Financial Instrument —*what next?*

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World Standard-setters Conference 2019

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Agenda

Financial Instruments with Characteristics of Equity
- Overview of the proposals in the Discussion Paper and the feedback received

Dynamic Risk Management
- Overview of the model and next steps

IBOR Reform
- Overview of the Board's decisions and next steps

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- Insert https://www.sli.do/ in the browser of your electronic device i.e. mobile phone, tablet or laptop
- Select the correct session from the dropdown menu and wait for further instructions.

Where are you from?

Question 1:
Where are you from?

A. Africa
B. Asia Oceania
C. Europe
D. Latin America
E. The Middle East
F. North America

Which topic are you most interested in?

Question 2:
Which topic are you most interested in?

A. Financial Instruments with Characteristics of Equity
B. Dynamic Risk Management
C. IBOR Reform and its Effects on Financial Reporting

Financial Instruments with Characteristics of Equity

Uni Choi, IASB Technical Staff
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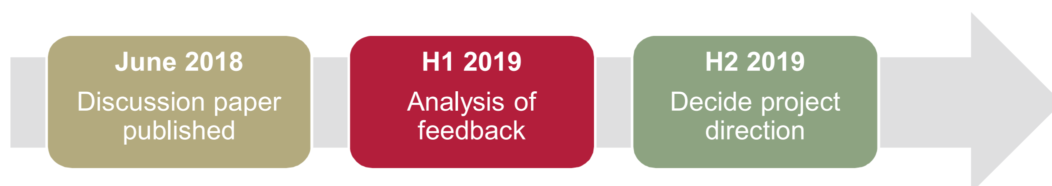
FICE project overview

- Project objective
  - improve the information that entities provide in their financial statements about financial instruments that they have issued
  - address challenges with applying IAS 32 *Financial Instruments: Presentation*
- Project timeline



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What is the problem?

IAS 32 works well for most financial instruments but…

Financial innovation since IAS 32 was issued has resulted in challenges with applying it to a growing number of complex financial instruments

Some inconsistent outcomes for economically similar instruments

Limited information provided for equity instruments

Resulting in application challenges and accounting diversity in practice

Diversity makes it difficult for investors to assess how these financial instruments affect companies' financial position and performance

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Which topic are you most interested in?

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Question 3:
What do you see as the biggest challenge when applying IAS 32?

A. Classification of derivatives on own equity (fixed-for-fixed condition)
B. Accounting for NCI puts
C. Accounting for contingent convertible instruments
D. Lack of information about equity instruments provided in the financial statements
E. Other practice problems
F. Other conceptual problems

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DP proposals—classification principle

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A financial instrument issued by an entity is a financial liability if the answer is yes to one or both of the following questions:

Does the issuer have an unavoidable obligation to transfer cash or another financial asset before liquidation?

Timing feature

Does the issuer have an unavoidable obligation to transfer an amount independent of the issuer's available economic resources?

Amount feature

Otherwise, it is an equity instrument

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DP proposals—classification outcomes and presentation proposals

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Amount feature / Timing feature	Obligation for **an amount independent** of the entity's available economic resources	No obligation for an amount independent of the entity's available economic resources
Obligation to transfer of cash or another financial asset **at a specified time other than at liquidation**	**Liability**	**Liability***
No obligation to transfer economic resources **before liquidation**	**Liability**	**Equity****

Presentation proposals
*Present income and expenses in OCI without recycling
**Attribute total comprehensive income to subclasses of equity

DP proposals—disclosure

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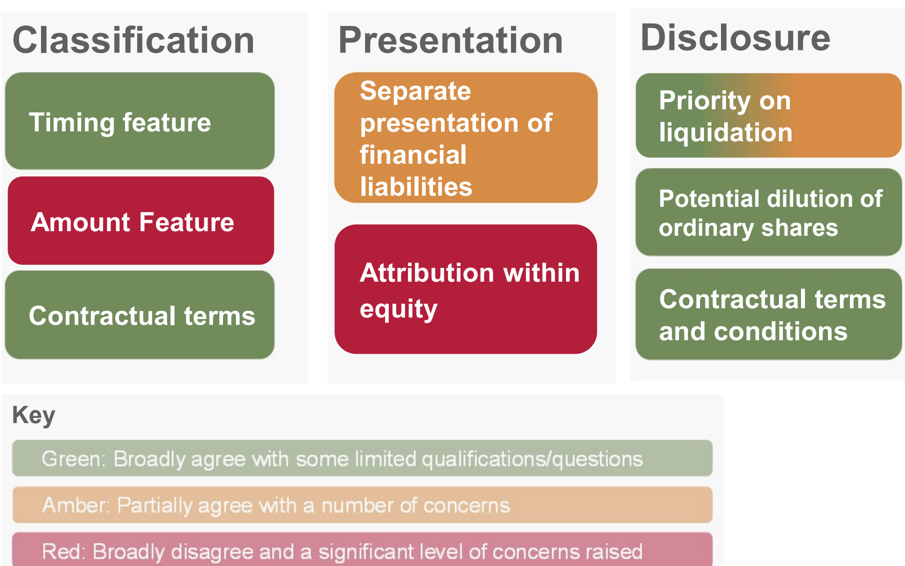
Priority on liquidation
- Priority of all financial liabilities and equity instruments on liquidation of the entity

