POSITION PAPER

IASB Discussion Paper – DP/2018/1 – Financial Instruments with Characteristics of Equity

ESBG (European Savings and Retail Banking Group)

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ESBG

General Comments

ESBG welcomes the opportunity to comment on the IASB's Discussion Paper - DP/2018/1 - Financial Instruments with Characteristics of Equity (the DP or FICE DP).

We would like to express our support to the IASB in its approach to carry out a project with the outcome of establishing solid principles for the distinction between liabilities and equity, without the need of an extensive list of rules and exceptions. The latter should be only considered in the new version of the Standard when the application of the general principles result in a classification which does not reflect the economic substance of the instrument.

Having said that, we believe that the principles identified by the IASB are not always clear to apply to some instruments, therefore ESBG questions whether the DP introduces excessive complexity. If the IASB were not able to define a set of solid principles to distinguish between liabilities and equity, then we would be more in favour of making limited changes to current IAS 32. This is in order to avoid new uncertainties in the classification between liabilities and equity and unintended accounting consequences.

We also question the fact that the DP does not specifically address interaction between 'contractual rights and obligations' and 'regulatory and legal' requirements which may impact the treatment of particular instruments (e.g. bail-in instruments). We may agree that the classification should be focused on the contractual terms of a financial instrument (consistently with IAS 32 and IFRS 9); however we also note that in IFRS 17 Insurance Contracts specific legal issues are considered in the standard.

In our view, there are still uncertainties on contingent convertible instruments (CoCos) which, upon a trigger event, may be mandatorily convertible into a variable number of own shares or there may be a mandatory write-down, which could also be at the discretion of the regulator. In this sense, we would expect sufficient guidance to permit an understanding of how these instruments will be classified under the IASB preferred approach.

Additional concerns exist regarding the treatment for undated non-cumulative preference shares with conversion, which deliver a variable amount of shares upon an event outside the control of entity, e.g. Tier 1 capital falling below a threshold. The conversion rate includes a floor price on shares and dividends are discretionary and non-cumulative. As per IAS 32 and the previous IFRIC discussions, these instruments, which are quite common in some jurisdictions, are considered as compound instruments: financial liability is measured at amortised cost, the equity component is zero and dividends are recognised in equity.

Moreover, we question the relevance of the amount condition which may trigger the reclassification of a non-cumulative perpetual instrument as a financial liability only based on settlement upon a remote event such as liquidation. This condition would unduly trigger the reclassification of instruments currently recognised as equity instruments such as cooperative bank shares or certain types of non-cumulative additional tier one. These instruments have no obligation to transfer cash (except under liquidation) and are designed as priority instruments to absorb losses (contrary to ordinary debt instruments). The lack of right to residual positive retained earnings upon liquidation should not prevent these instruments from being classified as equity.

The attribution approach introduces new complex reporting mechanism involving fair valuation of equity items with a questionable added value. Therefore, it should be carefully weighed against the real

need for its introduction from users' perspective. Some concerns could be alleviated by treating gross settled derivatives on own shares as derivative assets and liabilities.

We believe that at least the cases of derivatives with own shares which do not serve for issuing or repurchasing equity from long-term perspective would deserve a standard derivative rather than equity treatment. I.e. they should be treated as derivative financial assets and liabilities and revalued through profit or loss. The IASB should develop criteria which would define when treating gross settled derivatives with own shares as standard derivatives (e.g. when the entity acts as market maker or when using the derivatives for hedging other positions which are revalued through P&L). IAS 32 and IFRS 9 already use a similar approach in respect of contracts to buy or sell non-financial items.

On the other hand, ESBG believes that there are issues that the DP does not address sufficiently which are currently creating problems and diversity in practice:

a) Accounting of NCI puts (as mentioned already in the EFRAG letter, paras. 188 and 189).
b) Issued instruments which include '"temporary" write-off' clauses.
c) How the 'liquidation scenario' should be understood in the case of financial entities under the resolution mechanism.
d) Information related to 'priority of claims' is applicable only to instruments which are under the scope of the DP, whereas users may be also interested in obtaining an understanding about the priority of other balances such those with employees, tax authorities, etc.
e) Accounting for any interest or dividends paid on financial instruments that are mandatorily convertible into a variable number of shares upon a contingent non-viability event when such interest or dividends are discretionary (PL or equity).

