issues with other jurisdictions such as the US where cumulative irredeemable preferred shares achieve equity accounting.

5. Although it was not included as one of the examples used in the DP to illustrate the principles, we understand that the fact pattern that some users believe is not well addressed by IAS 32 is where a preference share is callable by the issuer. Their concern is that the instrument is priced and traded assuming that the issuer will call it after (say) five years, and so classifying it as equity does not reflect the substance of the arrangement.

    Applying the DP approach, would the liability component of a callable preference share be measured based on the expectation of it being called, which would mean that there would be a large liability? Also, would such a treatment apply equally to non-cumulative preference shares as to cumulative preference shares? The treatment of call features will need to be made clear in any ED. It would also follow that if a call feature results in the recognition of a liability and the callable preference share is denominated in a foreign currency, that the call feature would be classified as a derivative. If our members' understanding is correct it would also be helpful to make this clear.

If it is the view of the Board that callable non-cumulative preference shares should be recorded to include a significant liability, our members are concerned that the effect of the amount principle is to reflect the issuer's economic compulsion, but without creating an economic compulsion principle. They believe that the approach is technically flawed because:

i) Any amounts payable on a preferred share on liquidation are not a liability but a preferred interest in the residual value of the assets of the entity after deducting its liabilities. The amount due to the preference shareholders on liquidation is limited by the value of the entity's net assets. This acts as a loss absorption mechanism and differentiates a preference share from what is contractually debt;

ii) A holder of such an instrument does not buy it in order to hold it to a far off liquidation;

iii) The approach would lead to the potential for structuring, such that the accounting outcome may not be what the IASB intends. Instruments such as these are usually priced based on the option being exercised, and what happens at liquidation is largely irrelevant to the economics of the instrument. It follows that it would be possible to structure such an instrument so that there is no pay-out on liquidation. The additional cost of such an instrument would normally be very small for a highly rated issuer. This would lead to diversity of accounting outcomes for instruments that are, in substance, very similar.

The divergence of the principle of classification away from the economic fundamentals of the instrument is not helpful and could lead to other anomalies. The treatment under IAS 32 for such instruments is well understood and our members do not believe that a change here is helpful. Our members believe that the existing treatment under IAS 32 should be retained with additional disclosures of the expected cash flows (see our response to question 7).

Our members also have concerns about specific issues with the application of the principles, which are unclear:

1. It is unclear whether the concept of 'liquidation', which applies to both the timing and the amount feature, also includes other insolvency arrangements, such as administration and other consequences of default, such as restructuring. This is something which the Board should address, particularly as the bank resolution regimes in a number of jurisdictions make it virtually impossible for a bank to go into 'liquidation'. Given the prevalence of Additional Tier 1 (AT1) issuances by financial institutions, clarity on this issue is vital.

2. The DP is not clear what is meant by 'amount'. DP 3.21 states that the amount is not the fair value of the financial instrument and that the assessment of the amount "depends on whether the amount specified in the contract (the contractual pay-off) changes in response to the available economic resource". It would appear that what is meant by 'amount' is the fair values of the cash flows on each settlement date. Given its importance to the approach, should the IASB progress with it, 'amount' should be clearly defined.

   Also, the DP does not make it clear as to the level at which the concept of available economic resources should be applied, that is, whether it applies at the issuer level or the reporting entity level. If the latter, all instruments issued by subsidiaries of the reporting entity and NCI would fail equity treatment as they would not be based on the (full) available economic resources of the reporting entity. Given that the DP recognises the concept of NCI, the implication is that the assessment should be made at the issuer level, but this would benefit from being made clear.

Overall, the proposed approach seems too complicated and unnecessary and unlikely to achieve the Board's expected outcomes. A new set of principles which are not well understood and too complicated to apply will give rise to new accounting issues. If the main concern of users is that the IAS 32 approach gives insufficient information about the expected cashflows of equity instruments, then this would be better addressed through enhancing the disclosure requirements (see Question 7).

In Appendix II to this letter we set out the typical terms of a number of different forms of AT1 instruments given that many of our members concerns expressed here would be relevant to such instruments.

## Section 3—Classification of non-derivative financial instruments

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?

See our responses to question 2.

Question 4

The Board's preliminary view is that the puttable exception would be required under the Board's preferred approach. Do you agree? Why, or why not?

