POSITION PAPER

WSBI–ESBG Position Paper to the EFRAG consultation on its Draft Comment Letter (DCL) in response to the IASB Exposure Draft (ED) on Financial Instruments with Characteristics of Equity (FICE)

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GENERAL COMMENTS

In general, we welcome the IASB's efforts and approach to addressing issues that arise in practice related to IAS 32 Financial Instruments: Presentation by clarifying some of the underlying principles in IAS 32 and adding application guidance to facilitate the consistent application of the principles.

At the same time, we have some suggestions and concerns for reconsidering or clarifying the proposed requirements and providing additional guidance. The most important are:

- in assessing whether a contractual right or obligation is required by laws or regulations, we would expect more clarification and examples to illustrate the application of this requirement in order to ensure comparability across companies and to avoid unintended consequences on the classification of financial instruments that may arise from applying the IASB's proposals.
- recognition of the liability for the obligation to redeem entity's non-controlling interest should reduce non-controlling interests (as a separate component);
- removing the confusion in the Basis for Conclusions which may lead to viewing the loss absorption feature in Additional Tier 1 instruments as legal rather than contractual feature;
- additional guidance on how the total comprehensive income attributable to other owners of the parent is calculated; and
- it is important to test the new disclosure requirements to ensure that they are clear and can be implemented by entities, so the benefits of the disclosures will compensate the efforts to prepare them.

1. The effects of relevant laws or regulations

The combination of both contractual and legal regulations (enforceable framework) is necessary to understand the contract. The classification for an issuer solely based on contractual terms may lead to outcomes that contradict the principle-based nature of IFRS Accounting Standards. It may be noted that law and regulation can be changed unilaterally by an authority (without agreement from the counterparties in the contract) and that thus, in an all-inclusive approach, this could lead to continuous classification changes when there are frequent changes in the law. Further, this might impact the equity of an entity and accordingly may impact the lending decisions of a financial institution giving loans to such entity.

In assessing whether a contractual right or obligation is required by laws or regulations, we agree with EFRAG's concern on the practical challenges and unintended consequences on the classification of financial instruments that may arise from applying the IASB's proposals. In particular, we believe there are merits in exploring the consequences of the IASB proposals for certain instruments, both under the approach of the issuer and the holder, for example on puttable instruments where the obligation to repurchase for the issuer is set by regulation, and in the case of compound instruments when the remuneration is set by law and the instrument is classified as a liability.

The ED does not define what are laws or regulations and we believe that further clarification would be needed in this regard. In particular, it is important to clarify whether the regulatory guidance issued by a prudential regulator – which is expected to be applied by the entity although it is not a law or regulation by itself - is equivalent to those required by laws or regulations to ensure comparability across companies and to minimise diversity in practice.

Moreover, it may be complex to assess whether the terms explicitly stated in the contract are actually "in addition" to what is established by law. When a law or regulation mandatorily requires a contractual term to be included for all instruments issued, such term is not in addition to laws or regulations and, therefore, an entity would not consider that right or obligation for classification purposes. In contrast, if the issuance of a particular type of instrument is at the discretion of the issuer, it is unclear whether this is in addition to laws or regulations. We note that this proposed requirement is open to different interpretations and further clarification and field-testing would be essential in this context. Furthermore, for some of our members, it is important that 'bail-in' provisions resulting from legislation are disregarded when classifying financial instruments. This is achieved in the exposure draft, in our view.

However, we would like to note that the description of the 'bail-in' provisions in paragraph BC13(a) of the ED using Additional Tier 1 (AT1) instruments as an example is not correct. The loss-absorption feature referred to in this paragraph which, upon the occurrence of a trigger event, requires either write down or conversion into ordinary shares of the issuer should not be viewed as resulting from legislation. This is a key qualifying condition which the contractual terms must include for such instruments to qualify as a specific part of Tier 1 banking capital.

Paragraph 15A(b) of the ED requires that rights or obligations resulting from legislation which would arise regardless of whether they are included in the contract are not considered in classifying a financial instrument. The loss-absorption feature inherent in AT1 instruments does not belong to this camp. In this case the legislation provides a framework how contractual terms should be drafted so the instrument is granted a specific regulatory treatment. A legal framework with more or less details applies to all financial instruments.

