

STAFF PAPER

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Project	Financial Instruments with Characteristics of Equity (FICE)		
Paper topic	Obligations that only arise on liquidation of the entity—Background, outreach feedback and research findings		
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Introduction

1. At the October 2019 Board meeting ([Agenda Paper 5](#)), the Board discussed the project plan for the FICE project, including which practice issues to address as part of the project.
2. Applying paragraph 16 of IAS 32, financial instruments are classified as equity instruments only if the instruments contain no contractual obligation to:
 - (a) transfer cash or another financial asset; or
 - (b) to deliver a variable number of shares at a specified time other than at liquidation.
3. One of the practice issues discussed at the October meeting was the classification of particular financial instruments that contain obligations that arise only on

liquidation of the entity¹. For example, some financial instruments have no redemption date and contain terms that give an entity the contractual right to defer cash payment until liquidation, commonly referred to as ‘perpetual instruments’. However, these instruments may contain incentives for the issuer to routinely make cash payments such as coupon payments at specified date(s) or have other debt-like features.

4. At that meeting, the Board asked the staff to explore whether the Board needs to address this issue by:
 - (a) understanding the information needs of investors, especially those that invest in ordinary shares of companies; and
 - (b) evaluating the costs and benefits of a potential classification change.
5. The scope of this paper is limited to financial instruments described in paragraph 3 that are classified as equity instruments. The objective of this paper is to begin the Board’s discussion on the classification of these types of financial instruments. Based on the Board’s feedback at this meeting, the staff will develop a proposal and bring it back to the Board for further deliberation at a future meeting.

Background

6. Applying the classification approach proposed in the Discussion Paper *Financial Instruments with Characteristics of Equity* (2018 DP), financial instruments described in paragraph 3 of this paper would be classified as financial liabilities (at least in part) and would have been one of the main classification changes arising from the 2018 DP. We received a significant volume of feedback on this issue from users of financial statements (mostly debt analysts of companies) and other stakeholders. Most stakeholders raised concerns over the potential

¹ The financial instruments described in this paper do not include those that are subject to the specific exception in paragraphs 16C-16D of IAS 32, ie instruments, or components of instruments, that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation.

classification change although some acknowledged that these instruments have many economic similarities with debt instruments.

7. Since October 2019, the staff conducted targeted outreach with equity analysts to understand their information needs including whether:
 - (a) the current equity classification provides useful information for them to understand the nature and uncertainties arising from these instruments and how they affect returns and the entity's economic resources available to ordinary shareholders or
 - (b) classification as a financial liability would be more useful to meet their needs.
8. In addition, the staff performed research including a desktop review of IFRS financial statements of banks and corporates to understand the current classification of perpetual instruments, how they are presented in the financial statements and whether any regulatory classification of these instruments interacts with, or depends on, the accounting classification.
9. This paper is structured as follows:
 - (a) key features of common financial instruments that contain obligations that arise only on liquidation of the entity (paragraphs 10–16);
 - (b) summary of current requirements in IAS 32 (paragraphs 17–19);
 - (c) proposals in the 2018 DP (paragraphs 20–21);
 - (d) targeted outreach with equity analysts (paragraphs 22–27);
 - (e) research findings on classification and presentation (paragraphs 28–39);
 - (f) costs and benefits of a classification change (paragraphs 40–48);
 - (g) question for the Board (paragraph 49); and
 - (h) Appendix A— a summary of key features of common financial instruments that contain obligations that arise only on liquidation of the entity.

Key features of common financial instruments that contain obligations that arise only on liquidation of the entity

