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EBA-2019-D-2189

Mr Hans Hoogervorst
Chairman
International Accounting Standards Board
7 Westferry Circus
Canary Wharf
London E14 4HD

7 January 2019

Subject: Discussion Paper (DP/2018/1) – Financial Instruments with Characteristics of Equity

Dear Mr Hoogervorst,

The European Banking Authority (EBA) welcomes the opportunity to comment on the IASB's discussion paper DP/2018/1: *Financial Instruments with Characteristics of Equity* ("discussion paper"). The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

The EBA strongly supports the IASB's efforts to develop clear definitions for the distinction between equity and liability, promoting a consistent application and addressing the main issues identified under the current *IAS 32: Financial Instruments: Presentation*. An appropriate classification of financial instruments is not only highly significant for the presentation of financial statements but also, as a matter of fact, relevant when applying the rules set out in the regulatory capital framework. Under the Capital Requirements Regulation (CRR)[1], the qualification of instruments as Common Equity Tier 1 (CET1) under Article 28 or as State Aid under Article 31 requires, among other eligibility criteria, a classification as equity under the applicable accounting framework. Indeed, although prudential regulators have their own requirements for defining regulatory capital[2], the importance of the link between these requirements and the accounting standards should not be underestimated. It is therefore of the utmost importance for regulators to fully understand and be comfortable with the accounting principles behind the classification of financial instruments as liability or equity.

Based on the above considerations, the EBA comment letter is mainly focused on aspects of the proposals that may have a direct impact in prudential terms, including those for which additional clarifications regarding the Board's preferred approach presented in the discussion paper are

[1] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013.

[2] As highlighted in paragraph 1.42 of the discussion paper.

deemed necessary. We have not explicitly addressed the specific questions raised in the discussion paper.

General comments

In overall terms, the EBA believes that the Board's preferred approach as presented in the discussion paper better clarifies the rationale to be followed when determining the classification of financial instruments.

The EBA agrees with paragraph IN21 of the discussion paper, that the IASB's proposed approach would probably not change the classification outcomes for the majority of financial instruments. We suggest, however, that the IASB undertakes a cost-benefit analysis to ensure that the outcome of the FICE project would not lead to unintended consequences or undue operational costs. The IASB should also carefully consider how the proposals relate to the Conceptual Framework and other IFRS standards so that any inconsistencies identified can be properly understood and (if maintained) explained to stakeholders.

If the IASB concludes, from a cost-benefit perspective, that a complete review of IAS 32 is needed, the EBA would suggest that a standard level solution is considered instead of a non-mandatory guidance, which is one of the options listed in paragraph IN24 of the discussion paper. Consistency in the application of a set of criteria could only be achieved if requirements rather than guidelines are to be applied. The EBA believes that a non-mandatory solution would lead to inconsistencies in the reported financial figures and impede transparency and comparability.

Puttable exception and members' shares in cooperative entities

The EBA supports the proposal in paragraph 3.29 to 3.38 of the discussion paper that the current puttable exception under IAS 32 is kept. Without this exemption, instruments representing the most residual interest in the entity's net assets would meet the definition of a financial liability under the Board's preferred approach which could be counter-intuitive for the reasons mentioned in paragraph 3.31 of the discussion paper and BC50 of IAS 32.

Also in this context, the EBA strongly supports that the current accounting treatment applied to cooperative shares (IFRIC 2) is retained, as suggested in paragraph 8.34 of the discussion paper. This interpretation is of the utmost importance for cooperative entities in Europe as its application allows the eligibility of their shares as equity, taking into account specific characteristics of these shares in terms of redemption or right to reserves in insolvency or liquidation, and further as CET1 provided that all eligibility criteria stemming from the CRR (in particular Article 29) and related delegated regulations are met. However, the EBA would encourage the IASB to further consider whether the material in IFRIC 2 could be incorporated into the conceptual underpinning that is to be included in the standard itself. This would allow the specific aspects identified in relation to the issue addressed by IFRIC 2 to be imbedded in a robust manner, as part of a final revised version of IAS 32 without the need for significant exemptions to the general rule. Anyway, from a prudential perspective, the main aspect to be preserved is the current accounting classification as equity of these cooperative shares, in all its components, being the so-called puttable exception (right for the holder of the shares to get a redemption under certain conditions as specified in the CRR and related technical standards) or the amount feature (since the share usually provides its holder with rights to reserves in insolvency or liquidation limited to the nominal value of the share).