Potential dilution of ordinary shares
- Applies to financial instruments that may be settled in own shares
- Shows maximum number of ordinary shares an entity may need to deliver to settle such financial instruments outstanding at the reporting date, eg assuming all convertible bonds will be converted into shares
- A reconciliation of movement during the period

Terms and conditions
- Applies to financial liabilities and equity instruments
- Terms and conditions that are relevant to determining the timing and amount of cash flows of a financial instrument
- For example, if the issuer has an option to redeem an instrument, the timing and the amount of the redemption and if it depends on a trigger event, the description of that event

DP feedback— overview



Amount feature—obligations that arise only at liquidation

Today (IAS 32)	Discussion Paper	Feedback received
A financial instrument is generally **not a financial liability** if it requires the entity to deliver cash or another financial asset only on the liquidation of the issuer	A financial instrument **is a financial liability** if the amount of the obligation is independent of the entity's available economic resources regardless of when the obligation requires settlement, ie liability classification even if such settlement is only required at liquidation of the entity	Concerns expressed about: • Inconsistency with the going concern assumption • Changes in classification affecting many financial instruments, eg hybrid bonds, regulatory capital instruments • Measurement challenges • Accounting for issuer's call option

Classification of derivatives on own equity

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Today (IAS 32)	Discussion Paper	Feedback received
A derivative is classified as a financial asset or a financial liability **unless** the derivative meets the so-called 'fixed-for-fixed' condition (gross-physically settled) Practice challenges exist in relation to interpretation of the fixed for fixed condition	A derivative would be classified as a financial asset or a financial liability if: • it is net-cash settled; and/or • the net amount of the derivative is affected by a variable that is independent of the entity's available economic resources The DP discuses examples of variables, eg anti-dilution provisions and foreign currency	• Guidance in this area is welcomed • Request for further clarity and more examples • Determining whether a variable is independent of an entity's economic resources requires significant judgements and may lead to new interpretation issues

Accounting for written put options on NCI

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Today (IAS 32)	Discussion Paper	Feedback received
If a contract that contains an obligation for an entity to repurchase its own equity instruments for cash or another financial asset, recognise a financial liability for the present value of the redemption amount and **'reclassify'** from equity Accounting diversity exists especially the reclassification of equity	The DP proposes: • recognition of a financial liability and **derecognition of equity instruments** rather than 'reclassification' • in the case of written put option, recognition of '**an implicit call option**' that represents the holder's right to keep the shares	• Strong support for the Board addressing the issue • Concerns expressed about: - the consequences of derecognising equity instruments, eg the effects on profit or loss allocation and EPS calculation - Recognition of gross financial liabilities

Disclosures

Today	Discussion Paper	Feedback received
• Limited disclosure requirements for equity instruments • No specific disclosure requirements on priority of financial instruments on liquidation • Disclosure required for earnings per share but it does not capture all potential dilution	Disclosure proposed for: • Priority on liquidation • Potential dilution of ordinary shares • Contractual terms and conditions that affects the timing and amount of cash flows (eg contingent conversion options, issuer call options)	• Broad support, particularly strong support from investors • Some concerns about priority on liquidation • Some warned against 'disclosure overload' of terms and conditions • Request for improvement to the EPS disclosure requirements

Presentation

	Discussion Paper	Feedback received
Separate presentation of financial liabilities	• Present in OCI without recycling income and expenses on financial liabilities with 'equity-like' returns • Present in a separate line item on balance sheet	• Useful to distinguish • Mixed views on OCI vs profit or loss • Mixed views on recycling vs non-recycling
Attribution of total comprehensive income to equity instruments	• Non-derivatives: attribution based on dividends paid or declared • Derivatives: multiple methods considered using fair value as the basis	• Costs > Benefits • Complex to understand—attribution methods for derivatives in particular • Some support for attribution for non-derivatives