10. In the past 7-8 years, the issuance of financial instruments that contain obligations that arise only on liquidation of the entity has grown rapidly. The most common examples of such financial instruments are ‘corporate hybrids’ and specific regulatory capital instruments—Additional Tier 1 (AT1) issued by banks (for example contingent convertible bonds (CoCos)) and Restricted Tier 1 (RT1) capital instruments issued by insurers.
11. After the financial crisis, banks started to issue CoCos on a significant scale. At the end of 2015, the CoCo-market in Europe had grown to EUR157 billion². The global AT1 market has since grown to represent a total principal value in excess of US\$250 billion as at April 2020³. The RT1 market is relatively new and small. The first RT1 qualifying instrument was issued in late 2017. As at the end of November 2018, only seven instruments had been issued and less than US\$4 billion of RT1s were outstanding in comparison to more than US\$150 billion of existing insurance subordinated debt. The RT1 market is expected to continue to grow gradually. Furthermore, grandfathering provisions for legacy instruments under Solvency II run until 2026.⁴
12. In addition, corporate hybrids have become one of the preferred ways to raise funding by some companies in particular industries such as utility, telecommunication, oil and gas, and automobile industries. As at November 2018, the total amount of corporate hybrids (excluding certain forms of preference shares) that are accounted for as equity outstanding globally was around EUR120-130 billion.⁵ As of May 2019, the total size of the European corporate hybrid market exceeded EUR150 billion.⁶ In 2019 and the first half of 2020, new

² Source: Working paper University of Amsterdam/DNB, September 2017

³ Source: S&P Global, Europe’s AT1 Market Faces The COVID-19 Test, April 2020

⁴ Source: GAM Investments, A Guide to Insurance Restricted Tier 1 Market, 5 December 2018.

⁵ Source: Bloomberg, DB, issuer published disclosure, dated as of 21 November 2018

⁶ Source: Credit Suisse, European Corporate Hybrids 2019 Annual Update

issuances of European hybrid bonds amounted to EUR30 billion and EUR21.4 billion, respectively.⁷

13. While the contractual terms of these types of financial instruments vary, the staff understand that they share the following contractual features:⁸
- (a) they are perpetual, ie have no fixed maturity. The principal amount is due only at liquidation of the issuer and the issuer has no contractual obligation to redeem them earlier.
 - (b) they pay periodic coupons based on a specified percentage of the principal amount. For some of these financial instruments, unpaid coupons accumulate and are added to the amount due at liquidation of the issuer ie the issuer can defer coupon payments until the issuer's liquidation. For others, the coupons are discretionary ie unpaid coupons do not accumulate.
 - (c) the issuer has an option to redeem the financial instruments at a specified date(s) or on the occurrence of specified events such as a change in the tax treatment of the coupon paid, a change in the accounting classification, or a change in the regulatory capital treatment. For example, some of these instruments allow the issuer to redeem the instruments if the accounting classification changes from equity to a financial liability.
 - (d) typically, the instruments are subordinated to all other issued instruments (except ordinary shares) in terms of liquidation priority. In addition, many capital instruments issued by banks and insurers have loss absorption capacity ie they are converted into ordinary shares or written down if the bank's capital position deteriorates.
14. Although these instruments contain no contractual obligation for the issuer to redeem the principal or to pay the coupons other than at liquidation of the issuer, for some instruments, the issuer may have incentives (economic or otherwise) to redeem the instrument on the first date it has an option to redeem the financial

⁷ Source: Scope Ratings, Reports on Europe's hybrid bond market, July 2020

⁸ Appendix A provides a summary of key features of corporate hybrids and AT1 instruments.

instruments or incentives to pay the coupons. The issuer's incentives may be driven by a range of factors such as:

- (a) an immediate increase in the funding cost in the case of 'step-up' financial instruments. Some perpetual instruments include a contractual feature that resets the coupon rate to a higher rate if not called on the first call date, incentivising the redemption.
- (b) a negative effect on the issuer's future ability to issue similar financial instruments if the instrument is not redeemed at its first call date or coupons are not paid. These instruments are often priced based on an expectation from existing and potential investors that the issuer will choose to redeem the instruments at the first call date. Deferring coupon payments or not redeeming at the first call date could also be interpreted as a signal that the issuer is experiencing financial difficulties.
- (c) some perpetual instruments include a contractual feature that will give investors in the instrument a right to vote at shareholders' meetings if the issuer does not pay the coupon for a specified period.
- (d) some perpetual instruments also include a contractual feature such as a dividend stopper, which will incentivise the issuer to pay coupons on perpetual instruments if it wishes to pay dividends on ordinary shares.

