Martin Boer
Director
Regulatory Affairs

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INSTITUTE OF
INTERNATIONAL
FINANCE

Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street, First Floor
London, EC4M 6XH
United Kingdom

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

Dear Mr. Hoogervorst:

1. The Institute of International Finance (IIF), via its Senior Accounting Group (SAG), 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).
2. At the outset, we would like to underscore that we share the IASB's view that distinction between liabilities and equity plays a key role in how entities provide users with information in their financial statements. Equity instruments and other loss-absorbing instruments are particularly important for the banking industry, and banks are subject to extensive and comprehensive regulations that establish capital definitions and minimal capital requirements.
3. We acknowledge the challenges that may arise when applying IAS 32 and accordingly appreciate the work the IASB has carried out to address them. We appreciate the IASB for proposing overarching principles and associated application guidance, which is aligned with the spirit and purpose of the IFRS Standards of providing principles-based standards.
4. However, we are not convinced that the expected benefits of the IASB's preferred approach outweigh the costs of its implementation.
5. First, it is important to note that, as outlined in the FICE DP, IAS 32 works well in most circumstances and most of the time does not raise specific questions. So, while we

recognize that in many cases the IASB's preferred approach and current requirements would lead to similar outcomes, we are concerned that the proposed principles would change the accounting treatment for financial instruments that is well understood by all stakeholders. We believe the IASB should consider whether these changes are desirable as they would give rise to increased uncertainty and costs for preparers and users alike, while resulting in minimal impact.

6. Second, we are concerned that the IASB's preferred approach does not resolve some key challenges that arise through the application of existing requirements, the accounting for some puttable instruments being one of the most important. However, we share the IASB's view that under the IASB's preferred approach, the puttable exception would remain warranted.

7. Third, while we appreciate that the proposed definition of a financial liability aims at setting out a clear rationale to support distinction between equity and liability, we are worried that the introduction of new terms would raise issues of interpretation similar to those encountered at the introduction of IAS 32. As an example, we believe that it may be challenging for some financial instruments to draw a clear line between amounts that are independent of an entity's available economic resources and amounts that depend on an entity's available economic resources. Entities will have to assess this new criterion for all sorts of financial contracts and, in some cases, may reach different conclusions.

8. We believe that, taken together, these concerns are significant enough to call into question the benefits of the proposed classification principles whereas the costs of implementation would likely be substantial. Consequently, we would recommend the Board to give full consideration to approaches that rather seek to address users' concerns through better presentation and disclosures.

9. In this regard, we appreciate the IASB's proposals set out in section 6 and section 7. However, we strongly believe that these approaches, in particular those attempting to attribute total comprehensive income across equity instruments, are excessively complex and would have far-reaching implications that go beyond the scope of the FICE project.

10. Against that background, we would favor approaches that consist of targeted improvements to presentation and disclosures. We would like to stress that regulations already require banks to disclose very detailed and granular information about capital instruments. We strongly believe that coordinated approaches between regulatory and accounting disclosures are key to provide users with consistent and comprehensive

information. Thus, we acknowledge and support the objective of the IFRS Foundation and the Basel Committee on Banking Supervision (BCBS) to strengthen cooperation to foster long-term financial stability and enhance market discipline as formalized in the 2017 cooperation agreement[1].

11. We hope that you will find our comments useful and constructive. If you have any questions, please feel free to contact the undersigned at mboer@iif.com or Hassan Haddou at hhaddou@iif.com.

Yours sincerely,

Martin Boer
Director, Regulatory Affairs
Institute of International Finance (IIF)

[1] See BCBS and IFRS Foundation, *Memorandum of Understanding for Mutual Cooperation*, September 5, 2017 at https://www.bis.org/press/p170905.htm
https://www.ifrs.org/news-and-events/2017/09/basel-committee-on-banking-supervision/

Hereafter we take up and expand on the key comments set out above in the cover letter.

Section 1—Objective, scope and challenges

Question 1. Paragraphs 1.23–1.37 describe the challenges identified and provide an explanation of their causes. (a) Do you agree with this description of the challenges and their causes? Why or why not? Do you think there are other factors contributing to the challenges? (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?