What is subject to the assessment based on paragraph 15A of the ED are general 'bail-in' provisions resulting from bail-in power of a regulator to take actions which may lead of the instruments into a variable number of own shares of the issuer (= financial liability feature). These relate to a wide group of instruments issued by banks. They apply regardless of whether they are included in the contractual terms of the instruments. This is correctly described in paragraph BC21 of the ED.

Finally, we support the need for further guidance requested by EFRAG on the potential impact to the classification of financial instruments under IFRS 9 Financial Instruments from the holder perspective (par.13b DCL).

2. Settlement in an entity's own equity instruments

As there is limited guidance in IAS 32 on the fixed-for-fixed condition, various questions have arisen on how requirements in IAS 32 should be interpreted and applied in practice (e.g., adjustment clauses that alter the conversion ratio to prevent dilution). This lack of clarity has also led to diversity in practice. The proposal has provided a clarity on the principles in IAS 32 on the fixed-for-fixed condition to particular derivatives on own equity and would improve consistency and are fairly aligned with current practice. However, a clarity on whether the fixed-for-fixed condition is met for a convertible loan of variable interest rate (where both principal and interest are compounded to the convertible amount) may be provided.

Moreover, regarding the passage-of-time adjustments we consider that the proposed requirements in paragraph 22C(b) of the ED could be complemented by a reasonability test for the compensation of the passage of time. It would prevent from using unrealistic interest rates discount rates in the present value calculations.

In paragraph BC54 of the ED the IASB mentions that determining whether the adjustment is reasonable would require the exercise of judgement and the IASB would need to develop a guidance. In this respect we note that the assessment of 'reasonable' is already applied in IFRS without having a specific guidance. For example, paragraph B4.1.11 of IFRS 9 says that the prepayment amount may include reasonable compensation for the early termination of the contract. Such an assessment is common in the loan business and banks found the way to apply it without the accompanying guidance.

3. Obligations to purchase an entity's own equity instruments

The clarification provided in ED may be helpful for the entities who are allowed to take an obligation for purchasing its own equity instruments.

Nevertheless, the recognition of the financial liability in respect the obligation to redeem entity's own equity instruments is a special topic. The recognition principle as such can be challenged since, based on its logic, also derivatives to sell fixed number of entity's own equity instruments could lead to recognition of a financial asset. It might be appropriate to go as far as recognising the transaction as a stand-alone derivative. However, we do not consider that we should challenge these areas. The liability recognition has its accounting tradition and fundamental reconsiderations of this treatment would be beyond the scope of the project.

We would like to comment on the obligation to redeem entity's own equity instruments in respect of non-controlling interests (NCI). It is proposed to be recognised as a reduction in equity attributable to owners. We consider that it should rather be recognised as part of NCI. We understand the argument that consolidated financial statements are prepared on the basis of existing ownership interests (BC73 of the ED referring to paragraph B89 of IFRS 10). We also admit that while the obligation is outstanding non-controlling shareholders retain its rights to the returns associated with an ownership interest (BC74 of the ED referring to paragraph B90 of IFRS 10). We understand that existing ownership interests of non-controlling interest holders have not yet been extinguished.

However, we consider that the economic substance of the transaction is not captured by reducing equity attributable to owners of the parent. The transaction does not affect interests of the owners of the parent in any way. Recognition of the financial liability anticipates the cash outflow which will finally reduce the NCI. We note that the treatment that equity is reduced whereby the related ownership interest still exists would not be unique since it is applied to mandatorily redeemable shares.

As discussed above, the treatment of the obligation to redeem entity's own equity instruments as such is a special topic which deserves special considerations. It may be appropriate not to take the IFRS 10 requirements literally. When NCI are involved, we should take account of the substance of the transaction which does not affect the owners of the parent. As a result, we consider that the debit entry should be a separate component in non-controlling interests.

In considering the treatment of remeasurement for financial liabilities, there are differing viewpoints to be weighed. On one hand, there's recognition for the ED proposal's requirement to acknowledge remeasurement through profit or loss, aligning with standard accounting practices. However, there's also merit in viewing transactions involving written put options and forwards to purchase own equity instruments as interactions with owners in their capacity as owners. This alternative approach could potentially justify remeasuring a portion of the liability through equity.

