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Comments of German Banking Industry Committee on IASB ED/2023/5 – Financial Instruments with Characteristics of Equity

March 21, 2024

Attachment: 1

Dear Dr Barckow,

On behalf of the German Banking Industry Committee we welcome the opportunity to comment on the IASB's Exposure Draft ED/2023/5 "Financial Instruments with Characteristics of Equity".

Please find our general comments and our answers to your detailed questions attached to this letter.

If you have any questions or would like to discuss our comments further, please do not hesitate to contact us.

Yours sincerely,
on behalf of the German Banking Industry Committee
German Savings Banks Association

by proxy	by proxy
Dr. Maik Grabau	Eric Eispert

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German Lobby Register No R001459
EU-Transparency Register No
52646912360-95

Comments

on IASB ED/2023/5 – Financial Instruments with Characteristics of Equity

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Berlin, March 21, 2024

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General comments

We welcome the approach taken by the IASB in IASB/ED/2023/5 to focus on the existing principles for the distinction between equity and debt capital and to concentrate on certain application problems in practice. In our opinion, the existing regulations are fundamentally satisfactory, so that no fundamental changes - such as those suggested in the 2018 discussion paper - are necessary. Below you will find our comments on the questions.

Detailed comments

Question 1—The effects of relevant laws or regulations (paragraphs 15A andAG24A–AG24B of IAS 32)

The IASB proposes to clarify that:

(a) only contractual rights and obligations that are enforceable by laws or regulations and are in addition to those created by relevant laws or regulations are considered in classifying a financial instrument or its component parts (paragraph 15A); and

(b) a contractual right or obligation that is not solely created by laws or regulations, but is in addition to a right or obligation created by relevant laws or regulations shall be considered in its entirety in classifying the financial instrument or its component parts (paragraph AG24B). Paragraphs BC12–BC30 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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.

The exposure draft proposes that contractual obligations should only be taken into account in the classification if they do not simply reflect legal obligations but go beyond them.

We consider this to be a significant change to the status quo and believe it is misleading. In our opinion, this means conversely that contractually agreed rights and obligations (must) be completely disregarded if they merely correspond exactly to a legal requirement. An example is the case of a contract (instrument), which would, however, have different effects due to different laws in different countries. This also shows that the IASB's intended clarification does not lead to less diversity in practice or application problems, but actually increases them considerably.

In addition, we are concerned with the phrase “in addition to”, particularly on what is meant by it, how to interpret and operationalize it.

If all contractual components are derived from the law and no further contractual agreement is concluded, capital under stock corporation law or cooperative shares, for example, could not be recognised in equity. We are of the opinion that paragraph 15 A must be revised in order to achieve a meaningful result. Even a revision of the Basis for Conclusions could not help here.

Moreover, in EU, the CRR framework dictates the required features that financial instruments must have to qualify as eligible AT1 financial instruments; namely:

1. They are perpetual and must contain no incentive for the issuer to redeem them earlier.

2. They can pay periodic coupons but any coupon payments on the instruments are to be at the discretion of the issuer.
3. They are automatically converted into ordinary shares or written down upon the issuer breaching a specified capital ratio (specific loss absorption feature).
4. They are subject to the general bail-in power of the relevant regulator.

In the case of the discretionary coupon payments (feature no. 2), when the issuance of the financial instrument is not regulated by a particular law, an entity would consider this feature and classify it as an equity component under IAS 32.

However, when a financial instrument is regulated by a law, such as the issuance of AT1 financial instruments under the EU laws, one possible interpretation of the proposed paragraph 15A(a) of the exposure draft could result in the discretionary coupon payments to be disregarded as it is the same as that required under the EU laws and therefore does not meet the “in addition to” requirement in proposed paragraph 15A(a). This conclusion is the same as that derived by the IASB Staff and Board for the general bail-in power of the relevant regulator (feature no. 4), i.e., not considered in the classification of the instrument as a financial liability or equity instrument because the terms do not go beyond the legal requirements. We find this interpretation conceptually illogical that:

- For such an important feature as the discretionary coupon payments in a financial instrument, its consideration in the classification approach under the exposure draft depends on whether the financial instrument is regulated by laws or not.
- Moreover, we see a further implication when the discretionary coupon payments are not considered under the effects of laws or regulations proposals in the exposure draft for an AT1 financial instrument where the loss absorption feature is a conversion to a variable number of ordinary shares (feature no. 3). When the proposed laws and regulations in paragraph 15A is ignored, the proposed settlement provisions in the exposure would result in the AT1 financial instrument to be treated as a compound instrument, where the equity component comes from the discretionary coupon payments and the financial liability component comes from the loss absorption feature. In contrast, when the proposed laws and regulations in paragraph 15A are now taken into account, the classification of the AT1 financial instrument becomes different. Instead of a compound instrument, it is now classified as a financial liability in its entirety because the equity component is not considered under the proposed laws and regulations.