12. As stated above, it is important to note first that IAS 32 works well in most circumstances and is well understood by most entities. So, we are concerned that the new proposed principles may affect the classification of financial instruments that do not raise specific issues. As an example, it is not obvious that there would be added value to change the current classification of financial instruments such as irredeemable preference shares.

13. Further, we believe that the IASB should clarify the implications of the proposals for other IFRS standards such as IFRS 3, IFRS 9, IFRS 10, IAS 1, IAS 33 as well as the Conceptual Framework. Specifically, we believe that the proposals relating to the attribution of total comprehensive income and disclosures of potential dilution may have far-reaching consequences for IAS 33 and would require separate research or standards-setting projects to address them appropriately.

14. Beyond changes to accounting, we believe such changes may have knock-on effects that need to be considered. As an example, loan covenants and credit policies should be reviewed to assess the possible implications of the proposals on current and future transactions.

Section 2—The IASB's preferred approach & Section 3— Classification of non-derivative financial instruments

Question 2. The Board's preferred approach to classification would classify a claim as a liability if it contains:
(a) an unavoidable obligation to transfer economic resources at a specified time other than at liquidation; and/or

(b) an unavoidable obligation for an amount independent of the entity's available economic resources.

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 summarized in paragraph 2.50.

The Board's preliminary view is that information about other features of claims should be provided through presentation and disclosure.

Do you agree? Why, or why not?

Please see below.

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?

15. The proposed definition of a financial liability introduces the notion of an *independent amount* that would supersede the existing notion of *a variable number* of equity instruments. We are concerned that this new notion would give rise to difficulties of interpretation. In such case the proposals would not meet the objective of addressing application challenges as it would result in swapping some well-known questions that

arise from the application of IAS 32 for a set of new questions that entities would then endeavor to sort out.

16. The proposed definition includes other terms that may also warrant further explanation, e.g., the IASB uses the term *unavoidable obligation* to qualify the contractual *obligation* of which the existence, or otherwise, allows distinguishing between liability and equity whereas IAS 32 only refers to *obligation*. In this case, the Board may clarify to what extent *unavoidable obligation* and *obligation* differ. If any, it may be useful to provide examples of what constitutes *avoidable* obligations. Otherwise, we suggest removing any unnecessary terms from the definition of a financial liability.

17. We note that the proposed definition of a financial liability puts emphasis on the existence of a contractual obligation regardless of its likelihood. This may lead to counterintuitive classification, e.g., when no contractual obligation exists but redemption is almost certain ('economic compulsion') given the economic conditions, and vice versa. However, we acknowledge that it may prove challenging to factor in economic circumstances for classification purposes. We discuss this further in our comments on question 10 of the DP.

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?

18. While the IASB's preferred approach may change the classification outcomes of financial instruments that are well understood, the proposals do not resolve some important current issues such as the ones that led to the IASB granting an exception for some puttable instruments. Especially, the analysis and conclusions set out in BC50 of the Basis for Conclusions on IAS 32 would remain valid under the IASB's preferred approach. Accordingly, we believe that the puttable exception should be maintained if the IASB's preferred approach were to be applied.

Section 4—Classification of derivative 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?

19. As with proposals relating to non-derivative financial instruments, we are concerned that the proposed principles for classifying derivatives on own equity may raise new questions and difficulties of application.

20. Indeed, we are not convinced that the amount feature (whether the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources) is fundamentally more straightforward to interpret than the current fixed-for-fixed condition.

21. Furthermore, the proposals do not solve the issues associated with the foreign currency rights issue exceptions. We believe that this exception is well understood and does not pose any problems of application. Its removal would have detrimental consequences as the exception allows to deal properly with important cases where entities are obliged to issue rights denominated in a foreign currency when raising capital. As an example, laws or regulations may require some entities that are listed in more than one jurisdiction to do so.

22. These serious concerns aside, we share the IASB's view that derivatives on own equity should be classified in their entirety. The alternative would be complex and would not

faithfully reflect the economic substance of derivatives and would only undermine the consistency with the other IFRS standards.

