STAFF PAPER

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IASB® meeting

Project	**Financial Instruments with Characteristics of Equity (FICE)**
Paper topic	Summary of feedback—Classification of non-derivative financial instruments

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Objective

1. Agenda Paper 5A for this meeting includes the staff's summary of the feedback on the Board's preferred approach proposed in Discussion Paper *Financial Instruments with Characteristics of Equity* (DP), in particular, concerns relating to the application of the amount feature. Many respondents who expressed such concerns, provided examples of non-derivative financial instruments for which classification would change from equity to financial liabilities, if the Board's preferred approach were to be implemented. The most common examples of financial instruments and the associated feedback from respondents are summarised in this paper.

Structure of paper

2. The remainder of this paper is structured as follows:

   (a) Background—proposals in the DP (paragraph 3–4)

   (b) Key messages (paragraphs 5–6)

(c) Irredeemable financial instruments with non-cumulative coupons (paragraphs 7–16)

(d) Convertible instruments issued in a foreign currency (paragraphs 17–21)

(e) Irredeemable cumulative financial instruments (paragraphs 22–30)

(f) Request for transition relief (paragraph 31)

Background—proposals in the DP

3. The DP proposes 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 (*the timing feature*); and/or

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

4. Further, paragraph 3.10 of the DP states that:

> A non-derivative financial instrument may contain more than one possible settlement outcome that might depend on future events, or on the holder or issuer exercising rights […]. If an entity does not have the unconditional contractual right to avoid a settlement outcome that has one or both of the features of a financial liability […], then the entity identifies that unavoidable obligation first and classifies that obligation as a non-derivative financial liability. If the non-derivative financial instrument also contains another possible settlement outcome that does not have the feature(s) of a financial liability […], then the entity considers whether the instrument is a compound instrument […].

Key messages

5. **Do respondents agree with the Board's preferred approach to classification?** As summarised in Agenda Paper 5A for this meeting, almost all respondents agreed with the timing feature of the Board's preferred approach. Further, most respondents agree that both the *timing* of the required transfer of economic resources and the *amount* of the obligation are the relevant to distinguishing financial liabilities from equity. However, most respondents were not supportive of the amount feature assessment as described in the Board's preferred approach.

6. **Are the proposals in the DP leading to many changes in classification of non-derivative financial instruments?** Many respondents highlighted that applying the amount feature of the Board's preferred approach leads to classification changes from equity to financial liabilities for particular types of non-derivative financial instruments. Notably, financial instruments that contain an obligation for an amount independent of the entity's available economic resources (*independent amount*) that arises only *at liquidation* or that can be deferred at the issuer's discretion *until liquidation*—a feature common in many Additional Tier 1 (AT1) instruments issued by banks and perpetual bonds issued by corporates. Many respondents including investors[1] and issuers of such instruments expressed concerns that these classification changes may lead to market disruption—some disagreed with the liability classification while others did not welcome any change in classification of financial instruments that in their view are well understood. Some also highlighted application challenges that would arise from classifying these instruments (wholly or partly) as a financial liability.

Irredeemable financial instruments with non-cumulative coupons

7. Using an example of non-cumulative preference shares that pay discretionary dividends with an obligation to pay a fixed amount only at liquidation, the DP illustrated that the Board's preferred approach would classify such instruments, ie the fixed notional amount due on liquidation as a liability component and the discretionary dividends as an equity component. Further, as set out in the DP, the Board observed that the present value of the liability component would be negligible on a going concern basis.

8. Many respondents did not welcome the change in the classification of such financial instruments and raised concerns about the liability component. One of the most common examples provided for this type of instruments was AT1 instruments issued by banks and Restricted Tier 1 (RT1) instruments issued by insurers. Based on the feedback provided, these instruments commonly share the following features:

[1] In this Agenda Paper, we differentiate between investors and users of financial statements. Investors mean those who invest in the particular financial instruments described in this paper while users of financial statements refer to a broader group of investors.