Contractual terms

Today (IAS 32) & Discussion Paper	Feedback received
Classification of financial instruments should be based on the contractual terms, ie classification should not take into account: • economic incentives of the issuer • the effects of law and regulations	• General agreement • Practice issues highlighted • Request for: - application guidance - clarification on the interaction between some requirements in IAS 32 (eg interaction between indirect obligation requirement and contingent settlement provision requirement) • Consider a longer-term project to address the issue more comprehensively

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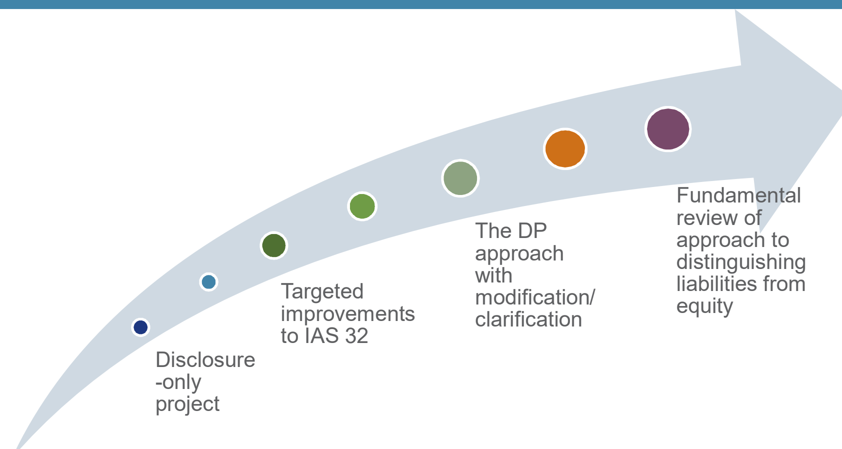
DP feedback—Do stakeholders think standard-setting is required?

General support for standard-setting to address known practice issues
but
a wide range of different directions suggested for the project



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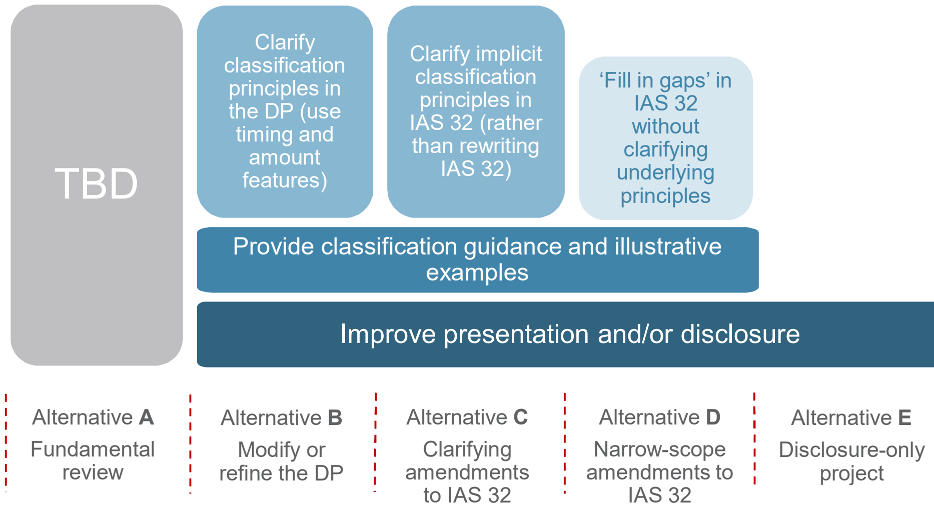
FICE project direction alternatives



Dynamic Risk Management

Riana Wiesner, IASB Technical Staff

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Background

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Business Activity of Financial Institutions

The difference between **interest revenue** and **interest expense** represent **net interest income (NII)**.

Interest Revenue — (**Deposit Interest** + **Liability Interest**) = **NII**

Dynamic Risk Management is the process that involves understanding and managing how and when a change in interest rates can impact NII. As NII is the net of interest revenue and interest expense, a change in interest rates that has an equal impact on both would not impact NII.

Consequently, one of the best ways to prevent NII from changing due to a change in interest rates is to "match" assets and liabilities, a common approach used by financial institutions.

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Transformation

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- IAS 39 and IFRS 9 require hedges to either be a fair value hedge or a cash flow hedge

Fair Value Hedge

A hedge of the exposure to changes in fair value.

Cash Flow Hedge

A hedge of the exposure to variability in cash flows.