Application of the "timing" and "amount" features and treatment of compound instruments

Contrary to CET1 capital instruments, the qualification of instruments as Additional Tier 1 (AT1) capital does not require a specific classification under the applicable accounting framework under the CRR. That said, as mentioned before, regulators have a strong interest in fully understanding the rationale behind accounting principles pertaining to the classification of financial instruments as liability or equity and in transparent and comparable financial statements. For AT1 instruments in particular, the accounting classification is not neutral in terms of hedge accounting to cover for foreign exchange risks for example.

Taking into account the level of complexity of this discussion paper and the concerns that it intends to address, the EBA would recommend the IASB to consider the possibility of providing additional clarifications on the following aspects:

- The Board's preferred approach is based on two features against which financial instruments should be assessed: timing and amount. There are some particular aspects on the application of these two features that could be better explained in conceptual and practical terms. Regarding the "amount feature", it should be clear what "independence of the entity's available economic resources" means when different types of variables are under consideration. While in some cases this assessment can be quite straightforward, for some specific variables different interpretations might exist (typically, those variables are affected by the level of economic resources of the entity but also by other external factors not entity-specific). An example of such a variable is the CET1 ratio for a bank (usually referred to as a trigger point for conversion or write-down) which can be affected by both entity-specific and external factors (for example changes in regulation). Additional guidance and concrete examples would be very much welcomed on this matter.

- Additionally, also in relation to the "amount feature", the concept of "independence of the entity's available economic resources" and the interaction with the "timing feature", it would be important to understand how the obligation for an amount independent of the entity's available economic resources is to be assessed in the case of liquidation. It is not clear from the discussion paper whether the ranking of a claim in liquidation might make a difference for this assessment. While paragraph 3.17 of the discussion paper might be read in a way that suggests the assessment would depend on the rank of a financial instrument (i.e. available economic resources would be determined taking into account more senior claims), paragraphs 3.22 and 3.23 of the discussion paper seem to imply the opposite ("amount is independent if it does not take into account the effects of other claims against the entity"). For this reason, this should be clarified in the final approach to be developed by the IASB.

- Regarding the accounting treatment of compound instruments, particularly contingent convertible bonds that require the entity to deliver a variable number of its own shares, the EBA considers that additional examples should be made available by the IASB on the classification principle for derivative financial instruments. While under the suggested classification principles it is quite clear that, in the example provided in paragraph 5.23 of the discussion paper, the financial liability component relates to the (contingent) obligation to deliver a variable number of own equity instruments, it is not so clear how the remaining rights and obligations need to be assessed based on the criteria for derivative financial instruments. An example on how this assessment would work for embedded caps and floors in these convertible instruments could be extremely useful. Additionally, it would be helpful to clarify if the conclusions reached in the January 2014 IASB Staff Paper on the treatment of the equity component under IAS 32 would remain valid (i.e., the equity component could be measured at zero).

Presentation and disclosure

Finally, on matters related to presentation and disclosures, the EBA would like to add the following:

- The EBA considers the attribution of total comprehensive income to equity instruments other than ordinary shares to be complex, burdensome and difficult to interpret. Additionally, it is not clear what the real benefits of this approach are. For this reason, the EBA would suggest that the IASB reviews the rationale behind this proposal and whether this would, indeed, contribute to the enhanced quality of financial reporting with clear benefits for the users of this information.

- While the consideration of economic incentives for classification purposes can be quite challenging in operational terms, lead to inconsistent interpretations and different outcomes and, as such, can be difficult to justify, the EBA believes that additional disclosures on this matter could be useful. The EBA would recommend the IASB to assess whether requiring such disclosures would represent an excessive burden for entities when compared to the benefit for stakeholders using this information. If this cost-benefit assessment is positive, the IASB could then further explore expanding the disclosure requirements on the economic incentives as part of the development of a final standard-level solution.

If you have any questions regarding our comments, please do not hesitate to contact us.

Yours sincerely,

[signed]

Jo Swyngedouw, EBA Alternate Chairperson
On behalf of the EBA Board of Supervisors