If this is what is meant, this principle would not be fundamentally appropriate.

In the light of our comments above, we recommend the IASB to either:

(1) withdraw the proposals on the effects of laws or regulations in paragraph 15A of the exposure draft, or
(2) undertake further research to make the proposals more robust and understandable to avoid diversity in interpretations and practice. In particular, the final standard should clarify that the interpretation as illustrated in the above example is not what the Board had intended and that the discretionary coupon payments should be taken into account when classifying the financial instrument.

Question 2—Settlement in an entity's own equity instruments (paragraphs 16, 22, 22B–22D, AG27A and AG29B of IAS 32)

The IASB proposes to clarify when the fixed-for-fixed condition in paragraph 16(b)(ii) of IAS 32 is met by specifying that the amount of consideration to be exchanged for each of an entity's own equity instruments is required to be denominated in the entity's functional currency, and either:

(a) fixed (will not vary under any circumstances); or

(b) variable solely because of:

(i) preservation adjustments that require the entity to preserve the relative economic interests of future shareholders to an equal or lesser extent than those of current shareholders; and/or

(ii) passage-of-time adjustments that are predetermined, vary with the passage of time only, and have the effect of fixing on initial recognition the present value of the amount of consideration exchanged for each of the entity's own equity instruments (paragraphs 22B–22C).

The IASB also proposes to clarify that if a derivative gives one party a choice of settlement between two or more classes of an entity's own equity instruments, the entity considers whether the fixed-for-fixed condition is met for each class of its own equity instruments that may be delivered on settlement. Such a derivative is an equity instrument only if all the settlement alternatives meet the fixed-for-fixed condition (paragraph AG27A(b)).

The IASB further proposes to clarify that a contract that will or may be settled by the exchange of a fixed number of one class of an entity's own non-derivative equity instruments for a fixed number of another class of its own non-derivative equity instruments is an equity instrument (paragraph 22D). Paragraphs BC31–BC61 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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.

We agree.

Question 3—Obligations to purchase an entity's own equity instruments (paragraphs 23 and AG27B–AG27D of IAS 32)

The IASB proposes to clarify that:

(a) the requirements in IAS 32 for contracts containing an obligation for an entity to purchase its own equity instruments also apply to contracts that will be settled by delivering a variable number of another class of the entity's own equity instruments (paragraph 23).

(b) on initial recognition of the obligation to redeem an entity's own equity instruments, if the entity does not yet have access to the rights and returns associated with ownership of the equity instruments to which the obligation relates, those equity instruments would continue to be recognised. The initial amount of the financial liability would, therefore, be removed from a component of equity other than non-controlling interests or issued share capital (paragraph AG27B).

(c) an entity is required to use the same approach for initial and subsequent measurement of the financial liability—measure the liability at the present value of the redemption amount and ignore the probability and estimated timing of the counterparty exercising that redemption right (paragraph 23).

(d) any gains or losses on remeasurement of the financial liability are recognised in profit or loss (paragraph 23).

(e) if a contract containing an obligation for an entity to purchase its own equity instruments expires without delivery:

(i) the carrying amount of the financial liability would be removed from financial liabilities and included in the same component of equity as that from which it was removed on initial recognition of the financial liability.

(ii) any gains or losses previously recognised from remeasuring the financial liability would not be reversed in profit or loss. However, the entity may transfer the cumulative amount of those gains or losses from retained earnings to another component of equity (paragraph AG27C).

(f) written put options and forward purchase contracts on an entity's own equity instruments that are gross physically settled—consideration is exchanged for own equity instruments—are required to be presented on a gross basis (paragraph AG27D).

Paragraphs BC62–BC93 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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.

We have no comments.