- While the DRM accounting model uses Other Comprehensive Income and reclassification, it is neither a cash flow hedge nor is it a fair value hedge model
- The proposed model creates a new type of relationship focused on "transformation" whereby derivatives are used to alter a financial asset such that it meets the entity's interest rate risk management objective

Transformation and capacity

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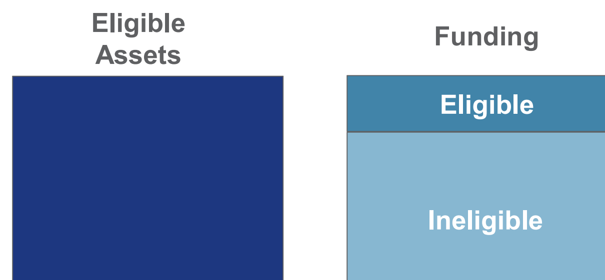
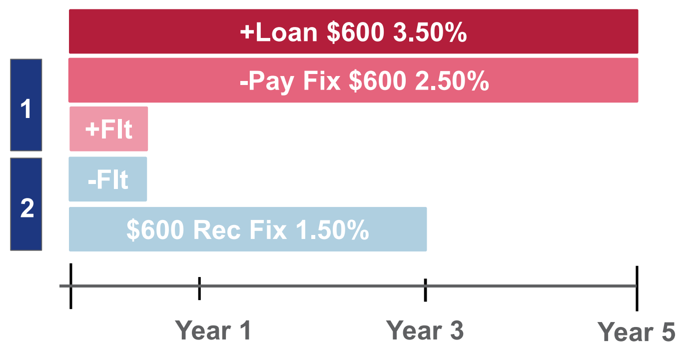
The intersection of risk management and the existing hedge accounting requirements creates the "**capacity issue**" where certain items are ineligible for hedge accounting even though they are considered from a risk management perspective. The best example is **core demand deposits**.



Transformation activities allow entities to alter financial assets such that they meet the risk management objective (ie, the altered assets match the liabilities).

Transformation—Example

An entity wants to transform a 5-year fixed rate financial asset such that it will re-price at the end of year 3, rather than the end of year 5. It can do so by using two interest rate swaps:



1 The five year pay fix, receive float interest rate swap "transforms" the loan from a fixed rate loan to a floating rate loan;

2 The three year receive fix, pay float interest rate swap transforms the combination to a 3-year fixed rate loan.

Transformation is important because matching assets and liabilities does not necessarily align with the fair value or cash flow hedge models.

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Objective and outline of the model

Objective of the model

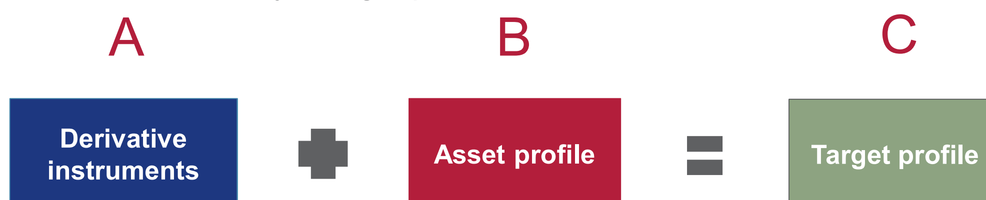
To **improve** the usefulness of **information** provided about interest rate risk management and how it affects a financial institution's **current and future economic resources**.

Outline of the model

When derivatives (A) are successful in aligning the asset profile (B) with the target profile (C), changes in fair value of such derivatives are deferred in OCI and reclassified to the statement of profit or loss.

Assuming perfect alignment, the results reported in the statement of profit or loss should reflect the entity's target profile.

A B C



Asset Profile

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Before transformation can begin, someone (ie, the entity) must know what it wants to transform.

The model calls the **financial assets subject to transformation** the "**Asset Profile**"

What is the asset profile?	The asset profile allocates designated financial assets into time buckets based on their re-pricing date
Board Tentative Decisions	Formal designation and documentation required Financial assets must be measured at amortised cost Future transactions must be highly probable

Target Profile

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Similar to the asset profile, before transformation can begin, the entity must know what it wants to accomplish through transformation.

The model calls the **transformation objective** the "**Target Profile**"

How is the target profile determined?	The target profile must be based on the entity's risk management strategy which in turn is influenced by: i. The contractual tenor of financial liabilities; and ii. The entity's core deposits.

Target Profile—Example

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Risk Management Strategy	Financial Liabilities	Deposit Approach
• Match assets and liabilities to stabilise net interest income	• CU 500 3-year fixed financial liabilities • CU 500 core demand deposits	• Treat the core demand deposit as 3-year fixed rate financial liabilities

In this example, the target profile is a 3 year fixed rate profile because:

- The entity's strategy is to match assets and liabilities to stabilise net interest income over a 3-year period; and
- The entity's financial liabilities are 3-year fixed rate considering the entity's approach to core deposits.