On the other hand, some members express concerns about presenting subsequent changes to the carrying amount of financial liabilities in profit or loss. They argue that such presentation could conflict with accounting requirements to reflect the effects of transactions with owners in equity. Additionally, there's a consideration that that it would be counterintuitive to have measurement changes being presented in profit or loss, as performance decreases when the value of the shares subject to the put option increases, and vice versa.

We appreciate that there is no reference to IFRS 9 regarding the subsequent measurement of the financial liability, in particular under which P&L captions should be recognised the changes in the liabilities' measurement. There are cases when no measurement category under IFRS 9 suits the substance of the transaction. For example, if the exercise price of a NCI put option on entity's own shares is related the entity's performance (e.g. profit) measurement of the financial liability at fair value would not be applicable because the financial liability is not held for trading and conditions for the fair value option could hardly be fulfilled . Measurement at amortised cost under IFRS 9 would lead to continuous catch-up adjustments and there would be no reasonable basis for recognition of the interest expense. As a result, we appreciate entities can develop the appropriate accounting policy on how to present the value changes and decide whether an interest component would be recognised separately.

4. Contingent settlement provisions

The clarification provided in ED may be helpful for initial recognition and measurement of financial instruments with contingent settlement provisions such as those that are mandatorily convertible into a variable number of shares upon a contingent 'non-viability' event. Such clarifications seem to be fairly aligned with current practice in certain jurisdictions and current requirements in IAS 32.

We agree with the clarification that some financial instruments with contingent settlement provisions which also have equity features are treated as compound instruments with both equity and liability components. In this regard, we welcome the requirement in paragraph 25A of the ED that the initial and subsequent measurement of the liability component does not consider probability and estimated timing of occurrence or non-occurrence of the contingent event. This requirement results in a practicable treatment of Additional Tier 1 instruments (with conversion feature into variable number of own shares) leading to a full liability component at inception. There is no need to estimate the discount rate and timing of the contingent event at inception and to periodically re-estimate the timing with potentially numerous catch-up adjustments over the instrument's life.

In this regard, we share EFRAG's position on clarifying and delving deeper into the accounting treatment for certain financial instruments with contingent settlement features or a liability component, which may include the presence of caps, exceeding the total consideration received by the entity upon issuance of the instrument.

Our concern, in line with that of EFRAG, involve elucidating the accounting treatment regarding the difference between the obligation amount (which may exceed the consideration received) and the consideration received at the issuance of the instrument.

We also agree with other proposed requirements addressing contingent settlement provisions.

5. **Shareholder discretion**

Overall, we consider that the proposed requirements can bring a helpful guidance for the assessment shareholders discretion. We consider that for the equity instruments some of our members' banks issue, the assessment would be straightforward.

At the same time, we would also like to note that for some of our international members, there is diversity in practice regarding whether to treat a shareholder decision as an entity decision and how shareholder decision-making rights affect whether the entity that has an unconditional right to avoid delivering cash or another financial asset. The ED sets out factors that an entity would be required to consider in assessing whether shareholder decisions are treated as entity decisions (paragraph AG28A of IAS 32 in the ED). An entity will need to consider relevant factors and applied weights to each factor in making that assessment depend on the specific facts and circumstances. Different factors might provide more persuasive evidence in different circumstances.

6. **Reclassification of financial liabilities and equity instruments**

To address the issue of lack of guidance on reclassification in IAS 32, the ED proposes the general requirements on reclassification between financial liabilities and equity instruments. Further, the reclassification shall be done prospectively from the date in which the change in circumstances occurs. Furthermore, if there are substantial modifications made to a financial liability, there is guidance in IFRS 9 on how to deal with these modifications. However, if there are substantial modifications made to an equity instrument or a compound instrument, the guidance or clarification on this would be helpful.

Additionally, we consider that cases when contractual terms become, or stop being, effective with the passage-of-time should result in reclassifications. The IASB acknowledges in paragraph BC144 of the ED that there would be merit in allowing this kind of reclassifications. However, then in paragraph BC145 the IASB says that this approach would increase costs and complexity for preparers because they would need to reassess at each reporting date whether an instrument should be reclassified. As preparers, we do not consider that such tracking would be onerous. Such terms and conditions must anyway be disclosed based on proposed paragraph 30F of IFRS 7 in the ED which involves tracking.