(a) no stated maturity date;

(b) an option for the issuer to redeem the instrument at a specified date, eg 5-10 years after the issuance or on the occurrence of a specified event, eg a change in the regulatory capital treatment;

(c) discretionary coupons or dividends based on a fixed % of the principal amount that can be cancelled by the issuer on a non-cumulative basis;

(d) loss absorption feature using conversion—an obligation for the issuer to convert the instrument into a fixed number of own shares on the occurrence of a specified trigger event, for example, if the issuer's Common Equity Tier 1 or solvency ratio falls below a certain threshold or if relevant authority deems the issuer non-viable (collectively referred to as 'contingent non-viability event');

(e) an obligation for the issuer to pay a fixed notional amount at liquidation; and

(f) at liquidation, the instrument ranks just above ordinary shares but below all other claims.

9. Respondents noted that applying IAS 32, these instruments are classified as equity in its entirety because they are viewed as a non-derivative financial instrument with an obligation to deliver a fixed number of own shares. They pointed out applying paragraph 25(b) of IAS 32, obligation that arises only on liquidation of the entity does not result in a financial instrument with a contingent settlement feature being a financial liability. The obligation described in paragraph 8(e) is therefore not classified as a financial liability applying IAS 32. Applying the proposals in the DP, the obligation to pay a fixed notional amount at liquidation described in paragraph 8(e) would be classified as a financial liability because that amount is independent of the entity's available economic resources.

10. Many respondents said that this classification change represents a fundamental departure from the classification approach in IAS 32 and that it does not provide relevant information to the users of financial statements. Agenda Paper 5A summarises such concerns.

11. Whilst these respondents acknowledge that these financial instruments would usually behave in a similar manner to debt when the entity is performing (and is a going concern), they note that the entity's option to cancel coupon payment, together with the absence of obligation to repay the notional amount before liquidation, provides a buffer should the entity experience financial difficulties. Further, respondents highlighted that once an entity is insolvent, these financial instruments absorb losses. For instruments with a conversion feature as described in paragraph 8(d), upon the occurrence of the contingent non-viability event (which would occur before liquidation), they will become ordinary shares. Therefore, these respondents suggest that an obligation to transfer cash or another financial asset only on liquidation should not affect the classification of a financial instrument consistent with the existing requirement in IAS 32.

12. With regards to the liability component that results from applying the Board's preferred approach, many respondents also expressed the following concerns:

   a) *Taking into account the probability of going concern in the measurement*—while the liability component at initial recognition may have a nil or insignificant value, the classification approach proposed in the DP introduces significant complexity in particular, for subsequent measurement. The liability component would be remeasured in subsequent reporting periods applying IFRS 9. Respondents asked whether the entity is required to make a binary assessment at the reporting date, ie is the entity a going concern or not, or assess the probability of the entity going into liquidation. The latter would introduce the need for significant judgement and complexity.

   b) *Taking into account the issuer's call option into the measurement*—a few respondents also raised questions on whether and how the issuer's option to call the instrument (described in paragraph 8(b)) should be taken into account in the measurement of a liability component. In the absence of an explicit discussion in the DP about how the issuer's option would affect subsequent measurement of financial liabilities, some respondents expressed the concern over a potential increase in the amount of the liability component. For example, if the first call date of the financial instrument were required to be factored in when measuring the liability component (which in many cases is between 5-10 years after the issuance) and if the issuer expects to exercise the call option, then, in these respondents view, this could give rise to a significant increase in the amount of the liability component. One of the respondents from the banking sector estimated the impact of such a shift to be approximately EUR 200 billion, considering instruments issued by European and Chinese banks. This respondent added that applying the existing requirements of IAS 32, the issuer's call options do not result in liability classification, because the exercise of the call option is at the issuer's discretion—only when the call option is exercised and is not revocable would the issuer reclassify the financial instrument from equity to liability. According to this respondent, the measurement of the liability component reflecting the issuer call option in the way described above[2] would be contrary to the objective of including the loss absorbing feature in these financial instruments.