The combination of assets and derivatives required to accomplish the entity's objective creates a 3-year fixed rate financial asset.

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Model overview

DRM Model—Overview

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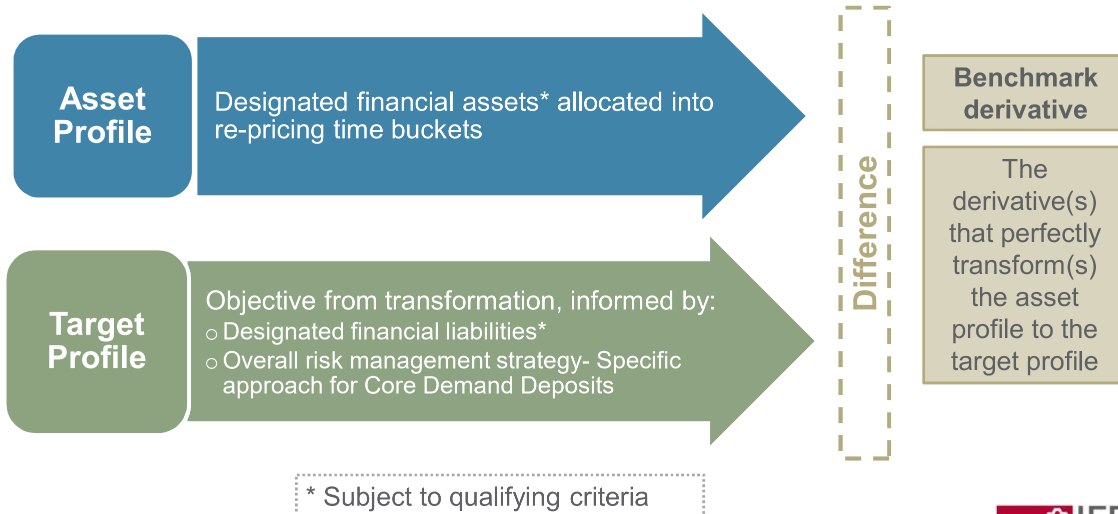

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DRM Model—Overview (cont)

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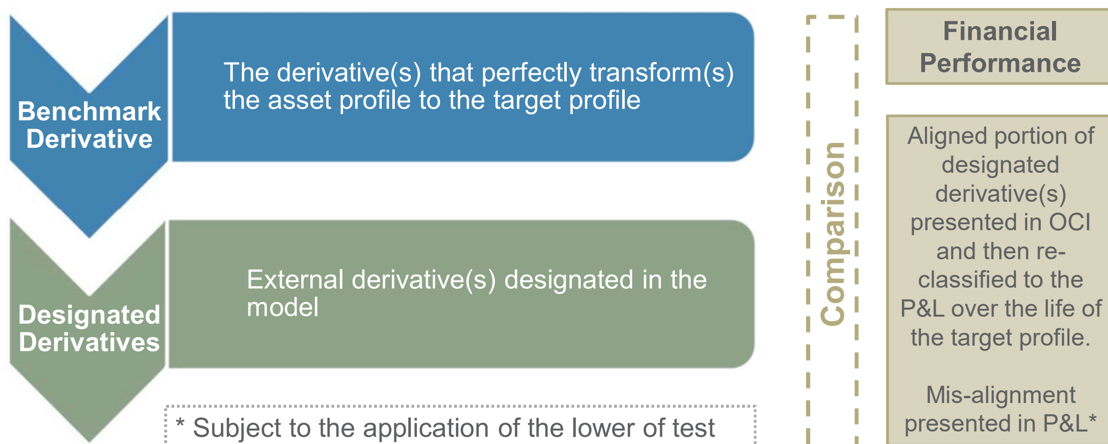