23. Likewise, we agree that derivatives on own equity should be classified as equity instruments, financial assets or financial liabilities. While not proposed in the DP to classify derivatives on own equity as either financial assets or financial liabilities would preclude all sorts of derivatives that only give right to a residual interest on the entity's net asset value from being accounted for as equity. If all derivatives on own equity were measured at fair value through earnings, then this would lead to increased volatility in earnings due to changes in the entity's available economic resources, which would not accurately reflect the entity's financial performance.

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?

24. We appreciate that, overall, the classification under the IASB's preferred approach of compound instruments and redemption obligation arrangements would be consistent with the current classification under IAS 32.

25. The IASB's preferred approach also has the merit of addressing some concerns expressed in the May 2012 Draft Interpretation on the accounting for NCI puts. The IASB's approach would assign a nil value to the equity component of written puts on own equity with a fair value strike price. Consequently, the return on such puts would

be altogether reflected in the changes in the liability component and would be recognized as income or expenses. We note also that gain and losses associated with the liability component would be presented separately since the claim is not independent of the entity's available resources.

26. We are concerned, however, that the IASB's preferred approach would leave unanswered important questions about the accounting of NCI puts. As an example, we may question why the NCI should be derecognized when neither the voting rights nor rights to dividends on the NCI are extinguished. One may argue that these transactions should be instead analyzed as transactions with owners acting in their capacity as owners and accordingly a contra-equity account may be recognized.

27. In addition, the IASB's approach requires identical accounting for convertible bonds and written put options. While we agree that two combinations of contracts with similar settlement outcomes should have similar accounting, we strongly believe that convertible bonds and written put options feature significant differences and should not be conflated for classification purposes. Turning written put options into convertible bonds is likely to make financial statements more complex while reflecting less accurately the actual rights and obligations of such financial instruments.

28. Finally, both IAS 32 and the IASB's preferred approach raise the question of whether it is appropriate to have some derivative financial instruments grossed-up, in particular when the obligation is conditional on exercise of an option. We urge the IASB to further consider the benefits of measuring all derivatives on own equity in a consistent manner, that is, on a net basis like other derivatives.

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?

Please see below.

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?

Presentation of financial liabilities

29. Pursuant to the proposed approach, an entity would be required to present in other comprehensive income (OCI), income and expenses arising from financial liabilities without an obligation for an independent amount as well as income and expenses arising from derivative financial assets and derivative financial liabilities that have net amounts unaffected by any independent variable or from partly independent derivatives. In addition, those amounts presented in OCI would subsequently not be reclassified to profit or loss. We appreciate that the IASB is seeking here to address counter-intuitive effects that the alternative implies, e.g., recognizing a loss when the entity performs well.

30. We are concerned, however, that those proposals would significantly increase the use of OCI and urge the Board to further assess the scope and implications of such proposals. Indeed, it may not be obvious that separate presentation in OCI would always properly reflect the financial performance of financial instruments falling under the proposed scope. Income and expenses stemming from some financial instruments

may be actual economic gains or losses for the entity, specifically when it comes to some financial instruments that are settled in cash.

31. Furthermore, if the use of OCI may allow addressing inconsistencies in financial statements, it is often at the cost of an increased complexity as the users of financial statements could have difficulty to understand the financial implications for the entity of the amounts recognized in OCI. This is all the more important because, contrary to some existing components of the OCI (e.g., gain or losses arising from changes in own credit risk of financial liabilities), the proposed presentation would be permanent, which poses the question of the ultimate articulation of the recognized amount with equity and profit or loss.

Partly independent derivatives

32. We do not support the proposed approaches relating to partly independent derivatives. We deem them excessively complex and believe that the costs of identifying such financial instruments would outweigh their marginal benefits.

33. Further, one may argue that the notion of partly independent derivatives tries to address issues arising from the application of the proposed definitions. If so, we invite the IASB to consider the alternative of spelling out clear exceptions to the classification requirements when need be (e.g., maintaining the current foreign currency rights issue exception).

34. If the Board decided to pursue the proposals, we would recommend applying alternative A over alternative B to hybrid instruments, the latter being more complex than the former with little added value.