<u>Question 4—Contingent settlement provisions (paragraphs 11, 25, 25A, 31, 32A, AG28 and AG37 of IAS 32)</u>

The IASB proposes to clarify that:

(a) some financial instruments with contingent settlement provisions are compound financial instruments with liability and equity components (paragraphs 25 and 32A);

(b) the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would not take into account the probability and estimated timing of occurrence or non-occurrence of the contingent event (paragraph 25A);

(c) payments at the issuer's discretion are recognised in equity even if the equity component of a compound financial instrument has an initial carrying amount of zero (paragraphs 32A and AG37);

(d) the term 'liquidation' refers to the process that begins after an entity has permanently ceased its operations (paragraph 11); and

(e) the assessment of whether a contractual term is 'not genuine' in accordance with paragraph 25(a) of IAS 32 requires judgement based on the specific facts and circumstances and is not based solely on the probability or likelihood of the contingent event occurring (paragraph AG28).

Paragraphs BC94–BC115 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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.

We support these proposals and think that they are consistent with those in IAS 32 at present, e.g. IAS 32.23 which requires the obligation to purchase an entity's own equity instrument to be measured at the present value of the redemption amount.

We believe that this approach is in line with market practice for the classification of AT1 instruments that convert into a variable number of ordinary shares on the bail-in event. The approach in the ED is therefore consistent with the objective to clarify principles rather than to significantly rewrite IAS 32.

However, we see an issue with the inconsistency that arises where the balance sheet classification of a compound instrument is effectively presented as 100% debt on the balance sheet as a 100% probability is assumed for the liability component, but the discretionary coupon is treated as equity. Unintended consequences could arise, e.g. interest rate hedge accounting may not be possible as per IFRS 9 6.5.2 the hedged item must affect the income statement: as a dividend does not impact the income statement, hedge accounting is problematic. Even if an entity took the view that a buyback of the instrument affects the income statement, the equity treatment of the coupon could result in hedge ineffectiveness.

We prefer a simpler and more intuitive approach where the discretionary coupon is recognised in profit or loss if the host instrument is classified as a financial liability. This matching treatment is easier for users to understand and to explain to analysts.
In the absence of treating discretionary coupons in profit or loss where the host instrument is classified as a liability, it would be helpful if the hedge accounting requirements could be adjusted to allow for the presentation of the coupon in the income statement if hedge accounting were applied. This would be similar to what today is allowed for FVOCI instruments where the hedge accounting requirements in IAS 39 and IFRS 9 supersede the requirement to recognise revaluations of hedged items in OCI.

We understand the IFRS 9 requirements to initially measure financial liabilities using fair value from the view of a market participant. However, we see this as an attribution issue between debt and equity rather than a fair value issue as the combined instrument will still be measured at fair value. IFRS 9 has a similar precedent to the ED for the attribution of a hybrid instrument containing an amortised cost host and a non-option bifurcated derivative. In IFRS 9 B4.3.3 the non-option derivative is also set to zero, similar to the approach in the ED where the equity component is effectively set to zero.

With regard to point (d) we see no need to clarify the term "liquidation".

Question 5—Shareholder discretion (paragraphs AG28A–AG28C of IAS 32)

The IASB proposes:

(a) to clarify that whether an entity has an unconditional right to avoid delivering cash or another financial asset (or otherwise to settle a financial instrument in such a way that it would be a financial liability) depends on the facts and circumstances in which shareholder discretion arises. Judgement is required to assess whether shareholder decisions are treated as entity decisions (paragraph AG28A).

(b) to describe the factors an entity is required to consider in making that assessment, namely whether:

(i) a shareholder decision would be routine in nature—made in the ordinary course of the entity's business activities;

(ii) a shareholder decision relates to an action that would be proposed or a transaction that would be initiated by the entity's management;

(iii) different classes of shareholders would benefit differently from a shareholder decision; and

(iv) the exercise of a shareholder decision-making right would enable a shareholder to require the entity to redeem (or pay a return on) its shares in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) (paragraph AG28A(a)–(d)).

(c) to provide guidance on applying those factors (paragraph AG28B).

Paragraphs BC116–BC125 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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.

We see no need for clarification.

