THE CHAIRPERSON



Floor 24-27, Tour Europlaza 20 Avenue André Prothin 92400 Courbevoie, France

T: +33 186 526 831

E: JoseManuel.Campa@eba.europa.eu

https://eba.europa.eu

Andreas Barckow
Chairman
International Accounting Standards Board
Columbus Building, 7 Westferry Circus
Canary Wharf
London E14 4HD, United Kingdom

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EBA-2024-D-4679

Subject: IASB Exposure Draft (IASB/ED/2023/5) – Financial Instruments with Characteristics of Equity

Dear Mr Barckow,

The European Banking Authority (EBA) welcomes the opportunity to comment on the IASB's Exposure Draft Financial Instruments with Characteristics of Equity (ED) that would amend IAS 32 Financial Instruments: Presentation, IFRS 7 Financial Instruments: Disclosures, and IAS 1 Presentation of Financial Statements. 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 notes the IASB's efforts to provide more clarity on the current classification principles, promoting a consistent application and addressing some of the issues identified under IAS 32. Ensuring an appropriate classification of financial instruments is of crucial importance for providing useful information to users of financial statements but is also relevant when applying the provisions set out in the regulatory capital framework. Indeed, although the qualification of financial instruments as regulatory capital is evaluated by regulators and supervisors in accordance with the prudential framework, and in particular according to the Capital Requirements Regulation (CRR)¹ provisions, it is crucial to carefully consider the link between these requirements and the accounting standards due to the latter being considered as a starting point from a prudential perspective.

The EBA notes the IASB's efforts in providing clarification on whether, and to what extent, relevant laws and regulations could create rights and obligations that affect the classification of a financial instrument as a financial liability or an equity instrument. This said, the EBA believes that more clarity and guidance should be sought, especially on the application of the current proposal to

¹ See Title I of Part Two of Regulation (EU) No 575/2013 of the European Parliament and of the Council on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012.



financial instruments that are almost fully regulated by these laws and regulations only by opposition to contractual terms and conditions, and on the consideration of contractual loss absorbency mechanisms of Additional Tier 1 (AT1) instruments in the classification assessment. As described in the Annex to this letter, the prudential framework applicable to capital instruments in the EU encompasses the regulatory provisions of the CRR, relevant regulatory and implementing technical standards, as supplemented by related guidance for the consistent and effective application of the regulatory framework provided by the EBA via its monitoring reports on capital instruments and related Q&As, all aspects taken together constituting the Single Rule Book.

In addition, while the proposed clarifications on the treatment of obligations to repurchase own equity instruments are intended to limit the different practices observed, the recognition of the financial liability against other component of equity may not only influence banks' current practices, but also have negative implications for banks' capital ratios, given its interactions with the prudential treatment of minority interests (MI). Therefore, it is EBA's view that additional analysis from the IASB may be warranted, and further considerations should be given to an alternative approach whereby the obligation to repurchase own equity instruments is primarily deducted from non-controlling interest (NCI) in order to avoid negative impacts in capital ratios stemming from (i) the prudential treatment of MI, and (ii) the full impact in CET1 capital of the deduction of the obligation from other component of equity.

Lastly, the EBA supports the IASB's proposal for clarifying the treatment of financial instruments with contingent settlement provisions that would in particular lead to consider discretionary payments on AT1 instruments as equity even if the instrument itself has been accounted as liability from inception. That said, the IASB is invited to consider whether to provide a suitable transition period and/or specific transitional arrangements to affected entities, given the potential implications and effects of these changes with existing hedging strategies put in place by banks on existing instruments' related coupons. Additional clarification on the proposals around contingent settlement provisions for AT1 instruments subject to cap and/or floor mechanisms under conversion mechanisms into a variable number of shares would also be needed on the existence or not of an embedded derivative, to ensure harmonised practices across banks and avoid potential volatility in capital ratios.

Based on the above considerations, the EBA comment letter is mainly focused on targeted aspects of the proposals that may have a direct impact in prudential terms. These are expressed in detail in the Annex to this letter.