Presentation of equity instruments

35. We share the IASB's objective to cater to the needs of users by providing them with better information about equity instruments. However, we believe that the proposals that attempt to attribute total comprehensive income pose several problems.

36. First, we are concerned that implementing any of the three proposed methods would significantly increase complexity and costs of equity accounting. These concerns are all the more serious because, as stated out in the DP, the three approaches have shortcomings that make uncertain the targeted benefits for users.

37. Second, any approach that attempts to attribute total comprehensive income across equity instruments would have far-reaching implications for IAS 33. The proposals would not only require key amendments to the standard but also set out new definitions of financial indicators to assess returns of equity instruments that overlap

and compete with the objectives of IAS 33, which we believe goes beyond the original objective and scope of the FICE project.

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?

Disclosures on priority of claims on liquidation

38. We support the IASB's goal to enhance the understanding by users of an entity's capital structure, as this is key to assess its solvency and returns. To that end, we share the IASB's view that useful and meaningful information about the priority of claims is necessary and, where appropriate, should be disclosed as much as possible.

39. In this regard, the industry would like to stress that banks already disclose comprehensive and detailed information about their capital positions. Especially, under the Basel Committee's Pillar III 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.

40. Furthermore, under Total Loss-Absorbing Capacity (TLAC) requirements, all global systemically important banks (G-SIBs) must disclose detailed information about TLAC resources. Specifically, these disclosures ensure that users have clarity about the order in which TLAC instruments will absorb losses on resolution. TLAC disclosure requirements also include templates that provide information on the instruments issued by resolution entities and material subgroup entities that rank *pari passu* with, or junior to, TLAC instruments.

41. In this context, it is important that cross-references in the financial statements be permitted and that accounting and regulatory disclosure requirements be as consistent as possible. Otherwise, it is likely that inevitable differences between financial statements and regulatory disclosures would impose burdensome and costly reconciliations on banks without bringing value to users.

Disclosures about potential dilution

42. While we commend the objective of providing useful information about the potential effects of financial instruments on earnings per share, we are concerned that addressing the issue may be beyond the scope of the FICE project. Indeed, we believe that determining what constitutes appropriate information reflecting the returns for shareholders is a complex issue that warrants a separate research project.

43. Furthermore, it is important to note that entities whose ordinary shares are not publicly traded are not required to apply IAS 33. Thus, this raises the question of the scope of proposed disclosures and whether they would be appropriate or even feasible for entities that do not apply IAS 33.

Disclosures about contractual terms and conditions

44. We strongly believe that under the current accounting and regulatory frameworks, banks already provide users with sufficient information about contractual terms and conditions of financial liabilities and equity instruments. Indeed, the IFRS Standards, through IFRS 7, already require entities to disclose key terms and conditions of financial instruments. In addition, banks are already required to disclose highly detailed and granular information about terms and conditions of capital and TLAC instruments. Market participants often complain that volumes of disclosure continue to balloon with little or no incremental benefit to them as users. Consequently, we invite the IASB to not add disclosure requirements to the current accounting and regulatory ones and/or to allow banks to make cross-referencing in financial statements.

Section 8—Contractual terms

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

Please see below.

Question 11. 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. Do you agree? Why, or why not?

45. We acknowledge the importance, when assessing an issuer's financial position, of considering economic incentives that might influence its decision to exercise its rights. However, we share the IASB's view that this is a complex issue and that doing so "may raise more questions than it answers."

46. Specifically, from a practical standpoint, it might prove very challenging to implement a consistent and straightforward accounting definition of what constitutes an "economic compulsion." More fundamentally, we believe that factoring in economic compulsion for classification purposes would create liabilities which are not actual obligations since they can in fact be avoided, particularly if circumstances change. That is not desirable since it would not faithfully reflect the rights and obligations of financial instruments.

47. Finally, we agree that there is value in carrying forward the requirements in paragraph 20 of IAS 32 for indirect obligations. Indeed, they provide useful guidance in determining what constitutes "an unavoidable obligation." We agree with the IASB that it is not relevant for classification purposes to consider a right if the holder never has an incentive to exercise it. Otherwise, such a clause might be artificially included to take advantage of the general principle and would give way to misleading classifications.