DRM Model—Example

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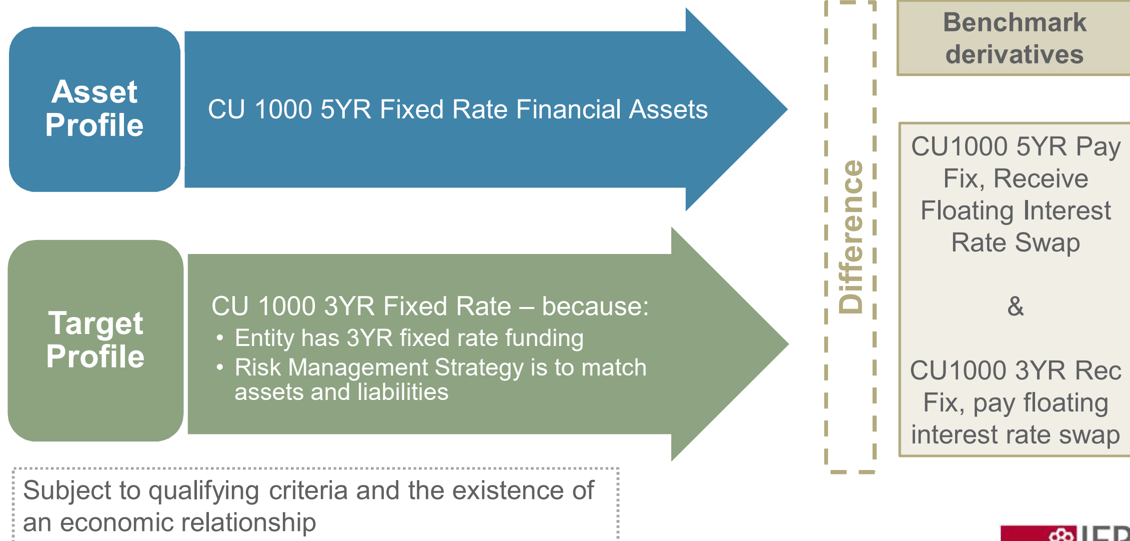

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Next steps

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DRM Model—Next Steps

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Next Steps

Q4 2019 – Commence outreach on core model

Outreach

- At this stage, the Board has tentatively decided not to issue a formal due process document
- The Board will consider the nature and format of outreach in the coming months
- Based on feedback received, the Board will determine next steps

IBOR Reform

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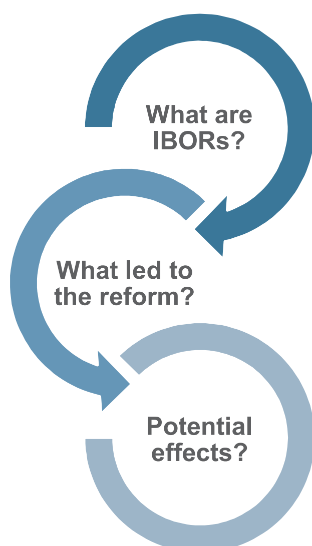
Iliriana Feka, IASB Technical Staff

Background



Interest rate benchmarks such as interbank offered rates (IBORs) play an important role in global financial markets. They index a wide variety of financial products worth trillions of dollars, ranging from mortgages to derivatives.

Market developments have undermined the reliability of existing benchmarks. The Financial Stability Board has recommended reforms. Some jurisdictions have made progress towards replacing existing benchmarks with nearly risk-free rates (RFRs).

This has, in turn, led to uncertainty about the future of existing interest rate benchmarks. Such uncertainties have some market implications which may also affect entities' financial reporting.

Two-phase project

The Board identified two groups of accounting issues:

Phase I *Pre-replacement issues*

- Issues affecting financial reporting before the replacement of an existing benchmark with RFR.

Phase II *Replacement issues*

- Issues that might affect financial reporting when an existing benchmark is reformed or replaced with RFR.

The *pre-replacement issues* are more urgent because they may affect financial reporting before the reform is enacted. They can also be addressed prior to finalisation of the details of the reform. Therefore, the Board decided to address these issues as a priority.

The amendments to IFRS 9, IAS 39 and IFRS 7 address Phase I issues only

IBOR Reform—feedback on Exposure Draft

Highly probable and prospective assessments	Risk components and application	Disclosure and other information
Green: Highly probable requirement	Green: Separately identifiable risk components	Amber: Disclosures
Green: Prospective assessment	Green: Mandatory / end of application	Green: Effective Date
Red: IAS 39 retrospective assessment*		Amber: Transition

Key

- Green: broadly agree with no or limited qualifications
- Amber: partially agree with some issues that need addressing or mixed views
- Red: broadly disagree and/or concerns raised

84 comment letters

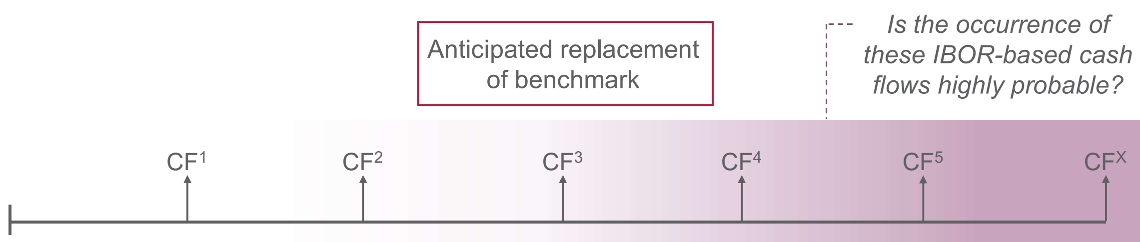
* Although the Exposure Draft did not include any proposed relief from the retrospective assessment, many commented that it is needed

Highly probable requirement

Assume that an entity designates as the hedged item forecast cash flows referenced to IBOR. These cash flows are expected to occur after interest rate benchmark reform takes place.