c) *Regulatory capital classification*—furthermore, a few respondents from Canada expressed concerns on the impact of this change in classification on the regulatory capital for banks. This is because, the capital adequacy requirements in this jurisdiction only permit financial instruments that are classified as equity for accounting purposes to be included as AT1s for regulatory purposes. Based on outreach conducted, the staff identified no other jurisdiction that require the accounting equity classification for an AT1 classification.

d) *Unresolved issues*—few respondents pointed that the proposals in the DP do not address one of the issues discussed by the IFRS Interpretations Committee. That issue relates to how the discretionary coupon payments on a compound financial instrument that has a zero-value equity component should be accounted for when they are paid—ie whether they should be accounted for as dividends or interest expense.[3] Based on outreach

[2] The Discussion Paper (DP) does not include specific discussion on issuer call options and how they affect the measurement of financial instruments.

[3] The issue referred was discussed at the IFRS Interpretations Committee meeting in January 2014. The instrument in that submission included an obligation to convert the instrument into a variable number of the issuer's own ordinary shares if the issuer breaches the required 'Tier 1 Capital ratio' (the contingent non-

conducted, the Staff understand that there is diversity in practice. Some treat coupons as interest expenses and recognise in profit or loss while others treat them as dividends on an equity component. One respondent said this 'flexibility' is valuable.

13. On the other hand, a standard setter highlighted that many stakeholders in this jurisdiction (Korea) expressed the view that recognising a liability component would better depict the economic substance of this financial instrument compared to current classification as an equity instrument applying IAS 32.[4]

14. Few respondents raised questions about loss absorption features. The mechanisms for loss absorption of these financial instruments vary. The feature that converts them into a fixed number of ordinary shares as described in paragraph 8(d) is one type but there are others. Other varieties include features that convert the instruments into a variable number of own shares and a write down feature. Further, the write down can be of a temporary or permanent nature, ie the nominal amount of the financial instrument would be permanently or temporarily written down upon a contingent non-viability event occurring. If the mechanism is temporary, then its nominal amount could be subsequently written back up. Respondents asked how each of these features will affect the classification. Some also asked how the financial instruments containing one of these features are relevant to the solvency assessment (see Agenda Paper 5A for this meeting for further detail). At least one respondent expressed the view that they should be treated consistently.

15. Further, few respondents questioned whether a feature that is contingent on the occurrence of a non-viability event is a variable that is independent of the entity's available economic resources. In their view, most non-viability events are directly related to the availability of the entity's economic resources. In addition, it could be argued that the contingent event of breaching the regulatory capital requirements is

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viability event). The instrument includes coupon payments based on a stated rate that can be cancelled by the issuer on a non-cumulative basis. The final agenda decision states that the issuer's obligation to deliver a variable number of shares meets the definition of a financial liability in IAS 32 and that the accounting for discretionary interest payments is a broad issue that likely cannot be resolved efficiently within the confines of existing IFRS Standards. Further information could be found at the staff paper: https://www.ifrs.org/-/media/feature/meetings/2014/january/ifrs-ic/ias-32-financial-instruments/ap9-non-viability.pdf

[4] Financial instruments described by this standard-setter share many features described in paragraph 9 of this paper while including some additional features such as an option for the holder to put the instrument in which case the issuer can choose to settled in a fixed number of own shares.

within the issuer's control due to the measures it could undertake to avoid the occurrence of the contingent non-viability event. However, one of the respondents noted that experiences during the 2008 financial crisis suggest this may not always be the case. This respondent expressed the view that different interpretations may arise hence suggested the Board provide a clarification.

16. In relation to financial instruments that have a conversion feature generally, few users of financial statements highlighted the importance of information that would allow them to understand the potential dilution of ordinary shares. More than one banking analysts said that the existence of a conversion feature in a financial instrument is important and may justify equity classification of the financial instrument.

Convertible instruments issued in a foreign currency

17. As explained in paragraph 4.47(a)(i) of the DP, currency other than the entity's functional currency is considered to be a variable that is independent of the entity's available economic resources, and therefore, a derivative on own equity that includes a foreign currency variable would be classified as a financial asset or a financial liability.