7. **Disclosure**

We have analysed the disclosure requirements. Despite a significant increase in the extent of the disclosures we consider that we could prepare the information at a reasonable cost and effort, nevertheless it is important to test these new disclosure requirements to ensure that they are clear and can be implemented by entities.

On disclosures related to terms and conditions about priority on liquidation, we are not convinced of the usefulness of this requirement from the financial institution's standpoint. A set of financial institutions may never enter into liquidation because of their size and global impacts. Such entities are subject to regulatory resolution measures. However, resolution priority as set by the resolution board is not available to the entity affected and to other interested parties (prepared and shared only within the supervisor) and must remain outside of the possible solutions to improve transparency for users of financial statements. For these financial institutions we wonder whether explaining in the notes to the financial statements that liquidation cannot happen would be enough for the purposes of the ED's disclosures.

Finally, we would appreciate if cross-referencing to other public disclosure documents required by existing regulatory bodies should be made possible.

8. Presentation

From the requirements it is not clear how the total comprehensive income (in respect of both profit or loss and OCI) attributable to other owners of the parent would be calculated. There are some hints in paragraphs BC248(b) or BC250 of the ED that this could be based on IAS 33 (= most commonly preference dividends). But the illustrative examples in paragraph IG6A of draft Amendments to Guidance on Implementing IAS 1 are confusing in this regard. The balance sheet line item 'Equity attributable to other owners of the parent' increases its carrying amount over years 20X6 and 20X7 due to profit or loss attributable to it (in 20X7 also due to dividends paid (-) and new issuance (+)).

It would be very helpful to understand how the attribution of total comprehensive income was calculated. This is normally obvious for ordinary shareholders of the parent and non-controlling interests as the attribution relates to the interests of common stockholders.

But regarding the other owners of the parent how would the attribution, for example, be calculated for Additional Tier 1 (AT1) instruments issued by banks classified entirely as equity (due to the write down feature)? AT1 instruments do not participate in the issuer's performance other than trough (discretionary) fixed coupon payments. Based on the logic for non-cumulative preference shares in paragraph 14(a) of IAS 33 the total comprehensive income would be attributed to these instruments to the extent of the coupon payments. Also, it would be deducted in the row 'Dividends' of the Statement of changes. As a result, the end of year carrying amount of 'Equity attributable to other owners of the parent' would not be affected. This would be the correct perspective, in our view. But without knowing the answer we cannot assess the impact of the amendments in this area properly.

9. Transition

We agree with the transition requirements.

10. Disclosure requirements for eligible subsidiaries

Since financial institutions in general are not eligible for the simplified disclosure requirements, which we regret, the proposed amendments are not applicable to subsidiaries in some of our members' groups and we do not provide comments.

Finally, we consider that the refinement in existing disclosure and additional disclosures proposed in the ED may expand the objectives of IFRS 7 and other accounting standards will provide useful information to users of financial statements.

About WSBI (World Savings and Retail Banking Institute)

Founded in 1924, WSBI brings together savings and retail banks from 67 countries, representing savings and retail banks worldwide. WSBI focuses on international regulatory issues that affect the savings and retail banking industry and provides a platform for knowledge exchange between member banks. Its aim is to achieve sustainable, inclusive, and balanced growth and job creation. Supporting a diversified range of financial services to meet customer needs, WSBI favours an inclusive form of globalization that is just and fair. It supports international efforts to advance financial access and financial usage for everyone. WSBI recognizes that there are always lessons to be learned from savings and retail banks from different environments and economic circumstances. It, therefore, fosters the exchange of experience and best practices among its members and supports their advancement as sound, well-governed, and inclusive financial institutions.

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About ESBG (European Savings and Retail Banking Group)

ESBG is an association that represents the locally focused European banking sector, helping savings and retail banks in 16 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 871 banks, which together employ 610,000 people driven to innovate at 41,000 outlets. ESBG members have total assets of €6.38 trillion, provide €3.6 trillion billion in loans to non-banks, and serve 163 million Europeans seeking retail banking services.

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