Section 1 - Objective, scope and challenges

Question to Constituents 21 Are constituents aware of **any other challenges with IAS 32** that have not been identified by EFRAG and the IASB?

No other challenges have been identified. In our view, the main issue with IAS 32 is the diversity in practice and the difficulties in classifying new complex instruments, such as compound instruments. However, we are not convinced that the expected benefits of the IASB's preferred approach outweigh the costs of its implementation. While some of the existing issues could be solved, uncertainty may also arise from the application of the new approach.

Section 2 - The IASB's preferred approach

Questions to Constituents 41 In paragraph 33 EFRAG agrees that information provided in the financial statements about claims on an entity should help users to assess the entity's liquidity and solvency. These information needs are also identified in the Conceptual Framework for Financial Reporting. The DP suggests providing information on both these factors by considering both 'timing' and 'amount' when distinguishing equity from a liability. EFRAG has considered whether it provides the most useful information to consider both these dimensions when distinguishing equity and liabilities. **Do you think that information about both liquidity and solvency should be provided through the classifications of claims on an entity?** If so, do you agree with using both the 'timing' and the 'amount' features when distinguishing equity from a financial liability from equity? If not, how should the distinction be made? 42 The IASB decided that, while the objective of the FICE project is to respond to challenges in distinguishing financial liabilities from equity instruments when applying IAS 32, any potential solution should limit unnecessary changes to classification outcomes that are already well understood. **Considering the IASB's preferred approach described in the DP, do you expect significant classification changes? If so, please describe the type(s) and extent of instruments affected, the existing classification in accordance with IAS 32 and why the classification could or would changes in accordance with the IASB's preferred approach**.

We agree that information provided in the financial statements about an entity's claims should help users to assess the entity's liquidity and solvency. Classification of claims based on the timing and amount features can serve as a starting point to achieve this objective. However, we would recommend the IASB to carefully assess whether this objective cannot be addressed by improving presentation and disclosure requirements, rather than by introducing new terms which may create significant implementation costs for preparers.

In this regard, it is worth mentioning the fact that the banking industry already discloses comprehensive and detailed information about their capital positions (i.e. under the Basel Committee's Pillar 3 framework, internationally active banks are required to disclose a description of the main features of regulatory capital instruments as well as to make available the full terms and conditions of their regulatory capital instruments).

In addition, as mentioned in the cover note, users could benefit from including in the disclosures related to priority of claims information of other account balances excluded from the scope of the DP such as obligations with employees, tax authorities, etc.

The main classification changes due to the application of the IASB's preferred approach are identified in Appendix D *Comparison of the Board's preferred approach and IAS 32* in the FICE DP and also detailed by EFRAG in its Draft Comment Letter.

However, the DP raises concern regarding cooperative shares, currently classified as equity instruments. When applying the IASB's preferred approach to members' shares in co-operative entities the 'timing' feature does not seem to be an issue (because of IFRIC2). However, further clarification regarding the 'amount' feature, due to a specific feature of most cooperative member shares would be required. Cooperative shares are normally issued at face value and reimbursed at face value. The holder does not have access to retained earnings, which form a kind of "collective" capital. Only if losses go beyond retained earnings, a value lower than the face value would be redeemed. Since the redemption amount depends only partially on available economic (loss absorption but no right on retained earnings in case of liquidation), this seems to meet the "amount" condition proposed by the DP to define liability.

Therefore, when applying the IASB's preferred approach to members' shares in co-operative entities, the 'amount' feature seems to fundamentally change the existing classification outcome of IAS 32 as the current guidance proposed in the DP does not take into account the very specific features of members' shares. This change could have an impact on regulatory capital (CET1) which is linked to the accounting classification. We believe that this consequence is not aligned with the Board's expectation to fundamentally not change the classification outcome of IAS 32.