18. In response to this proposal in the DP, few respondents, primarily from the banking sector, pointed out that many AT1 instruments are denominated in a currency other than the issuer's functional currency and they typically contain similar features as those described in paragraph 7, including a fixed amount payable at liquidation described in paragraph 8(e), which is denominated in a currency other the issuer's functional currency.

19. As reproduced in paragraph 4 of this paper, applying the Board's preferred approach to classification, when classifying a financial instrument, an entity would firstly identify an obligation that has a feature of a non-derivative financial liability. The obligation to pay a fixed amount at liquidation would be classified as a non-derivative financial liability because of the 'independent amount' even if it is only payable at liquidation. The DP further states that if the financial instrument contains alternative settlement outcomes, the entity would apply the derivative classification principle to those contractual rights and obligations, in this case the conversion obligation described in paragraph 8(d). Applying this principle would result in a

derivative financial liability classification because the conversion feature in this case represents an obligation to exchange a fixed number of own shares for extinguishing a financial liability that is denominated in a foreign currency—a derivative on own equity that includes an 'independent variable', being foreign currency.

20. Respondents noted that the applying the Board's preferred approach would result in a change in how this type of instruments is typically classified and some expressed concerns similar to those described in paragraphs 10–11. Similar to the explanation in paragraph 9, these instruments are currently classified as equity in its entirety because they are viewed as a non-derivative financial instrument with an obligation to deliver a fixed number of own shares. Based on outreach conducted, the staff understand that the equity classification of these instruments on this basis is prevalent although there appeared to be some diversity in views.

21. These respondents shared the view that an instrument should not be classified as a financial liability solely because of the foreign currency denomination for the reasons similar to those described in paragraph 34 of Agenda Paper 5C for this meeting.

Irredeemable cumulative financial instruments

22. Irredeemable *cumulative* financial instruments share many of the features of the irredeemable *non-cumulative* financial instruments described in paragraph 7. The most notable difference is that their distributions (dividends or coupons) are *cumulative*, although the issuer often has an option to defer the payment of the coupons until the liquidation of the entity. On liquidation, any accumulated unpaid coupons will be due to the holder of the instrument together with a fixed notional amount. While respondents in different jurisdictions used different names to describe this type of instruments (eg 'corporate hybrids', 'hybrid instruments' and 'perpetual bonds'), the following were the typical features commonly present:

    (a) no stated maturity date;

    (b) an option for the issuer to redeem the instrument at a specified date, eg 5-10 years after the issuance or on the occurrence of a specified event, a change in tax treatment or a change in the accounting classification;

(c) an obligation to pay coupons or dividends based on a fixed % of the notional amount that can be deferred by the issuer until liquidation on a cumulative basis. Some instruments include a feature that resets the coupon rate to a higher rate if not called on the first call date, incentivising the redemption;

(d) an obligation for the issuer to pay a fixed notional amount at liquidation; and

(e) at liquidation, the instrument ranks just above ordinary shares but below all other claims.

23. IAS 32 classifies irredeemable cumulative financial instruments (for example, cumulative preference shares) as equity instruments because there is no contractual obligation to transfer cash or another financial asset or to deliver a variable number of shares. As explained in paragraph 9, applying IAS 32, the obligation to transfer a fixed notional amount and accumulated unpaid coupons at liquidation does not result in a liability classification. In contrast, the Board's preferred approach,[5] would classify such financial instruments as financial liabilities in their entirety because the entity has an unavoidable obligation to pay fixed rate coupons and the fixed notional amount, which are independent of the entity's available economic resources, even though they are contractually due only at liquidation.