Question 6—Reclassification of financial liabilities and equity instruments (paragraphs 32B–32D and AG35A of IAS 32)

The IASB proposes:

(a) to add a general requirement that prohibits the reclassification of a financial instrument after initial recognition, unless paragraph 16E of IAS 32 applies or the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement (paragraphs 32B–32C).

(b) to specify that if the substance of the contractual arrangement changes because of a change in circumstances external to the contractual arrangement, an entity would:

(i) reclassify the instrument prospectively from the date when that change in circumstances occurred.

(ii) measure a financial liability reclassified from equity at the fair value of that financial liability at the date of reclassification. Any difference between the carrying amount of the equity instrument and the fair value of the financial liability at the date of reclassification would be recognised in equity.

(iii) measure an equity instrument reclassified from a financial liability at the carrying amount of the financial liability at the date of reclassification. No gain or loss would be recognised on reclassification (paragraph 32D).

(c) provide examples of changes in circumstances external to the contractual arrangement requiring reclassification (paragraph AG35A).

Paragraphs BC126–BC164 of the Basis for Conclusions explain the IASB's rationale for these proposals.

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. Would the proposal to reclassify the instrument prospectively from the date when a change in circumstances occurred give rise to any practical difficulties? If so, please describe those practical difficulties and the circumstances in which they would arise.

We have no comments.

Question 7—Disclosure (paragraphs 1, 3, 12E, 17A, 20, 30A–30J and B5A–B5L of IFRS 7)

The IASB proposes:

(a) to expand the objective of IFRS 7 to enable users of financial statements to understand how an entity is financed and what its ownership structure is, including potential dilution to the ownership structure from financial instruments issued at the reporting date (paragraph 1).

(b) to delete the reference to derivatives that meet the definition of an equity instrument in IAS 32 from paragraph 3(a) of IFRS 7.

(c) to move paragraphs 80A and 136A from IAS 1 to IFRS 7. These paragraphs set out requirements for disclosures relating to financial instruments classified as equity in accordance with paragraphs 16A–16B and/or paragraphs 16C–16D of IAS 32 (paragraphs 12E and 30I). The IASB also proposes to expand paragraph 80A to cover reclassifications if there are changes in the substance of the contractual arrangement from a change in circumstances external to the contractual arrangement.

(d) to amend paragraph 20(a)(i) of IFRS 7 to require an entity to disclose gains or losses on financial liabilities containing contractual obligations to pay amounts based on the entity's performance or changes in its net assets, separately from gains or losses on other financial liabilities in each reporting period.

(e) to include disclosure requirements for compound financial instruments in IFRS 7 (paragraph 17A).

The IASB proposes to require an entity to disclose information about:

(a) the nature and priority of claims against the entity on liquidation arising from financial liabilities and equity instruments (paragraphs 30A–30B);

(b) the terms and conditions of financial instruments with both financial liability and equity characteristics (paragraphs 30C–30E and B5B–B5H);

(c) terms and conditions that become, or stop being, effective with the passage of time (paragraph 30F);

(d) the potential dilution of ordinary shares (paragraphs 30G–30H and B5I–B5L); and

(e) instruments that include obligations to purchase the entity's own equity instruments (paragraph 30J).

Paragraphs BC170–BC245 of the Basis for Conclusions explain the IASB's rationale for these proposals.
Do you agree with the proposals? Why or why not? If you disagree with any of the proposals, please explain what you suggest instead and why.

We consider the required disclosure on "Nature and priority of claims on liquidation, arising from financial instruments" to be very comprehensive. Very broadly speaking, this could apply not only to issued financial instruments, but possibly even to deposits. For example, this would be a high burden for a banking group that operates in different jurisdictions, without any corresponding benefit. In addition, information on this is already required under Pillar III disclosure, so the disclosure required here does not appear to be appropriate.

With regard to the disclosure on "Priority on liquidation", we would like to note that the possibility of cross-referencing (e.g. to Pillar III), which generally exists for IFRS 7, is not possible for the planned new disclosure (since, according to IFRS 7.B6, this only applies to paragraphs 31-42). Cross-referencing should also be possible for the aforementioned information. We kindly ask you to adjust this.

Paragraph 30 E, point c of IFRS 7 requires the disclosure of "information about any significant uncertainty about how laws or regulations applicable to financial instruments could affect their priority on liquidation". But "an entity would not be required to predict what the legal outcomes might be when providing this disclosure". We consider this disclosure requirement to be incomprehensible. What should be the content of such a disclosure requirement? Additionally, its implementation would be very challenging and far-reaching to analyze all possible laws or regulations that could affect a particular financial instrument's priority on liquidation. That's why we advocate a deletion of this disclosure requirement.