Section 3A - Classification of non-derivative financial instruments

Question to Constituents
73 **What are the most common non-derivative financial instruments with characteristics of equity in your jurisdiction** (e.g. perpetual bonds, reverse convertible bonds, callable shares with discretionary dividend, non-cumulative and cumulative preference shares, etc.)?
74 Do you consider that **it is relevant to classify financial instruments that are only settled on liquidation** (e.g. cumulative preference shares) **as financial liabilities**?

The most common non-derivative financial instruments in our jurisdiction for financial entities are additional Tier 1 instruments, particularly non-cumulative preference shares with conversion, which either deliver a variable amount of shares or may be written down upon events outside control of entity, e.g. Tier 1 capital falling below specific threshold.

Different views in practice, being classified as liabilities or equity in their entirety or as compounds instruments. We question the relevance of the amount condition when it leads to identify a liability component for non-cumulative perpetual instruments only based on settlement upon a remote event such as liquidation. The liability component may be nil or insignificant (according to the DP). However, the DP introduce complexity and uncertainty on the outcome because there is no guidance on the method and assumption to demonstrate that the liability component is nil. We also consider that, for these particular instruments, the DP may have unintended consequences (for the holder under IFRS 9 for instance) since they will not be qualified as "pure" equity any more.

In light of the above, we agree that for some instruments the issue on classification can be more related to a 'resolution' than to 'liquidation', as stated by EFRAG in paragraph 35b) From this perspective, the concept of resolution may need to be taken into account for classification of some financial instruments.

Section 3B – Puttable exception

Questions to Constituents
86 To what extent is the **'puttable instruments' exception** in paragraph 16A-B **used in your jurisdiction**?
87 To what extent is the **'obligations arising on liquidation' exception** in paragraph 16C-16D **used in your jurisdiction**?
88 What are the **application challenges that arise with these two exceptions**?

We do not have sufficient data to conclude whether the 'puttable instruments' exception and the 'obligations arising on liquidation' exception are used in our jurisdiction.

In any case, we share the IASB's view to carry forward the exception to account for some financial liabilities as if they are equity instruments if they meet the conditions as set out in paragraphs 16A–16B or 16C–16D of IAS 32.

Section 4 - Classification of derivative financial instruments

Notes to Constituents
111 Some commentators consider that standalone and embedded derivatives on own equity should be classified as derivatives assets or derivatives liabilities at fair value through profit or loss. This would mean that all standalone and embedded derivatives on own equity would be scoped out from IAS 32 to be under the scope of IFRS 9.
Questions to Constituents
112 Considering the arguments provided in paragraph 105 above, do you consider that **accounting for all derivatives on own equity as derivatives assets or derivatives liabilities under the scope of IFRS 9 together with disclosures on the maturity of any redemption amount under IFRS 7 would be a simpler approach and still provide relevant information to users** of financial statements?

As mentioned in the cover note, we believe that at least the cases of derivatives with own shares which do not serve for issuing or repurchasing equity from long-term perspective would deserve a standard derivative rather than equity treatment. (i.e. they should be treated as derivative financial assets and liabilities and revalued through profit or loss). The IASB should develop criteria which would define when treating gross settled derivatives with own shares as standard derivatives (e.g. when the entity acts as market maker or when using the derivatives for hedging other positions which are revalued through P&L). IAS 32 and IFRS 9 already use a similar approach in respect of contracts to buy or sell non-financial items.

Section 5 - Compound instruments and redemption obligation arrangements

Questions to Constituents
206 To what extent are **contingent convertible bonds (CoCo's) and written puts on NCI used by the entities in your jurisdiction**?
207 What **types of entities** are using them the most?

As mentioned in section 3A, contingent convertible bonds are particularly common in our jurisdiction, especially within the banking industry.

Section 6 – Presentation

Section 7 – Disclosure

Section 8 - Contractual terms

Question to Constituents 387 To what extent is the IFRIC 2 interpretation being used by the entities in your jurisdiction?

We understand that the interpretation and application of IFRIC 2 *Members' Shares in Co-operative Entities and Similar Instruments* is quite limited in Spain, however it is widely used by several cooperative banks (for example in France).

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 1,000 banks, which together employ 780,000 people driven to innovate at 56,000 outlets. ESBG members have total assets of €6.2 trillion, provide €500 billion in SME loans, and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking.

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