24. Many respondents including a significant number of preparers from the corporate sector and the investors in such instruments, expressed concerns over this change in the classification outcome. These respondents highlighted the following:

(a) *Cumulative coupons and the issuer's ability to defer coupons*—although the financial instrument has a stated coupon, usually at a fixed rate which accumulates if not paid, the issuer's option to defer them until liquidation provides a buffer in times of financial difficulty. Further, few respondents questioned whether the fixed-rate distributions which accumulate over time

[5] Paragraph 3.23 (c) of the DP describes an irredeemable fixed-rate cumulative preference share with a stated coupon or dividend amount that accumulates in the case of non-payment as examples of financial instruments with amounts independent of the entity's available economic resources. The amount of the cumulative preference share is independent of the entity's available economic resources because changes in the entity's available economic resources will not result in changes in the amount of coupon or dividend right of the cumulative preference shares.

are indeed an amount that is *independent* of the entity's available economic resources. The issuer would defer the payment if it does not have sufficient economic resources available to satisfy the payment.

(b) *Deep subordination*—subordinated to the issuer's other creditors, and senior only to issuer's ordinary shareholders. Many respondents expressed the view that classifying this type of financial instruments as financial liabilities does not necessarily represent a better accounting outcome. This is because, due to their deep subordination and ability to defer their payments until liquidation, the settlement of these financial instruments at liquidation ultimately depend on the entity's economic resources available after the senior claims have been paid. Some acknowledged that the Board's preferred approach to classification does not take into account priority on liquidation. Based on our outreach, these respondents did not think the classification approach should be based on liquidation priority when considered together with the challenges that could result from such an approach.

(c) *Permanent part of the capital structure*—although the issuers often choose to and are expected to redeem the instruments at the first call dates, redemptions often are followed by issuances of another instrument with very similar features. Accordingly, many issuers and investors consider this type of instruments as a permanent part of the issuer's capital structure.

25. At the same time, many respondents acknowledged that this type of instruments do behave like a debt instrument unless the issuer is in financial difficulties. Respondents often used the phrase 'acts like debt in good times and acts like equity in bad times' to describe how this type of instruments have both features of a financial liability and equity. They noted the following:

(a) *No fixed maturity but incentives to redeem the instruments*—Many respondents acknowledged that there is strong expectation from the existing and potential investors that the issuer will choose to redeem the instruments at the first call date.[6] These instruments are priced based on such

[6] One user respondent said approximately 95% of them are called at the first call date.

expectations. The issuer's decision not to meet that expectation can often be detrimental to its ability to issue similar instruments in the future. Also, some of these instruments require a reset of the coupon to a higher rate if the issuer chooses not to call the instrument, which makes it economically attractive for the issuer to exercise the call, even if the issuer has no contractual obligation to do so.

(b) *The issuer's disincentive to defer coupons*—Some respondents acknowledged that while the issuer has the ability to defer the coupons, it often has a strong incentive not to do so because it will signal that the issuer is experiencing financial difficulties and could affect their ability to issue similar instruments in the future. At the same time, a few respondents including investors noted that while the deferral of the coupons happened before, it is rare. Moreover, some instruments include a linkage between the coupon payments and dividends on ordinary shares, eg dividend pushers and dividend stoppers, which requires the issuer to pay coupons on this type of instrument before paying dividends on ordinary shares.

(c) *Fixed rate coupons*—When paid, the coupons will often be of a fixed % of the notional amount, ie its pay-off does not change with the entity's available economic resources. The return on this type of instruments does not represent the risks and rewards inherent in the business operation of the issuer.

26. Further, some users of financial statements acknowledged that liability classification better reflects the economic substance when financial instruments are callable by the issuer and are priced and traded assuming the issuer will call the instrument at the first call date. It was noted that these instruments are generally invested in by fixed income investors. Some investors who were not in favour of the classification change formed such a view primarily because they generally do not like changes in how these instruments are treated (including accounting, rating agency methodology, tax, etc) rather than because they prefer equity classification.

27. Standard-setters and regulators from Latin America agreed that the liability classification better reflects the economic substance. They said that the issuer's incentives to redeem the instrument can be viewed as part of the contractual terms and encouraged the Board to revisit its decision regarding economic compulsion being excluded from its classification approach. They believe considering economic incentives are necessary in order to reflect their substance over form. The Staff will provide further details on the feedback for this topic and present it to the Board at a future Board meeting, along with other feedback received on economic compulsion.