Our members agree with the proposal in the DP that the puttable exception should be kept.

**Section 4: Classification of derivatives financial instruments**

Question 5

The Board's preliminary view for classifying derivatives on own equity—other than derivatives that include an obligation to extinguish an entity's own equity instruments—are as follows:

(a) a derivative on own equity would be classified in its entirety as an equity instrument, a financial asset or a financial liability; the individual legs of the exchange would not be separately classified; and

(b) a derivative on own equity is classified as a financial asset or a financial liability if:

(i) it is net-cash settled—the derivative requires the entity to deliver cash or another financial asset, and/or contains a right to receive cash for the net amount, at a specified time other than at liquidation; and/or

(ii) the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources.

Do you agree? Why, or why not?

There are certain issues that we believe the Board might wish to consider further.

1. Embedded derivatives

It is not always clear where the derivative guidance takes over from the amount feature. Where the pay out on an instrument is determined based on the performance of an index or basket of equities which includes the entity's own equity, it is not clear what the accounting would be. As the entity is a constituent of the basket, the pay-out is not independent of the financial resources of the entity, hence according to the amount principle there is arguably no liability.

It is not clear if this would be regarded as a compound instrument with an equity host and an embedded derivative for the other components of the index or basket. Our members believe this should be clarified.

2. Measurement mismatches

The DP does not provide any option to designate a liability at fair value in the case of an accounting mismatch and our members suggest that the Board consider providing such an option. Where an entity enters into a derivative over an index which includes the entity's own equity and hedges its position through a series of derivatives on the various components, including its own equity, the index derivative will be measured at fair value through profit or loss under IFRS 9 while the element of the hedge relating to the entity's own shares will be measured at fair value through OCI as it is a derivative over own equity with no independent variable. Therefore without the option to designate at FVPL there will be an accounting mismatch between profit or loss and OCI.

3. Stock borrows and similar costs.

Many equity derivatives include price adjustments that cause the settlement amount to vary with:

i) changes in dividends paid on the underlying shares;
ii) changes in withholding tax rates for one or both parties to the contract;
iii) changes in hedging costs for the derivative counterparty;
iv) changes in stock borrow costs for the derivative counterparty; and
v) market disruption clauses which require adjustment for hedging costs;
vi) the adjustment of terms of the derivative or financial instrument to offset the net gain or loss resulting from a merger announcement, tender offer or a similar event.

It would be helpful for the ED to clarify how these would be considered and which of these would be viewed as independent variables that would cause a derivative to be classified as a liability. If these are viewed as independent variables, few existing equity derivatives would qualify to be accounted for as equity.

4. Net share settled derivatives

Net share settled derivatives to deliver a fixed number of an entity's own shares in exchange for receiving a variable number of its own shares for a value equal to a fixed amount in the entity's functional currency would be classified as an equity instrument under the DP (DP 4.42(a)). This is despite it being possible for the entity to be required to deliver or receive shares.

However a derivative to deliver a variable number of own shares equal to a fixed amount of cash in exchange for receiving a fixed number of own shares (e.g. the reverse of the above) would be treated as a compound instrument because it results in the extinguishment of a fixed number of own equities and in this case the entity needs to consider the whole of the redemption obligation (DP5.15).

While the logic in the DP may work in the case of an option, because the outcome will be that either shares are delivered if the option is in the money or not if the option is out of the money, with other forms of derivatives this will not be the case. In the case of a swap, the entity either receives or delivers shares depending on the movement of the share price, in which case there will not necessarily be an extinguishment of own equity instruments. It is not clear conceptually why these instruments should be classified as a redemption obligation arrangement when they are just as likely to lead to own shares being received.

5. Foreign currency instruments

It is unclear why, under both IAS 32 and the proposals in the DP, a foreign currency convertible bond contains a derivative as opposed to an equity component. Under IFRS 9, the holder of an asset always assesses and accounts for the instrument in its currency and it is unclear why the same principle should not apply to the issuer as well. In certain jurisdictions, entities have to raise capital in their non-functional currency due to limited liquidity in the markets for their functional currency. These foreign currency bonds are frequently hedged to their functional currency by currency swaps. The proposed requirement in the DP does not consider the impact of the linkage between the foreign currency bond and the derivative hedge and requires the foreign currency bond to be accounted for as a convertible bond.

