ERSTE Group

Erste Group Bank AG
Am Belvedere 1
1100 Vienna
www.erstegroup.com

Gabriele Tauböck
+43 (0) 50100 - 10100
gabriele.tauboeck@erstegroup.com

Commercial Court Vienna
Commercial Register No.: 33209m
Bank Code: 20100
Swift Code / BIC: GIBAATWWXXX

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Mr. Wolf Klinz
EFRAG Financial Reporting Board Chair
35 Square de Meeûs
1000 Brussels
Belgium

Comment letter on the EFRAG Draft Comment Letter on the IASB’s Exposure Draft Financial Instruments with Characteristics of Equity (IASB/ED/2023/5)

Dear Mr Klinz,

Thank you for the opportunity to comment on the EFRAG draft comment letter (DCL). Please find below our comments on the specific questions raised by EFRAG. They are in line with our answers in the EFRAG online survey on the topic submitted by Erste Group on 1 March 2024.

Kind regards,

Gabriele Tauböck
Head of Group Accounting

Questions to constituents

16 When applying the IASB proposals on the effects of applicable laws on the contractual terms of financial instruments, do you expect any classification changes on instruments such as *(i)* bail-in instruments, *(ii)* ordinary shares with statutory minimum dividends, *(iii)* IFRIC 2-type instruments or *(iv)* any other financial instruments or situations (e.g., limited life companies or limited partnerships)?

17 Do you consider that the IASB should address MTOs?

18 EFRAG was made aware that the IASB's proposal, when read in conjunction with the Basis for Conclusions, could have unintended consequences in terms of either excluding certain banking products, such as loans or banking saving deposits, from the scope of IFRS 9 / IAS 32, or in classifying such instruments as equity. In the latter case, those instruments would end up being classified as equity instruments (classified as equity in the entity's financial statements and with a corresponding debit entry as financial asset measured at fair value through profit or loss).

Do you consider that the IASB's proposal could lead to the accounting of some banking products in their jurisdiction, such as loans or banking saving deposits, being disrupted by the proposal. Please explain.

We do not expect classification changes for the instruments which we issue as part of our business. Among those listed in the question only the bail-in instruments are relevant to our bank and they are of particular importance to us. Our understanding in this regard is that the proposed requirements would not lead to classification changes.

However, we would like to note that the description of the 'bail-in' provisions in paragraph BC13(a) of the ED using Additional Tier 1 (AT1) instruments as an example is not correct. The loss-absorption feature referred to in this paragraph which, upon the occurrence of a trigger event, requires either write down or conversion into ordinary shares of the issuer should not be viewed as resulting from legislation. This is a key qualifying condition which the contractual terms must include for such instruments to qualify as a specific part of Tier 1 banking capital.[1]

[1] In the EU the conditions are prescribed in Articles 52(1)(n) and 54(1)(a) of CRR *(Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms)* and require that upon CET1 capital falling below 5.125% (or higher level if agreed in the provisions of the instrument) the principal of the instruments be written down or the instruments be converted to CET1 instruments.

Paragraph 15A(b) of the ED requires that rights or obligations resulting from legislation which would arise regardless of whether they are included in the contract are not considered in classifying a financial instrument. The loss-absorption feature inherent in AT1 instruments does not belong to this camp. In this case the legislation provides a framework how contractual terms should be drafted so the instrument is granted a specific regulatory treatment. A legal framework with more or less details applies to all financial instruments.

What is subject to the assessment based on paragraph 15A of the ED are general 'bail-in' provisions resulting from bail-in power of a regulator to take actions which may lead of the instruments into a variable number of own shares of the issuer (= financial liability feature). These relate to a wide group of instruments issued by banks. They apply regardless of whether they are included in the contractual terms of the instruments. This is correctly described in paragraph BC21 of the ED.

Regarding the EFRAG's question on MTOs we consider that due to unclarities regarding the treatment of MTOs mentioned in the EFRAG draft comment letter we consider that the IASB should address them.

As to the question on the accounting for some banking products being disrupted by the proposals we believe that this would not be the case in our jurisdictions. But the issue could be relevant in other jurisdictions. We consider that the IASB should further clarify how to treat features which are specified directly in the law and must be included in the contract in as qualifying conditions for a specific type of instrument to exist.

Question to constituents

40 Do you consider that the IASB's proposals on passage-of-time adjustments will lead to classification changes for options that can be exercised at different pre-determined dates (as described above)? If so, how pervasive would these classification changes be?

We agree that the example mentioned in paragraph 38 of EFRAG DCL would not be an allowable passage-of-time adjustment since it does not fix the consideration in terms of present value. However, this issue is not relevant for our bank as we do not use such instruments in our business.

Regarding the passage-of-time adjustments we would also like to note that the proposed requirements in paragraph 22C(b) of the ED could be complemented by a reasonability test for the compensation of the passage of time. It would prevent from using unrealistic discount rates in the present value calculations.

In paragraph BC54 of the ED the IASB mentions that determining whether the adjustment is reasonable would require the exercise of judgement and the IASB would need to develop a guidance. In this respect we note that the assessment of 'reasonable' is already applied in IFRS without having a specific guidance. For example, paragraph B4.1.11 of IFRS 9 says that the prepayment amount may include reasonable compensation for the early termination

of the contract. Such an assessment is common in the loan business and banks found the way to apply it without the accompanying guidance.