28. While acknowledging the 'hybrid' nature of this type of instruments, as described in paragraphs 24–26, the respondents raised the following concerns about the effects of the proposed classification change in addition to those already described in paragraphs 11–12 about the liability classification of a fixed notional amount payable at liquidation:

    (a) *Market impact*—many respondents including investors, highlighted that such a classification change would affect entity's debt covenants, their credit ratings and significantly affect corporate's capital structure. Respondents highlighted the size of the market for corporate hybrids; a range between EUR 110-130 billion of nominal outstanding was noted.

    (b) *Accounting calls*—as described in paragraph 22(b), this type of instruments typically include an option for the issuer to call the instruments should the accounting treatment change (the accounting call). Concerns were also highlighted by a few respondents particularly investors about the classification change giving the issuer the option to call the instruments. The strike price of such call option is fixed often at 101% of the par amount and investors will suffer losses if called when these instruments are trading above the strike price. Some noted that the market value may fall in anticipation of, or at the risk of, the issuer exercising the accounting call option. In contrast, another investor expressed the view that the change in accounting classification of corporate hybrid bonds does not necessarily impact investor's investment policy as that is primarily based on the issuer's credit worthiness and the extent of yield the financial instrument earns. This respondent as well as a few others said that the treatment by rating agencies are more important than accounting classification.[7] Based on outreach conducted, the Staff understand that a change in accounting classification

[7] There are hybrids instruments that are not rated by rating agencies. The issuers of such instruments emphasized that the accounting classification is of a very high importance for them.

would not affect how rating agencies assign an equity credit to this type of instruments at least based on the current methodology. The staff further understand that rating agencies typically view this type of instrument as 50% equity and 50% debt.

(c) *Potential transition to non-cumulative instruments*—additionally, two debt analysts expressed the view that a possible effect of the classification proposal in the DP might be that the market of these financial instruments may transition from a cumulative financial instrument to what is essentially a non-cumulative financial instrument to achieve the desired accounting classification, that is, at least in part, equity classification.

(d) *Difference in classification of cumulative and non-cumulative coupons*—a few respondents disagreed with the differences in classification between cumulative and non-cumulative instruments because in their view, these instruments differ little in substance. They highlighted that both types of these instruments share similar key risks (namely extension risk and subordination risk) and similar recovery rates on both a going concern and liquidation basis. Further, both types allow the issuer to defer payments until liquidation. Some added that when a cumulative instrument is measured on a going concern basis, the amount of accumulated coupon payable should also be discounted back to nil or insignificant value in the same way as a fixed notional amount payable, especially if the deferral of the coupons do not attract additional interest. Respondents asked whether this could result in the entire value of this instrument being attributed to an equity component.

(e) *The need for classification change*—at least two debt analysts said that the current accounting classification is clear and well understood. One of them added that the understanding is that if an instrument has a fixed maturity date, it is classified as a liability and if undated, equity. Respondents noted that at least in Europe, the terms of corporate hybrid bonds are highly standardised and therefore well understood by the market participants. However, a debt analyst acknowledged that the same level of understanding is not shared with equity analysts who think corporate hybrids are complex.

29. Acknowledging that these financial instruments have distinct features compared to an equity instrument such as ordinary shares, few respondents suggested the Board consider a presentation or disclosure solution instead of classifying them as financial liabilities.

30. Few users highlighted that there is currently diversity in practice amongst financial analysts in classification of this types of instruments for their analysis purposes—some analysts consider them as half equity, half liability and others treat them entirely as a financial liability.

Request for transition relief

31. As described above, most respondents who provided feedback about specific classification changes consider that the changes from equity to financial liabilities would have a significant impact in a wide range of industries. To mitigate the impact, these respondents urged the Board to consider the following, if the Board decide to proceed with the proposals in the DP:

    (a) perform a comprehensive impact assessment to fully take into consideration the effects and underlying costs of implementing these proposals.

    (b) provide a phase-in period of several years (ie allow several years before the change in classification takes effect for existing financial instruments) or allow grandfathering of existing financial instruments, in order to ensure a smooth transition.