Yours sincerely,

José Manuel Campa^{*}



Annex I: Detailed comments on the IASB's Exposure Draft Financial Instruments with Characteristics of Equity

Question 1 – The effects of relevant laws or regulations

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

- 1. The EBA welcomes the IASB efforts to clarify whether and to what extent relevant laws or regulations (such as statutory or regulatory requirements) could create rights and obligations that affect the classification of a financial instrument as a financial liability or an equity instrument. In particular, the EBA believes that some of the clarifications provided would limit existing grey areas in the application of IAS 32, ensuring a more defined and consistent framework for the distinction between equity and liability. This is deemed a very important objective from a prudential perspective as the accounting classification of financial instruments is not only relevant for financial reporting purposes, but is also of importance within the regulatory capital framework.
- 2. The link between accounting and prudential requirements is fully evident for the qualification of instruments as Common Equity Tier 1 (CET1) capital, as under the Capital Requirements Regulation (CRR)² CET1 instruments are required, *inter alia*, to be classified as equity within the meaning of the applicable framework. Conversely, although the CRR does not specifically require a particular accounting classification for the qualification of instruments as Additional Tier 1 (AT1) capital, there are prudential implications associated with classifying these instruments as either equity or liability. This is especially pertinent in relation to the potential application of hedge accounting to mitigate certain inherent risks (e.g., such as interest rate and foreign exchange (FX) risks).
- 3. In this context, it is worth reminding that the EU regulatory capital framework encompasses a set of harmonised rules established by laws and regulations (i.e., CRR and technical standards) supplemented by complementary guidance (e.g., EBA Q&As and monitoring reports on capital instruments). Consequently, capital instruments must fulfil all the eligibility criteria set out in the CRR while holistically considering other relevant provisions and guidance provided on the implementation of the regulations, following a cascading approach. In this regard, it is important to recall that terms and conditions of instruments qualifying as regulatory capital instruments cannot contradict the provisions laid down in the relevant law, regulation, and guidance as provided by the EBA.
- 4. The proposed changes of the FICE ED have been assessed according to this context and background.

² Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions.



Relevant laws or regulations that create rights and obligations

- 5. The EBA acknowledges that the changes proposed by the IASB would lead to different treatments of rights and obligations that stem from relevant laws and regulations and those only stipulated in the contractual terms of financial instruments in the classification assessment. While the EBA welcomes the IASB efforts and understands that an "all-inclusive" classification approach would go beyond clarifying the classification requirements in IAS 32, it is the EBA's view that certain elements of the current proposal would contradict the principle of "substance over form" a key element of "faithful representation" in accordance with paragraph 2.12 of the Conceptual Framework³ and not in line with paragraph 18 of IAS 32⁴. These concepts are particularly relevant for providing a consistent classification of financial instruments that have similar economic substance (IAS 32 BC16).
- 6. Indeed, under the current approach, two entities based in different jurisdictions that issue economically similar financial instruments would classify the instruments differently, solely due to the elements that trigger the classification being established through the relevant laws and regulations or via the provisions governing the instrument⁵. This might also bring inconsistencies from a prudential perspective given the interplay between the accounting and prudential frameworks mentioned under the previous paragraphs.
- 7. In the same vein, clearer guidance is also needed for the consideration of the terms and conditions of financial instruments which are strongly regulated by law (e.g., regulated deposits). For these instruments, a literal reading of the proposed changes implies that the classification assessment should disregard most of the rights and obligations as they are specified in the relevant regulation. As a consequence, instruments that would generally be classified as financial liabilities (i.e., deposits) could now qualify as equity instruments.
- 8. As regards to paragraphs BC23 to BC26, while the EBA agrees with the IASB's rationale that an entity should consider a right or obligation in its entirety, as any other treatment would increase complexity and practical implementation challenges, more clarity is needed to determine what should be considered as "incremental". In accordance with the example provided by the IASB under paragraph BC25, when a regulation requires an entity to establish a trigger level for the conversion of an instrument into a variable number of shares, different consideration would be given in the assessment of the classification to minimum trigger levels, as required by regulation,

³ In accordance with paragraph 2.12 of the Conceptual Framework "Financial reports represent economic phenomena in words and numbers. To be useful, financial information must not only represent relevant phenomena, <u>but it must also faithfully represent the substance of the phenomena that it purports to represent.</u> In many circumstances, the substance of an economic phenomenon and its legal form are the same. <u>If they are not the same, providing information only about the legal form would not faithfully represent the economic phenomenon" (emphasis added).</u>

⁴ In accordance with paragraph 18 of IAS 32 "The substance of a financial instrument, rather than its legal form, governs its classification in the entity's statement of financial position. Substance and legal form are commonly consistent, but not always."