15. Essentially, these types of financial instruments are designed to behave like a bond (ie pays interest based on a specified coupon rate and is repaid at a specified date even though there is no contractual obligation to do so), in normal circumstances ie when the issuer is not in financial difficulty. However, they are also designed to provide some flexibility if the issuer experiences financial difficulties by allowing the issuer to defer (or in some cases cancel) the interest and/or the principal repayments.⁹

16. We note that not all AT1/RT1 instruments and corporate hybrid instruments are classified as equity instruments in the financial statements. For example, some AT1 instruments are classified as compound instruments because they contain an

⁹ Being a perpetual instrument, this type of financial instrument would not have a contractual maturity. The principal repayment will be 'deferred' from its 'expected' repayment date if the issuer does not choose to exercise the call option to redeem the financial instrument.

obligation to deliver a variable number of shares on the occurrence of a trigger event and coupons are discretionary. Some corporate hybrids are classified as financial liabilities because they have a maturity date and are therefore not perpetual instruments. The focus of this paper is only on perpetual instruments that are classified as equity instruments.

Summary of current requirements in IAS 32

17. Applying IAS 32, these types of financial instruments are classified as equity instruments if there is no contractual obligation to transfer cash or another financial asset before liquidation of the entity or to deliver a variable number of shares in settlement. Specifically, applying paragraph 25(b) of IAS 32, an obligation that arises only on liquidation of the entity does not result in the financial instrument containing such an obligation to be classified as a financial liability.

18. Paragraph 25 of IAS 32 states that:

A financial instrument may require the entity to deliver cash or another financial asset, or otherwise to settle it in such a way that it would be a financial liability, in the event of the occurrence or non-occurrence of uncertain future events (or on the outcome of uncertain circumstances) that are beyond the control of both the issuer and the holder of the instrument, such as a change in a stock market index, consumer price index, interest rate or taxation requirements, or the issuer's future revenues, net income or debt-to-equity ratio. The issuer of such an instrument does not have the unconditional right to avoid delivering cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability). Therefore, it is a financial liability of the issuer unless: [...] **(b) the issuer can be required to settle the obligation in cash or another financial asset (or otherwise to settle it in such a way that it would be a financial liability) only in the event of liquidation of the issuer [...]. (emphasis added)**

19. As stated in paragraph BC18 of the Basis for Conclusions on IAS 32, the Board concluded that contingent settlement provisions that would apply only in the event of liquidation of an entity should not influence the classification of the instrument because to do so would be inconsistent with a going concern assumption. A contingent settlement provision that provides for payment in cash or another financial asset only on the liquidation of the entity is similar to an equity instrument that has priority in liquidation and therefore should be ignored in classifying the instrument.

Proposals in the 2018 DP

20. Unlike IAS 32, the Board's preferred approach explored in the 2018 DP would have classified these types of financial instruments as, at least in part, financial liabilities. This was based on the Board's preliminary view that a financial instrument should be classified as a financial liability if it contains an unavoidable contractual obligation for an amount that is independent of the entity's available economic resources even if that contractual obligation only arises on liquidation of the entity—the 2018 DP referred to this as the 'amount feature'.
21. Many stakeholders, including both the companies that issue these types of financial instruments and the investors in these types of financial instruments expressed concerns about the potential classification change. Further details of the feedback received in this area have been discussed at the Board meetings in June 2019 ([Agenda Paper 5B](#)) and July 2019 ([Agenda Paper 5D](#)).

Targeted outreach with equity analysts

22. Since October 2019, the staff carried out 4 outreach meetings. These included discussions at the December 2019 UK CRUF meeting and meetings with individual equity analysts in Q2-Q4 2020.
23. Feedback from UK CRUF members could be summarised as follows:
- (a) a few members have occasionally come across these types of financial instruments in analysing the companies they cover. A member from the non-financial sector said they would treat them as debt in normal

circumstances so would prefer classification as a financial liability with disclosures about key terms in the notes.