The DP is also unclear whether the classification of an instrument changes if the functional currency changes. For example, would an instrument which is denominated in a foreign currency and is classified as a liability solely because the foreign currency is an independent variable, be reclassified as equity if the functional currency of the entity changed to that currency in which the instrument is denominated, as the currency would cease to be an independent variable? (Or vice versa). This is an example of a wider issue, as to whether the debt-equity classification needs to be reassessed if circumstances change.

This is an example of an area where our members believe that there is scope for improvement of IAS 32, and believe that improving IAS 32 would be preferable to wholesale changes to the standard.

6. Dilution

The DP proposes that a contractual term may adjust the amount of a derivative on own equity, such as adjustments in the conversion ratio or strike price, to compensate the holder for missed distributions to which holders of existing equity instruments would be entitled (DP 4.59). Varying a conversion ratio for time value and to align the bondholder with a holder of ordinary shares makes sense and we believe this could be incorporated into IAS 32.

The DP in 4.55 to 4.56 suggests that an anti-dilution provision which adjusts the conversion ratio in the event of dilution to keep the derivative holder in the same economic position as ordinary shareholders would not necessarily introduce an independent variable and would therefore not cause the instrument to be classified as a liability. However it is not clear whether a “down round” feature would also be considered to be not independent. “Down round” features require the downward adjustment of the strike price of a convertible bond if new shares are issued at a price lower than the conversion price. This protects the holders of the convertible instrument from the dilution risk which is suffered by the ordinary shareholders and therefore puts them in a better position than the shareholders.

Similar to the point on “down rounds” above, we are also unclear whether the DP means to propose that other asymmetric dilutions where the derivative holder is put in a better position than the shareholders, are not independent variables. The example in DP 4.58 suggest this is the case in the example in which the holder of the option is entitled to receive 25% of the shares in issue for a fixed amount of functional currency. This puts the option holder in a much stronger position than the equity holders as, if any new shares are issued, the option holder will continue to have a right to 25% of the shares for a fixed amount of functional currency while the equity holders will have paid for the new shares issued.

## Section 5—Compound instruments and redemption obligation arrangements

Question 6

Do you agree with the Board’s preliminary views set out in paragraphs 5.48(a)–(b)? Why, or why not? Applying these preliminary views to a derivative that could result in the extinguishment of an entity’s own equity instruments, such as a written put option on own shares, would result in the accounting as described in paragraph 5.30 and as illustrated in paragraphs 5.33–5.34.

For financial instruments with alternative settlement outcomes that do not contain an unavoidable contractual obligation that has the feature(s) of a financial liability as described in paragraph 5.48(c), the Board considered possible ways to provide information about the alternative settlement outcomes as described in paragraphs 5.43–5.47.

(a) Do you think the Board should seek to address the issue? Why, or why not?

(b) If so what approach do you think would be most effective in providing the information, and why?

While we agree that NCI puts should be classified as gross liabilities, our members do not agree with the notion that an issue of a share and a short put is ‘equivalent’ to a liability with an embedded short call for the following reasons:

i) On the former the entity pays dividends, on the latter interest;
ii) In the event of insolvency before the option exercise date the position of the counterparty would be very different;
iii) In the former case the other party has a right to vote.

Our members believe that it is appropriate to account for the NCI put as a liability but believe it would be more appropriate to recognise the debit within equity rather than derecognising the NCI shares. This is because the shareholding still legally exists and the NCI holders of those shares are entitled to the distributions from the subsidiary. The proposal is unclear if a dividend received by the NCI holder would be presented as interest.

**Section 6—Presentation**

Question 7

Do you agree with the Board’s preliminary views stated in paragraphs 6.53–6.54? Why, or why not?

The Board also considered whether or not it should require separation of embedded derivatives from the host contract for the purposes of the presentation requirements as discussed in paragraphs 6.37–6.41. Which alternative in paragraph 6.38 do you think strikes the right balance between the benefits of providing useful information and the costs of application, and why?

While our members appreciate the Board’s concerns around the counter-intuitive accounting effects of financial instruments that contain an obligation for an amount that is affected by changes in the entity’s economic resources, our members do not believe that increased use of OCI is appropriate. The Revised Conceptual Framework states that “the Board may decide in exceptional circumstances that income or expenses arising from a change in the current value of an asset or liability are to be included in other comprehensive income when doing so would result in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that period” (CP 7.17). Our members do not believe that use of OCI proposed in the DP amounts to an “exceptional circumstance”. Our members believe that there are other ways this information can be brought to the users’ attention either through disclosure or through separate presentation in the income statement. We do not believe that adding more items to the statement of other comprehensive income is helpful or appropriate.