⁵ Under paragraph BC18, the Board provides a similar reasoning for disregarding one of the approaches considered as it is understood that users of financial statements would expect economically comparable instruments to have a similar classification.



and higher ones. This could theoretically imply that two instruments with identical terms and conditions, except for the trigger level, could be accounted for differently, which would be counterintuitive from a prudential perspective.

- 9. In this regard, the EBA observes the following:
- Distinction should be made between the laws and regulations that set up a mandatory requirement and those that provide a set of options at discretion of the parties to the contract that, altogether, establish the requirement that the entity needs to comply with. In the latter case, the EBA believes that those provisions cannot be considered as "established by the relevant laws or regulations" as these contractual rights and obligations can be subject to negotiation and agreement between the parties to the contract and should, therefore, be taken into account in determining the classification of the financial instrument.
- With specific reference to the example made by the IASB in paragraph BC25, the EBA notes that, in general, provisions governing AT1 instruments provide a set of options for the parties to determine, among others, the specific loss absorbency mechanism that allows an instrument to be considered as eligible AT1 capital. While it is understood that those obligations stem from a legal requirement, without the clause in the contractual arrangement that specifies the form of the loss absorbency mechanism the provision would not be directly applicable and, more importantly, the instrument not eligible as AT1.
- 10. Based on the above considerations, the EBA invites the IASB to provide more guidance regarding which contractual rights and obligations should be deemed supplementary to those established by applicable laws or regulations, which is crucial to prevent inconsistent practices that could jeopardise transparency and comparability of the financial statements across jurisdictions.

Bail-inable instruments

- 11. In accordance with paragraph BC22, the Board concluded that it would be appropriate for the rights and obligations established by the relevant laws or regulations not to be considered when classifying bail-inable instruments because the laws or regulations would exist regardless of whether they are included in the contract. In the view of the EBA, this clarification results in a more appropriate approach than a full consideration of the relevant resolution laws and regulations in the classification of an instrument. This is because while, in general, EU banks are, for prudential purposes, required to include a reference in the contractual arrangements that those instruments may be subject to write-down and conversion powers, the rights and obligations that arise are enforceable only at the discretion of the relevant resolution authority.
- 12. In addition, it should also be noted that those resolution powers might vary across jurisdictions and may leave significant discretion to resolution authorities, thus it is not clear how the resolution authority will choose to exercise their powers at the point of resolution, which could result either in a (full) write-down or conversion into an unspecified number of shares.



Therefore, a full consideration of those rights and obligations would not allow for a definitive classification of the instrument as it would depend on banks' own assumption, at the inception of the contract, on how resolution powers may be exercised.

Relevant laws or regulations that prevent enforceability of a contractual right or obligation

- 13. As mentioned above, the terms and conditions governing capital instruments should at all times satisfy the requirements set out in the relevant prudential framework in its entirety. That said, the EBA supports the clarification that contractual rights and obligations that are included in an instrument's terms and conditions but that are not enforceable by law (e.g., terms and conditions that are not in line with the applicable prudential framework) should not be taken into account in the classification as a financial liability or equity instrument.
- 14. In addition, the EBA believes that the proposed approach is in line with the principles established in IFRIC 2 Members' Shares in Co-operative Entities and Similar instruments whereby an entity must consider all the terms and conditions of the financial instrument, including relevant local laws, regulations and the entity's governing charter, when determining its classification (IFRIC 2.5). A different approach would result in the classification of financial instruments being driven by rights and obligations that are not applicable under the relevant law or regulation, resulting in misleading information for the users of financial statements.
- 15. The EBA strongly supports that the current accounting treatment applied to cooperative shares under IFRIC 2 is retained, given the importance of this interpretation, especially, for mutual, cooperative entities established in Europe to allow their classification as equity⁶.