- (b) one member commented that they treat such financial instruments as debt for the purpose of valuing the equity shares of companies. Another member commented that they consider a key feature of an equity instrument is that it pays dividends that reflect the performance of the entity. They would therefore not consider a financial instrument that pays a coupon unrelated to the entity's performance as an equity instrument.
- (c) some members said that investors want transparency of terms and conditions of financial instruments and that clear disclosure of why the instrument is classified as a financial liability or equity would be helpful. One member specifically acknowledged that disclosure cannot be a solution to everything and said if the entity has issued perpetual instruments, these should stand out immediately on the balance sheet regardless of classification.

24. The equity analysts of banks were very familiar with these instruments as they often qualify as AT1 instruments for regulatory purposes. Equity analysts generally acknowledged that these financial instruments are different from most financial liabilities and from ordinary shares. Most equity analysts consider them as debt and look for information about the coupons. These analysts explained that they deduct the coupon from profit or loss and the principal from equity in calculating return on equity. They also deduct them from book value in calculating the price to book ratio.
25. Another equity analyst commented that changing the classification to a financial liability for accounting purposes would not change their calculation or models but would make the information easier to find. Most equity analysts preferred liability classification and believed this would make it clearer how much of the entity's net assets are attributable to its ordinary shareholders. However, these equity analysts also said that if equity classification is retained, then separate presentation of these instruments and additional disclosure in the notes would provide useful information. They further said disclosure in a single note would be very helpful.

26. An equity analyst further explained that their aim is to forecast how much banks will pay on AT1s, whereas another equity analyst said they preferred equity classification to highlight the differences from vanilla financial liabilities ie during a crisis AT1s behave like equity. An investor mentioned that if these instruments were classified as financial liabilities, they would not find fair value changes in these financial instruments useful if the fair value changes do not represent changes in the actual cash amount the issuer would need to pay on these instruments.
27. An equity analyst explained that they assume the instruments will get called at the first call option date. However, if a bank does not call the instruments, in their view there is less market impact today on the value of the perpetual instruments compared to a few years ago because market participants may be more tolerant if there are economic reasons for not exercising the call. Therefore, the probability of calling on the first call date does not make a significant difference in their equity valuations and calculations and they rely on management commentary on intention to call instead of spending a lot of time trying to estimate it. Another equity analyst also confirmed that issuer call options do not affect their modelling because companies replace them by issuing similar instruments.

Research findings on classification and presentation

Regulatory classification

28. During the outreach performed on the 2018 DP, many stakeholders highlighted the interaction between the accounting classification and the regulatory treatment of capital instruments. The staff therefore performed research to understand the consequences of any potential changes in accounting requirements on the regulatory capital treatment.
29. The Basel Framework consists of internationally agreed recommendations on banking regulations and applies to internationally active banks. The members of the Basel Committee decide how to implement the recommendations in their own jurisdiction. For example, in the EU, the implementation applies to all banks, regardless of size, even though there are some relaxations for the smaller banks.

Under the Basel Framework, regulatory capital consists of high-quality capital that is classified based on their loss absorbing capacity, ie how readily the capital is available to be used to absorb losses. Tier 1 capital is the highest quality form of a bank's capital and absorbs losses on a going-concern basis. Tier 1 capital comprises of:

- (a) Common Equity Tier 1 (CET1) capital, which is the highest quality of regulatory capital, as it absorbs losses as they occur and consist predominantly of common/ordinary shares and retained earnings. There are regulatory adjustments (ie filters and deductions) made to total shareholders' equity as per the IFRS balance sheet in order to get to CET1 capital; and
- (b) AT1 instruments, which seeks to impose principal losses on their holders during firm-level financial distress, outside the normal bankruptcy process and without recourse to public funds. To qualify as AT1 capital, instruments must have principal loss absorption through a conversion to common shares or a write-down mechanism allocating losses at a trigger point and must also meet further requirements (instruments have to be perpetual with no incentive to redeem, the institution must have full dividend/coupon discretion at all times, etc).

30. Tier 2 capital on the other hand, is the second layer of capital that absorbs losses only on a gone-concern basis and consist of subordinated debts. Tier 2 capital has certain quantitative limits in calculating the regulatory capital. To qualify as Tier 2 capital, capital instruments or subordinated debt must have an original maturity of at least five years. Moreover, eligible capital instruments may inter alia not contain an incentive to redeem, a right of investors to accelerate repayment, or a credit sensitive dividend feature.