Our members also note that the DP proposes that amounts recognised in OCI for these instruments is not recycled to profit or loss despite the rebuttal presumption in the Revised Conceptual Framework. “Income and expenses included in other comprehensive income in one period are reclassified from other comprehensive income into the statement of profit or loss in a future period when doing so results in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that future period" (CP 7.19). As the instruments covered by this requirement would all be classified as liabilities because of the timing feature, there is a clear basis for identifying the period in which reclassification occurs and we do not see why there should not be recycling to profit or loss on settlement. Furthermore, we note that in IFRS 9 where the own credit element of a designated to fair value financial liability is presented in OCI without recycling, the own credit element will usually revert to zero by maturity. This will not be the case here.

The proposal set out in DP 6.34 would require derivatives affected by currency to be recorded at FVPL unless the denomination is imposed by an external factor, such as law, regulation or market forces. This can be read to mean that those entities that originally requested the rights issue exemption would not qualify, since the denomination was not strictly required by law, regulation or market forces. However, the denomination was consistent with that of the ordinary shares and it would have been impractical to have issued the rights issue in the functional currency without first creating shares in that currency. It would be helpful for the IASB to make it clear that this fact pattern would qualify for measurement through OCI.

One consequence of applying the available economic resources notion at the subsidiary level will be that fund units issued by subsidiary funds (that do not qualify for the puttable exception) and reported at the group level will be financial liabilities whose 'amount' feature would not be independent of the entity's available economic resources and in accordance with the proposals in 6.11 (a) in the DP will require separate presentation in OCI. This will create a mismatch between fair value movement of these units and assets entered into the determination of funds NAV. It would be appropriate for there to be an option to record fair value changes in profit or loss if to do otherwise would create a measurement mismatch.

It is the view of our members that remeasurement of a derivative embedded in a hybrid instrument but that is not separated, should be reported in OCI if it would qualify to do so, is unnecessarily complicated.

Question 8

The Board's preliminary view is that it would be useful to users of financial statements assessing the distribution of returns among equity instruments to expand the attribution of income and expenses to some equity instruments other than ordinary shares. Do you agree? Why, or why not?

The Board's preliminary view is that the attribution for non-derivative equity instruments should be based on the existing requirements of IAS 33. Do you agree? Why, or why not?

The Board did not form a preliminary view in relation to the attribution approach for derivative equity instruments. However, the Board considered various approaches, including:

(a) a full fair value approach (paragraphs 6.74–6.78);
(b) the average-of-period approach (paragraphs 6.79–6.82);
(c) the end-of-period approach (paragraphs 6.83–6.86); and
(d) not requiring attribution, but using disclosure as introduced in paragraphs 6.87–6.90 and developed in paragraphs 7.13–7.25.

Which approach do you think would best balance the costs and benefits of improving information provided to users of financial statements?

Our members disagree with the attribution approach. It is complex and the costs are likely to exceed any benefits. Our members believe the real issue is with IAS 33 which is both difficult to understand and explain and needs updating. The DP highlights a number of defects with IAS 33 including:

- potential ordinary shares are considered dilutive only if the potential ordinary shares decrease earnings (or increase loss) per share from continuing operations;
- there is no specific requirement to disclose the effect of options or warrants that are antidilutive, i.e. out-of-the-money and purchased options;
- the calculation of diluted earnings per share reflects the intrinsic value of the option rather than the fair value;
- there is a lack of information on:
  - the total number of ordinary shares potentially outstanding at the period end;
  - the number of shares that could be issued to settle instruments that could dilute basic EPS but are anti-dilutive;
- there is no requirement to provide information about potential changes in the number of shares outstanding at period end arising from existing rights and obligations.

We believe the Board could more usefully address these known shortcomings in IAS 33. It is unclear what information the attribution approach proposed in the DP is trying to provide and whether it is doing so in a way that makes sense. Profit is attributed for listed entities using the requirements of IAS 33, whereas the attribution approach proposed in the DP covers total comprehensive income and so is different from EPS.