Question 2 – Settlement in an entity's own equity instruments

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

- 16.In overall terms, the EBA supports the clarifications made by the IASB to determine whether the "fixed-for-fixed" condition is met, more specifically, on the types of adjustments that are consistent with and the effect that foreign currency has within the "fixed-for-fixed" condition. With reference to the latter, the EBA welcomes the IASB's decision to maintain the current application of the requirements laid down in paragraph 16(b)(ii) of IAS 32 in the case of foreign currency rights, options and warrants, as the industry considers such an exception to be important.
- 17.Regarding the clarifications made on the passage of time adjustments, the approach proposed by the IASB requires the amount of consideration to be paid or received for each of an entity's own equity instruments on each possible settlement date to be predetermined at inception of

⁶ In accordance with Article 28(c)(ii) CRR, capital instruments shall qualify as Common Equity Tier 1 instruments if, other conditions being met, the instruments are classified as equity within the meaning of the applicable accounting framework.



the contract, to vary only with the passage of time and to have the effect of fixing on initial recognition the amount of consideration to be paid or received in terms of a present value.

18.In the EBA's view, more guidance would be needed to:

- Assess whether the difference between the amount of consideration to be paid or received on each settlement date represents only a compensation "proportional" to the passage of time. The EBA believes that the current proposal to determine what "proportional" is embeds high judgement and, therefore, more guidance and/or illustrative examples would be needed to avoid, for instance, the use of unrealistic discount rates in present value calculations to achieve certain pre-defined outcomes.
- Determine the adjustments that can be considered in line with the IASB's concept of passage-of-time. In accordance with paragraphs IE82-IE86 an adjustment in which a strike price, that is based on a predefined formula, varies with an interest rate benchmark or an inflation index cannot qualify as a passage-of-time adjustment. Nevertheless, the EBA believes that the rationale for such adjustment not meeting the condition of passage-of-time is not sufficiently clear and that further consideration would be needed in this regard⁷. Namely, to clarify if the non-compliance with the passage-of-time condition is due to the benchmark rate not being set or fixed for each exercise date at the inception of the contract, or otherwise.

Question 3 – Obligations to purchase an entity's own equity instruments

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

- 19. While the EBA welcomes the efforts of the IASB for providing clarifications that would reduce the diversity observed in practice, it is worth noting that the envisaged approach may differ from current practices followed by banks which, generally, imply the recognition of the liability against non-controlling interests (NCI) and not against other component of equity. The reason behind the use of such approach is the representation of the accounting effects that would be visible at the settlement of the obligation, as reported by banks.
- 20.More importantly, from a prudential perspective, the proposed approach would also affect capital ratios, primarily due to the prudential treatment of NCI (i.e., minority interests (MI) for prudential purposes). The calculation of the eligible minority interests ⁸ for prudential purposes might differ from the one followed under accounting to determine NCI, generally including in regulatory capital only a portion of the NCI. Thus, recognising the financial liability against other component of own equity rather than NCI might have negative effects on solvency ratios.

⁷ For the purposes of the Solely Payments of Principal and Interest (SPPI) assessment, adjustments based on an interest rate benchmark or an inflation index qualify as passage-of-time ones [on the former, see IFRS 9.B4.1.11.(a) and, on the latter, see IFRS 9.B4.1.13].

⁸ In the prudential framework, minority interest is the equivalent concept to the accounting NCI and which, subject to certain conditions and limits, are part of the institutions' own funds. See Title II of Chapter 6 of Part Two of the CRR.



This is because while the recognition of NCI in regulatory capital is generally lower, the impact stemming from the removal of the liability from own equity would be fully recognised in regulatory capital ratios, resulting in a situation where banks are not only penalised by the (lower) regulatory recognition of NCI but also by the full recognition in equity of the obligation to repurchase own equity instruments.