31. In accordance with the Basel Framework, for an instrument to be included in CET 1 capital it must be classified as equity under the relevant accounting standards. On the other hand, accounting equity classification is not a requirement for inclusion in AT1 or Tier 2 capital. Canada has implemented the Basel framework with some changes which include a stricter requirement that, other than specific legacy preferred shares accounted for as a financial liability,

instruments included in AT1 capital must be classified as equity for accounting purposes.

32. In addition, globally significant banks and other significantly important banks are subject to the Total loss-absorbing capacity (TLAC) and Minimum Requirement for own funds and Eligible Liabilities (MREL) requirements respectively.¹⁰ We understand that apart from CET1 capital, accounting classification as equity is not a required criterion to qualify as TLAC/MREL instruments. Therefore, accounting classification as equity or a financial liability does not affect a financial instrument's eligibility to be a TLAC or MREL instrument (other than as CET1 instruments).
33. For insurers, International Capital Standard (ICS)¹¹ identifies two tiers of capital, ie Tier 1 (going-concern basis) and Tier 2 (gone-concern basis) by its quality. Tier 1 capital is also divided into 'Unlimited' (eg ordinary shares) and 'Limited (LT1)' (eg subordinated debts). Both categories commonly include the criterion that the paid-in amount is recognised as equity for supervisory purposes ie when determining whether liabilities exceed assets in a test of insolvency.¹² If the current classification of equity for supervisory purposes aligns with the accounting classification of equity, a change in accounting classification for

¹⁰ [TLAC \(Total loss-absorbing capacity\)](#) is an international standard, finalised by the Financial Stability Board (FSB) in November 2015, intended to ensure that G-SIBs have enough equity and bail-in debt to pass losses to investors and minimise the risk of a government bailout. It aims to (1) reduce the probability of failure of G-SIBs by increasing their loss-absorbency (addressed in the Basel framework); and (2) reduce the extent or impact of failure of G-SIBs, by improving global recovery and resolution measures (where work is led by the FSB). TLAC instruments are composed of regulatory capital and other eligible financial instruments with some adjustments. MREL (Minimum Requirement for own funds and Eligible Liabilities) is similar standard for European banks, which is included in [Bank Recovery and Resolution Directive 2014/59/EU \(BRRD\)](#).

¹¹ [The Insurance Capital Standard \(ICS\)](#) is a consolidated group-wide capital standard that applies to internationally active insurance groups (IAIGs). It is a part of a package of reforms completed by the International Association of Insurance Supervisors (IAIS) in response to the Financial Crisis of 2007–2009. Currently, large, global insurance groups are subjected to different capital standards that make it difficult to compare their solvency positions. The ultimate goal of the ICS is to establish a single ICS that includes a common methodology that achieves comparable outcomes across jurisdictions. The current ICS version 2.0 is not a finalised standard and is tested in a 5-year monitoring period. In the monitoring period of 2020–2024, the IAIS will annually review the participation of IAIGs and the feedback received from supervisors and industry stakeholders during the monitoring period will be used to further improve the ICS.

¹² The main differences between balance sheet amounts for supervisory purposes (eg insolvency test) and those for accounting purposes could arise due to the different valuation approaches for assets and insurance liabilities. The classification of financial instruments on the supervisory balance sheet would generally align with the accounting classification. For more information, refer to ['FSI Insights–Accounting standards and insurer solvency assessment'](#).

perpetual instruments would not, on its own, affect the regulatory capital classification.

34. For insurance companies in Europe, Solvency II is relevant. Because the classification of Solvency II capital instruments does not refer to the accounting treatment, a change in accounting classification is not expected to affect the regulatory capital classification. Tier 1 capital is also divided into 'Unrestricted' (eg ordinary shares) and 'Restricted (RT1)' (eg subordinated debts). To qualify for RT1 capital, a financial instrument must be perpetual and have a principal loss-absorption mechanism at a pre-specified trigger event which shall be significant non-compliance with the Solvency Capital Requirements.