Whilst we understand that these requirements have been proposed to address the requests of equity analysts, we are concerned that the application of these proposed requirements will result in added complexity and result in making the financial statements less accessible to other users of the financial statements.

We are also concerned that the DP does not provide any scoping for this requirement. IAS 33 is only required for listed entities. As a minimum we would expect entities that are scoped out of IAS 33 to be scoped out of the proposed attribution requirements.

Given the current issues with IAS 33, our members believe that it would be more appropriate to improve IAS 33 and the disclosures around IAS 33 and provide information through additional disclosure. We believe that much of the additional information that users require could be provided by enhanced disclosure of the impact of certain events on cash flows. Such disclosure could take the form of information concerning conditions required for the triggering of settlement of obligations related to such instruments and their impacts on cash flows. If the Board decided not to proceed with the amount principle (see our response to Question 2) then such disclosure could include conditions and cash flows related to callable preferred shares.

**Section 7—Disclosure**

Question 9

The Board's preliminary view is that providing the following information in the notes to the financial statements would be useful to users of financial instruments:

(a) information about the priority of financial liabilities and equity instruments on liquidation (see paragraphs 7.7–7.8). Entities could choose to present financial liabilities and equity instruments in order of priority, either on the statement of financial position, or in the notes (see paragraphs 6.8–6.9).

(b) information about potential dilution of ordinary shares. These disclosures would include potential dilution for all potential issuance of ordinary shares (see paragraphs 7.21–7.22).

(c) information about terms and conditions should be provided for both financial liabilities and equity instruments in the notes to the financial statements (see paragraphs 7.26–7.29).

Do you agree with the Board's preliminary view? Why, or why not?

How would you improve the Board's suggestions in order to provide useful information to users of financial statements that will overcome the challenges identified in paragraphs 7.10 and 7.29?

Are there other challenges that you think the Board should consider when developing its preliminary views on disclosures?

Our members agree that the disclosure requirements of IFRS 7 should be re-examined, in particular since they believe that disclosure would be a better solution to some of the concerns of users that have led to the proposal of the 'amount feature' (see Question 2). However, they do not support the introduction of further disaggregation of line items on the face of the financial statements and are opposed to additional disclosure if it overloads the financial statements. Before the introduction of IFRS 7, IAS 32 required disclosure of information about the terms and conditions of financial liabilities and equity instruments that were deleted due to this concern. The proposed additions could result in a significant increase in the disclosures, especially for entities which have a large number of issued instruments, and our members would challenge whether the proposed requirements will provide users with information that is useful. Our members recommend that the ED includes a disclosure objective that allows for the level of detail that is required to be disclosed to be commensurate with the value to users.

There are also significant disclosure requirements from regulatory bodies such as the BIS (Bank for International Settlements). Our members would recommend that the IASB considers existing and proposed disclosure requirements and as far as possible seek to align the disclosure requirements proposed in the DP with those of regulatory bodies.

The DP proposes providing a list of all financial liabilities and equity instruments in order of priority (DP 7.8(a)). Our members note that listing claims by priority in liquidation can be challenging in consolidated accounts since the level of priority will be specific to individual entities. The proposed approach should consider how this information can be disclosed on a consolidated level as well as on an individual basis.

**<u>Section 8—Contractual terms</u>**

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| Question 10<br><br>Do you agree with the Board's preliminary view that:<br><br>(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?<br><br>(b) the requirements in paragraph 20 of IAS 32 for indirect obligations should be retained? Why, or why not? |

Our members agree with the DP's proposal to continue with the approach in IAS 32 to not consider economic incentives in classifying equity and liabilities.

Our members agree with retaining the requirements of IAS 32.20.

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| Question 11<br><br>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.<br><br>Do you agree? Why, or why not? |

Our members agree in principle that the DP's approach should be applied in accordance with the substance of the contractual arrangements in line with the requirements of IAS 32.15. Our members appreciate that this gives consistency with standards such as IFRS 9, however believe that whilst the contractual principle generally works when considering the solely payments of principal and interest test under IFRS 9, there are potential problems when applying the same approach to the classification of financial liabilities and equity. There are a number of issues concerning this principle, which our members believe the Board should consider.

1. The scope paragraph of IFRIC 2 states unambiguously that the interpretation applies to financial instruments within the scope of IAS 32 (IFRIC 2.3), so if the proposed approach is to be adopted the scope of IFRIC 2 would need to be amended.