Anticipated replacement of benchmark

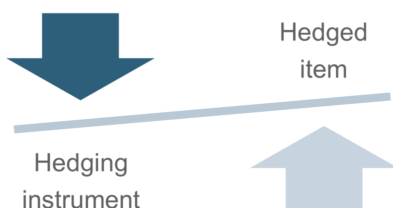
Is the occurrence of these IBOR-based cash flows highly probable?



Until the uncertainty is resolved, the entity should assume the forecast cash flows will not be altered as a result of the reform (ie will continue to be IBOR-based). If, however, the cash flows are no longer expected to occur for other reasons, then hedge accounting must be discontinued.

Prospective assessments

For example, in making prospective assessments, currently entities would have to consider possible changes to designated future cash flows.



These assessments might be affected by uncertainties around timing and amount of designated cash flows.

For example, entities might be uncertain about:

(a) what the cash flows from the hedging instrument and hedged item after the reform will be; and

(b) when the replacement will occur.

Until the uncertainty is resolved, entities should assume that the interest rate benchmark on which the cash flows of the hedged item and the hedging instrument are based is not altered as a result of the reform.

Retrospective assessment (IAS 39 only)

In addition to the prospective assessment, IAS 39 requires a *retrospective assessment* where the actual results of the hedge must be within the range of 80–125%.

Uncertainties from the reform could affect timing and amount of designated cash flows and consequently the actual results of a hedge.

Entities must continue to measure the hedging instrument and hedged item as required by current IFRS Standards. This exception does not change the requirement to measure and recognise ineffectiveness in P&L.

Until the uncertainty is resolved, entities should not discontinue hedge accounting when the actual results of a hedge fall outside of the 80–125% range. Entities still need to comply with all other hedge accounting requirements, including the prospective assessment.

Separately identifiable risk components

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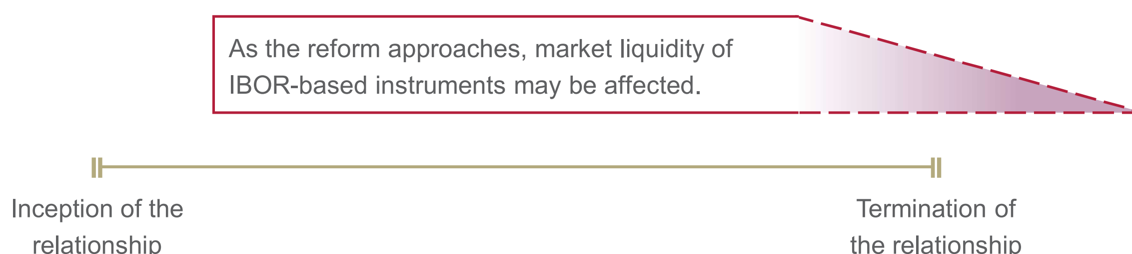
For example, assume an entity designates the IBOR component of a fixed-rate financial liability as the hedged risk in a fair value hedge. At inception, the entity assesses the relevant facts and circumstances and concludes that IBOR is a separately identifiable risk component.



Entities will assess the separately identifiable requirement at the inception of the relationship only. In other words, the assessment is not reperformed over the life of the hedge. Similar exception applies to macro hedges.

End of application of the relief

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Why is the end of application important?

- The exceptions should only apply during the period of uncertainty
- Once uncertainty is resolved, the exceptions should cease to apply

End of application

As a general principle, entities shall cease to apply the exceptions when uncertainties arising from the reform are no longer present or, if earlier, when the hedging relationship is discontinued.

End of application does not apply to separately identifiable risk components. That relief applies during the entire life of the hedging relationship.

End of application of the relief – example

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Contractual amendments

- Contractual amendments might eliminate uncertainties arising from benchmark interest rate reform.
- For example, if a contractual amendment specifies the replacement date and the specific RFR, then the uncertainty regarding the timing and amount of the designated cash flows is eliminated when the contract is amended.
- However, some contractual amendments might not eliminate uncertainty. In such cases, uncertainty continues so the exceptions would still apply.