Desktop review of IFRS financial statements

35. The staff reviewed the IFRS financial statements of 29 banks and 12 non-financial corporates to understand the current classification of perpetual instruments and how they are presented in the statement of financial position, statement of financial performance or statement of changes in equity.¹³ Our sample covered banks from Europe, Asia Oceania, North America, Latin America and Africa, and corporates from Europe and Asia. We selected corporates from those two regions because of the prevalence of the perpetual instruments in those regions. Overall, our research showed diverse practice in presentation and disclosure of information about these types of financial instruments.
36. Of the 29 banks selected:
- (a) 20 banks classified some or all of their AT1 instruments as equity whereas 9 banks classified all of their AT1s as financial liabilities.¹⁴
 - (b) only 9 banks explicitly explained the reason for classifying their AT1 instruments as equity or financial liabilities. The most common reason for liability classification was a feature that converts the instruments into a

¹³ We looked at a number of insurance companies to review how they present and disclose information about Restricted tier 1 (RT1) instruments. Only few insurance companies have issued RT1 instruments to date. We did not include insurance companies in our findings as the sample size was too small to draw any meaningful conclusion.

¹⁴ Some AT1 instruments classified as financial liabilities are specifically described as compound instruments with zero equity value.

variable number of shares on the occurrence of a non-viability event. However, for some others, it was not clearly explained why they were classified as financial liabilities.

37. Of the 20 banks which classified their AT1 instruments as equity
- (a) 17 banks presented the AT1 instruments as a separate line item in the statement of financial position.
 - (b) 18 banks presented them in a separate column in the statement of changes in equity. Of those that present a separate column in the statement of changes in equity:
 - (i) 9 banks showed capital movements (issuances and redemptions) and coupons/dividends paid in this column.
 - (ii) The other 9 banks presented only capital movements in this column.
 - (c) 12 banks presented profit or loss or total comprehensive income attributable to AT1 instrument holders separately at the end of the income statement.
 - (d) 8 banks disclosed the coupons/dividends paid in the notes to the financial statements.
38. All 12 corporates that we reviewed classified their perpetual instruments as equity. 10 of these corporates explained the reason for classifying their perpetual instruments as equity.
39. In terms of presentation and disclosure for corporates,
- (a) 6 corporates presented their perpetual instruments as a separate line item in the statement of financial position.
 - (b) 10 corporates presented them in a separate column in the statement of changes in equity. Of those that presented a separate column,
 - (i) 6 corporates presented capital movements (issuances and redemptions) and coupons/dividends paid in this column; and
 - (ii) 4 corporates presented only capital movements in this column.

- (c) 5 corporates presented profit or loss or total comprehensive income attributable to the perpetual instrument holders separately at the end of the income statement.
- (d) 6 corporates disclosed the coupons/dividends paid in the notes to the financial statements.

Costs and benefits of a classification change

40. Arguably, one of the benefits of changing the classification of these types of instruments from equity to financial liability is that financial liability classification might better represent the substance and economics of how these types of financial instruments are expected to behave in the normal course of business. However, other equity-like features such as loss absorption capacity may not be faithfully represented by financial liability classification.
41. Additional information would be presented or disclosed if these types of financial instruments are classified as financial liabilities. This includes:
- (a) interest, coupons or dividends paid to holders would be recognised in profit or loss together with interest expense on other financial liabilities issued by the entity. This would make it easier to determine the profit or loss attributable to ordinary shareholders.
 - (b) the carrying amount would be updated to reflect the likely timing and amount of the future cash flows. Although different requirements would apply depending on whether the instrument is carried at amortised cost or at fair value through profit or loss, the instruments would be subject to remeasurement and changes in the carrying amount would be recognised in profit or loss.
 - (c) gains or losses on derecognition of these instruments would be recognised in profit or loss similar to other financial liabilities issued by the entity;¹⁵ and

¹⁵ Excluding financial liabilities designated at fair value through profit or loss where changes in own credit risk are presented in other comprehensive income, and such amounts are not subsequently transferred to profit or loss.