Question 8—Presentation of amounts attributable to ordinary shareholders (paragraphs 54, 81B and 107–108 of IAS 1)

The IASB proposes to amend IAS 1 to require an entity to provide additional information about amounts attributable to ordinary shareholders. The proposed amendments are that:
(a) the statement of financial position shows issued share capital and reserves attributable to ordinary shareholders of the parent separately from issued share capital and reserves attributable to other owners of the parent (paragraph 54);
(b) the statement of comprehensive income shows an allocation of profit or loss and other comprehensive income attributable to owners of the parent between ordinary shareholders and other owners of the parent (paragraph 81B);
(c) the components of equity reconciled in the statement of changes in equity include each class of ordinary share capital and each class of other contributed equity (paragraph 108); and
(d) dividend amounts relating to ordinary shareholders are presented separately from amounts relating to other owners of the entity (paragraph 107).
Paragraphs BC246–BC256 of the Basis for Conclusions explain the IASB's rationale for these proposals.
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. Would the proposed requirement

to allocate issued share capital and reserves between ordinary shareholders and other owners of the parent give rise to any practical difficulties in determining the required amounts? If so, please describe the possible difficulties and specify areas in which further guidance would be helpful.

Allocating profit or loss to “Ordinary shareholders of the parent” and “Other owners of the parent” seems to cause big challenges. It is unclear in detail what exactly is to be allocated and how (e.g. profits from hedging, revaluation result, fx adjustments).

Beyond that we consider it preferable to prioritise the application and implementation of IFRS 18 *Presentation and Disclosure in Financial Statements*, announced for publication in April 2024, over the introduction of new requirements.

Question 9—Transition (paragraphs 97U–97Z of IAS 32)

The IASB proposes to require an entity to apply the proposed amendments retrospectively with the restatement of comparative information (a fully retrospective approach). However, to minimise costs, the IASB proposes not to require the restatement of information for more than one comparative period, even if the entity chooses or is required to present more than one comparative period in its financial statements.

For an entity already applying IFRS Accounting Standards, the IASB proposes:

(a) to require the entity to treat the fair value at the transition date as the amortised cost of the financial liability at that date if it is impracticable (as defined in IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors) for the entity to apply the effective interest method in IFRS 9 Financial Instruments retrospectively (paragraph 97X);

(b) not to require the entity to separate the liability and equity components if the liability component of a compound financial instrument with a contingent settlement provision was no longer outstanding at the date of initial application (paragraph 97W);

(c) to require the entity to disclose, in the reporting period that includes the date of initial application of the amendments, the nature and amount of any changes in classification resulting from initial application of the amendments (paragraph 97Z);

(d) to provide transition relief from the quantitative disclosures in paragraph 28(f) of IAS 8 (paragraph 97Y); and

(e) no specific transition requirements in relation to IAS 34 Interim Financial Reporting for interim financial statements issued within the annual period in which the entity first applies the amendments.

For first-time adopters, the IASB proposes to provide no additional transition requirements.

Paragraphs BC262–BC270 of the Basis for Conclusions explain the IASB’s rationale for these proposals.

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. Would the proposal to apply the proposed amendments retrospectively give rise to any other cases in which hindsight would be necessary? If so, please describe those cases and the circumstances in which the need for hindsight would arise.

We have no comments.

Question 10—Disclosure requirements for eligible subsidiaries (paragraphs 54, 61A–61E and 124 of [IFRS XX])

The IASB proposes amendments to the draft Accounting Standard [IFRS XX Subsidiaries without Public Accountability: Disclosures], which will be issued before the proposals in the Exposure Draft are finalised. [IFRS XX] will permit eligible subsidiaries to apply the recognition, measurement and presentation requirements in IFRS Accounting Standards with reduced disclosures. The IASB's proposals select appropriate disclosure requirements from those proposed for IFRS 7, based on the IASB's agreed principles for reducing disclosures. Paragraphs BC257–BC261 explain the IASB's rationale for the selected disclosures.
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, taking into consideration the reduced disclosure principles described in BC258.

We have no comments.