Disclosures

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For those hedging relationships affected by the amendments, entities would be required to provide the following disclosures:

a) significant interest rate benchmarks to which the entity's hedging relationships are exposed;

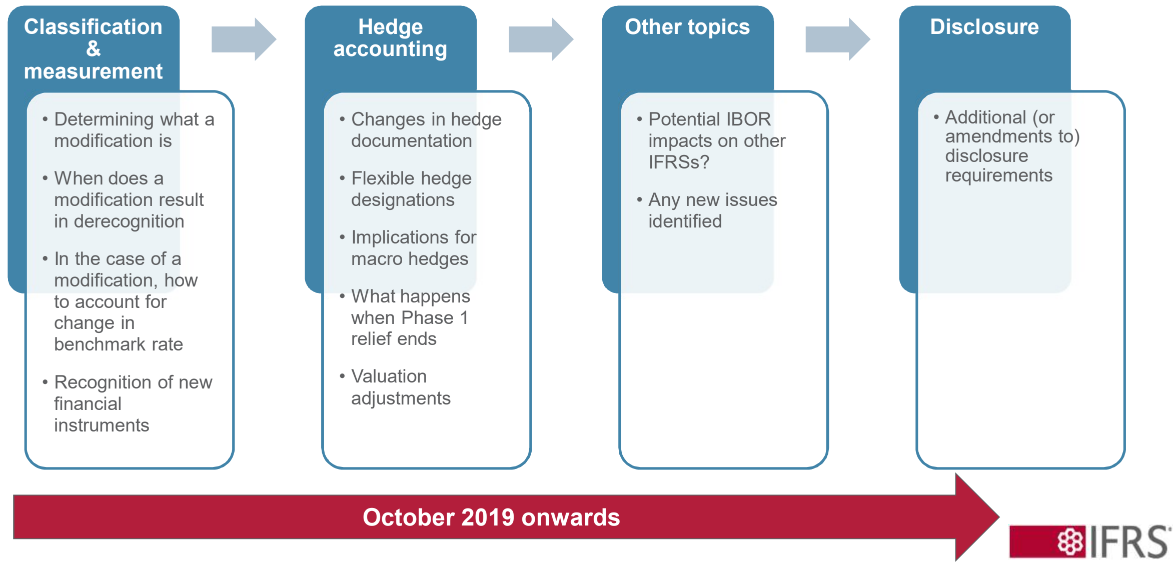
b) how the entity is managing the process to transition to alternative benchmarks;

c) the extent of the entity's risk exposure that is directly affected by the reform;

d) significant assumptions or judgements the entity made in applying the exceptions; and

e) the nominal amount of the hedging instruments in those hedging relationships.

Disclosure requirements have been significantly reduced from the proposals in the ED



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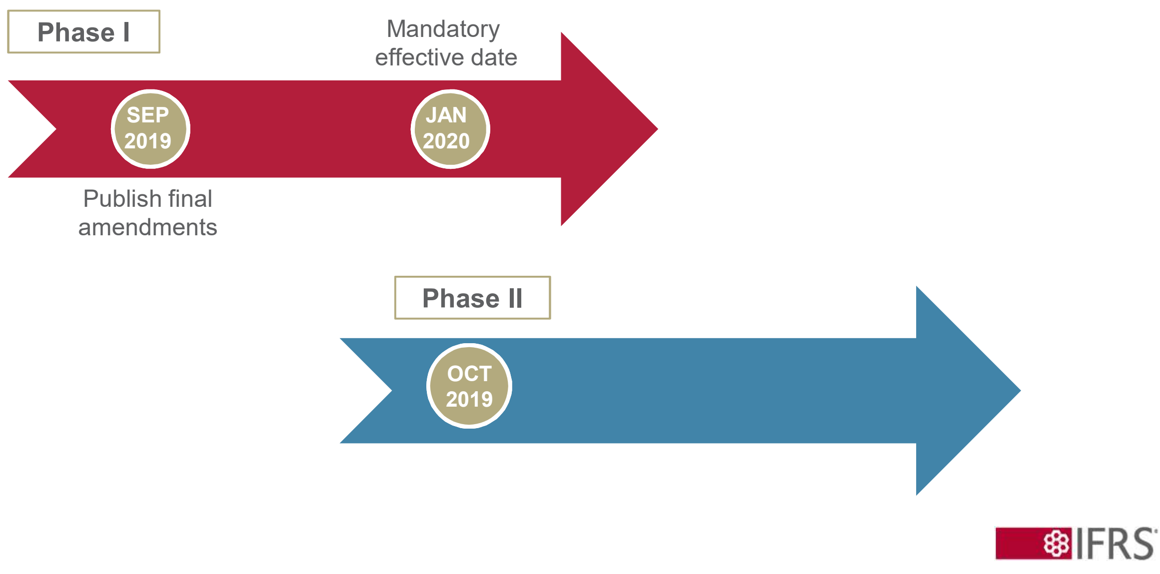

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