2. Certain contracts have contractual terms which mirror statutory requirements. It is not clear whether such terms would be regarded as contractual or statutory terms. In addition it is not clear whether an instrument which explicitly mirrors statutory requirements is treated in the same way as an economically identical instrument which is affected by the law or regulation without specifying those terms in the contract. Both have the same economic effect. One way this is interpreted under IFRS 9 is that such terms should only be regarded as contractual if they would remain unchanged if there statutory or regulatory requirements are amended. If the IASB agrees with this interpretation it would be helpful to make this clear.

3. It is not clear, under the DP, whether contractual terms that provide an option to a statutory person such as a regulator should be regarded as a contractual or statutory term. For example, certain unsecured, subordinated instruments, which are designed to absorb losses, provide their regulator with the option to convert the instrument to equity or to write down the instrument in the event of an event specified in the contract or in statute.

4. The DP is not clear what happens where certain contractual terms are not required because statute provides default terms, for example in the UK, it is not legally required to have contractual terms for ordinary shares, but the default is that the terms (i.e., the memorandum and articles) are set by statute ('Table A'). In many other jurisdictions shares are a statutory rather than a contractual concept. It is not clear whether these terms would be contractual terms by default or whether they are statutory and would be ignored under the proposals in the DP?

5. As already mentioned in response to Question 2, the principles proposed in the DP place reliance on an entity's obligations to transfer economic resources at liquidation. In many jurisdictions, procedures on liquidation are driven by statute or regulation rather than contractual terms. It is therefore unclear whether, when analysing an entity's obligations at liquidation, statutory requirements should be ignored.

6. The Revised Conceptual Framework when discussing obligations states, "many obligations are established by contract, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed". (CF 4.31) This implies that conceptually there is a requirement to look wider than the contractual terms and to also consider legislation and legal enforceability when considering obligations. The Board should consider whether this principle should also be applied with financial liability and equity instruments.

**Appendix 2 – typical terms of AT1 instruments**

Bank AT1s and insurance RT1s are issued to bolster the regulatory capital ratios of the issuer. There are in excess of €100bn of AT1s and RT1s outstanding issued by European issuers alone. A significant portion is classified as equity under IFRS and as Additional Tier 1 (for banks)/ Restricted Tier 1 (for insurers) under Basel/CRR regime.

While the mechanism for loss absorption may vary, as noted in the four variants below, other key terms are typically as follows:

- Issuer: bank or other deposit-taking institution;
- Maturity: no final maturity; the issuer usually has the discretion to redeem the Notes at their nominal amount (plus accrued unpaid interest) after [5-10] years from the issue date; no obligation to redeem the notes at any time other than liquidation;
- Ranking in liquidation: in liquidation hybrid noteholders have a claim for the nominal amount of the notes (plus accrued unpaid interest) ranking subordinated to senior claims and senior to ordinary share capital;
- Distributions: Subject to deferral noted below, AT1 noteholders are entitled to fixed distributions every [12] months set on the issue date of the Notes as a percentage of their nominal amount. The distribution rate is usually reset on regular intervals to reflect moves in benchmark rates;
- Distributions' deferral: the payment of distributions is at the issuer's discretion. Should the issuer elect to defer a payment, such a distribution would be lost to noteholders (i.e. non cumulative);
- Issuer special event calls: the issuer has the discretion to redeem the notes in special circumstances such as if the notes were to lose their regulatory treatment.

Mechanism for Principal Loss Absorption:

1. *Temporary write down*: if the CET1/solvency capital ratio of the issuer falls below a certain threshold [or if the relevant authority deems the issuer non-viable], the nominal amount of the Notes would be written down. The nominal amount of the Notes could subsequently be written back up at the discretion of the issuer upon a return to financial health.
2. *Permanent write down*: as for 1 above, except the write down is permanent.
3. *Conversion into variable number of shares*: if the CET1 capital ratio of the issuer falls below a certain threshold [or if the relevant authority deems the issuer non-viable], the nominal amount of the Notes would be converted to a variable numbers of shares based on the then-prevalent share price. Note that to avoid dilution most variable share AT1 notes have a floor on the share price (i.e. cap on the number of shares to be issued).
4. *Conversion into fixed number of shares:* as for 3 except the conversion is into a predetermined fixed number of shares.