- 21.Indeed, the effects of the proposed treatment on regulatory capital ratios might even be more impactful in the case of non-regulated financial subsidiaries ⁹. In such scenario, whilst a deduction from NCI would be neutral from a capital perspective due to MI not being recognised from a prudential perspective, the deduction from other component of equity will automatically reduce CET1 capital, which might be seen as double counting from a prudential standpoint.
- 22.In light of the above, the EBA is of the view that the IASB should further consider and assess whether the proposed approach might have unintended consequences for banks. For the same reasons, the EBA would see merits in not disregarding the possibility to use an approach whereby the amount of the financial liability is mainly removed from the NCI component, in order to avoid potential negative impacts in the capital ratios of banks.
- 23. Finally, with reference to the measurement of the financial liability, paragraph 23 of the ED clarifies that the financial liability that arises from the obligation to purchase own equity instruments is measured at the present value of the redemption amount, which is discounted, assuming redemption will occur at the earliest possible redemption date specified in the contract. This would imply that, for instance, in the case of a put option that is exercisable each year for a period of five years, the entity will assume at initial recognition of the financial liability that redemption will occur in one year time (i.e., redemption amount will be discounted assuming a one-year maturity).
- 24. The EBA is of the view that, for cases like the one abovementioned, the measurement of the financial liability when the earliest possible redemption date (e.g., one year) has expired without being exercised is not sufficiently clear. In this regard, the EBA believes that more guidance and illustrative examples would be needed to ensure consistency, in particular, on the discounting period that should be used and where to recognise the related adjustments.

Question 4 - Contingent settlement provisions

Do you agree with these proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

25. The EBA supports the IASB's proposal for clarifying the treatment of financial instruments with contingent settlement provisions that would lead to coupon payments being considered as equity even if, at initial recognition, an institution classifies the principal as liability from an

⁹ In accordance with Article 18(1) of the CRR, only subsidiaries that qualify as institutions, financial institutions or ancillary services undertakings shall be fully consolidated for prudential purposes, unless Article 18(8) of the CRR applies.



accounting perspective. In the EBA's view, the proposed approach would help reduce inconsistent practices that have been observed from banks (i.e., recognition in full of a liability or separation of the liability and equity components), increasing comparability and limiting the current room for interpretation.

- 26. Nevertheless, it is worth to consider that the proposed approach might have a non-negligible impact on banks' current practices, in particular, with reference to the hedging strategies in place to manage the foreign exchange and interest rate risks stemming from the payment of the coupon. For this reason, the EBA invites the IASB to consider whether enough of a transition period is given to entities, allowing them to reshape their current hedging strategies to comply with the proposed changes, as well as to consider adding specific transition arrangements in case of reclassification of the related hedged item due to the application of the proposed amendments.
- 27. With reference to the clarifications on the measurement of the financial liability, the EBA agrees with the IASB proposal that, in applying the requirements of paragraph 25A of IAS 32, the probability and estimated timing of the contingent event should not affect the initial or subsequent measurement of the liability. In the EBA's view, this approach would result in a more consistent outcome where the amount that would be payable upon the occurrence of a contingent event would be already reflected in the financial statements of entities, allowing a fair representation that is in the interest of the users of the financial statements.
- 28. The EBA has also observed situations in which financial instruments with contingent settlement provisions are subject to cap and/or floor mechanisms. For instance, AT1 instruments whose loss absorption mechanism consists in the conversion into a variable number of shares, upon the occurrence of a trigger event, subject to a floor price per share to be delivered. In this regard, it is noted that IAS 32 does not provide clear guidance on how to account for those features, allowing for different treatments as it has been observed in practice (e.g., full recognition of a financial liability without accounting for the cap/floor feature or recognition of both a financial liability and an embedded derivate).
- 29. In accordance with IAS 32, the conversion feature should be assessed as a whole (i.e., if the contingent settlement provision requires to deliver a variable number of shares, the fixed condition would not be met and the conversion feature would be classified as a liability, disregarding any scenario in which the fixed condition could be met). However, it is not clear whether the cap and/or floor features should be considered as a (embedded) derivative whose value should be included in the liability component. Consequently, the EBA considers that more guidance in the form of illustrative examples is needed to determine the treatment for financial instruments with contingent settlement provisions that are subject to cap and/or floor features, which would ensure a consistent approach across all entities and avoid potential volatility in capital ratios.