- (d) they will be subject to more comprehensive disclosure requirements in IFRS 7 *Financial Instruments: Disclosures*, for example, fair value disclosures.
42. Based on the feedback from users of financial statements, they cited the information about interest, coupons or dividends paid to holders and additional disclosures described in paragraph 41(a) and 41(d) of this paper respectively as the beneficial information for them.
43. However, additional information comes with additional cost to preparers and possibly additional cost for users of financial statements to analyse and consume the information.
44. In addition, as highlighted in the feedback received on the 2018 DP, classifying these instruments as financial liabilities may lead to accounting challenges. For example, the following questions would arise:
- (a) how to apply the measurement requirements in IFRS 9 to an obligation that arises only on liquidation:
- (i) whether the entity needs to estimate the likelihood and timing of its own liquidation or whether the entity needs to estimate the expected life of the financial instrument; and
- (ii) whether it makes a difference if there is compounding of interest on deferred coupons; and
- (b) how to measure the issuer's call option, especially given that multiple options often exist that allow the issuer to call the instrument at a specified date and on the occurrence of specified events.
45. There has also been a concern that an accounting classification change may cause market disruption ie negatively affect the incentive of issuers to issue these types of financial instruments and therefore reduce the number of issuances and the size of this market. Many companies value accounting equity classification because of its effects on solvency and leverage ratios and loan covenants. Some investors were concerned that liability classification will make these instruments less attractive for issuers and increase their cost of capital.

46. Another concern raised relates to accounting call options. Some corporates' perpetual instruments give the issuer an option to redeem the instrument at a specified value (typically at par or at 101% of the par value) if its accounting classification changes from equity to a financial liability. Some investors were concerned that they would suffer a loss if the instrument were to be redeemed when it is trading above the specified redemption value.
47. Based on the concerns above, when the 2018 DP was in consultation, many issuers of and investors in these types of financial instruments did not welcome the potential classification change. This is particularly relevant to instruments issued by companies outside the financial services industry because the primary driver for companies in the financial services industry to issue these types of financial instruments is regulatory capital treatment rather than accounting classification.
48. In Agenda Paper 5F, the staff explore alternatives that the Board could consider to address these concerns.

Question for the Board

49. The staff would like to ask the Board the following question.

Question for the Board

Does the Board have any questions or comments on the matters discussed in this paper?

Appendix A

A1. The following table summarises our understanding of the key features of financial instruments relevant to the discussion set out in this paper.

	Corporate hybrids	AT1
Reason for issuance	Combination of advantageous features: rating agency treatment as 50:50 debt and equity, tax deductibility of the coupon (at least in some jurisdictions), equity accounting classification, popularity amongst investors due to high returns.	Issued primarily to meet regulatory requirements on capital adequacy.
Incentives for redemption at the first call date	Redemption at its first call date is considered as a market convention. Instruments often contain various incentives for the issuer to redeem at the first call date such as a step-up clause. They act as protection for investors providing more certainty of redemption at the first call date.	Regulation requires that the instrument does not contain any incentives for redemption eg step-up features. Redemption is subject to the relevant regulator’s approval and are subject to specified conditions. For example, redemption needs to be followed by replacement with a capital instrument of a higher or equal quality. Often redeemed and replaced at the first call date.

Conditions for early redemption	Instruments often include a call option for the issuer in the event of changes in tax deductibility of the coupon. Some instruments also include an issuer-held call option for changes in accounting classification.	Instruments often include a call option for the issuer in the event of changes in tax deductibility of the coupon and in the event of changes in regulations which result in the instrument no longer qualifying as AT1.
Cumulative vs non-cumulative	Cumulative coupon appears more common, ie coupon can be deferred but cannot be cancelled.	Regulations require the coupon on the instrument to be non-cumulative to qualify as AT1.
Perpetual vs dated	Some are dated (classified as a financial liability) while other are perpetual (classified as equity).	Regulations require the instrument to be perpetual to qualify as AT1.
Current accounting classification applying IAS 32	Most of them are classified as equity but some of them are classified as a financial liability (dated instruments, ie they are not perpetual).	AT1s that convert to a fixed number of shares and those that are written down are classified as equity. AT1s that convert to a variable number of shares are classified as financial liabilities or compound instruments. ¹⁶

¹⁶ Classification of these types of instruments will be addressed when the Board discusses contingent settlement provisions in a future Board meeting.