Questions to constituents

52 Regarding the accounting for the obligations to purchase an entity's own equity instruments (NCI written put option), do you support

(a) the gross presentation, as outlined by the IASB, whereby an entity initially recognises a financial liability for the redemption amount with the debit side going against the parent's equity if the entity does not yet have access to the returns associated with ownership of those equity instruments? If so, are you not concerned that the accounting depends on whether the entity does have access to the returns associated with ownership of the equity instruments? Please explain.

(b) Do you support the gross presentation whereby an entity initially recognises a financial liability for the redemption amount with the debit side going against non-controlling interests on the basis that not doing so would not reflect the economic substance of the transaction and would result in double-count of the non-controlling interest as highlighted in paragraph BC77 of the Basis for Conclusions or as argued by Mr Uhl in paragraph AV5 of the Basis for Conclusions? Please explain.

(c) Do you support the net approach resulting in the recognition of a stand-alone derivative measured at fair value as indicated by Mr Uhl in the Basis for Conclusions (paragraphs AV1 to AV6)? Please explain.

53 Do you have any views on how NCI puts should be accounted for in the separate financial statements? Please explain.

Recognition of the financial liability in respect the obligation to redeem entity's own equity instruments is a special topic. The recognition principle as such can be challenged since, based on its logic, also derivatives *to sell* fixed number of entity's own equity instruments

could lead to recognition of a financial asset[2] (as noted in the alternative view of Mr Uhl). It might be appropriate to go as far as recognising the transaction as a stand-alone derivative. However, we do not consider that we should challenge these areas. The gross presentation has its accounting tradition and fundamental reconsiderations of this treatment would be beyond the scope of the project.

We consider that the financial liability for the redemption amount should be recognised as part of NCI (rather than reducing equity attributable to owners of the parent as proposed in the ED). We understand the IASB argument that consolidated financial statements are prepared on the basis of existing ownership interests (BC73 of the ED referring to paragraph B89 of IFRS 10). We also admit that while the obligation is outstanding non-controlling shareholders retain its rights to the returns associated with an ownership interest (BC74 of the ED referring to paragraph B90 of IFRS 10). We understand that existing ownership interests of non-controlling interest holders have not yet been extinguished.

However, we consider that the economic substance of the transaction is not captured by reducing equity attributable to owners of the parent. The transaction does not affect interests of the owners of the parent in any way. Recognition of the financial liability anticipates the cash outflow which will finally reduce the NCI. We note that the treatment that equity is reduced whereby the related ownership interest still exists would not be unique since it is applied to mandatorily redeemable shares.

As discussed above, the treatment of the obligation to redeem entity's own equity instruments as such is a special topic which deserves special considerations. It may be appropriate not to take the IFRS 10 requirements literally. When NCI are involved, we should take account of the substance of the transaction which does not affect the owners of the parent. As a result, we consider that the debit entry should be a separate component in non-controlling interests (as suggested in the alternative view of Mr Uhl).

Regarding the question on how NCI puts should be accounted for in the separate financial statements we note that paragraph 2.1(a) of IFRS 9 says that IFRS 9 shall be applied to derivatives on an interest in a subsidiary unless the derivative meets the definition of an equity instrument of the entity in IAS 32. In the separate financial statements the definition of an equity instrument would not be met. As a result, a derivative treatment in accordance with IFRS 9 would apply.

[2] There is no executory contract because there is no combined right and obligation to exchange economic resources since own equity instruments are no economic resources of the entity. As a result, a financial liability should be recognised for the obligation to pay when purchasing own equity but also a financial asset could be recognised for the right to receive cash when selling own equity.

Questions to constituents

59 Assuming that the gross presentation is retained, do you consider that subsequent changes to the carrying amount of the financial liability should be presented

(a) in profit or loss (as proposed by the IASB),

(b) within equity (on the basis that it is a transaction with owners in their capacity as owners, particularly if NCI and other owners of the parent retain ownership rights), or

(c) based on any other approach, such as in OCI in full or a split between profit or loss and OCI? Please explain.

60 Assuming that the net approach is retained, do you consider that subsequent changes to the fair value of the stand-alone derivative should be presented

(a) in profit or loss (in line with all other derivatives) or

(b) within equity (on the basis that the derivative stems from a transaction with owners in their capacity as owners)?

Regarding remeasurement of the financial liability we agree with the requirement that it is recognised through profit or loss. There may be a merit in viewing written put options and forwards to purchase own equity instruments as transactions with owners in their capacity as owners. In this case the liability would be remeasured through equity. However, we consider that once we the liability is recognised its remeasurement goes hand in hand with it and should be recognised in profit or loss.

We appreciate that there is no reference to IFRS 9 regarding the subsequent measurement of the financial liability. There are cases when no measurement category under IFRS 9 suits the substance of the transaction. For example, if the exercise price of a NCI put option on entity's own shares is related the entity's performance (e.g. profit) measurement of the financial liability at fair value would not be applicable because the financial liability is not held for trading and conditions for the fair value option could hardly be fulfilled[3]. Measurement at amortised cost under IFRS 9 would lead to continuous catch-up

[3] Conditions for the fair value option are not fulfilled because: There is no elimination or significant reduction of an accounting mismatch (IFRS 9.4.2.2(a)), the financial liability is not part of group of financial instruments managed and evaluated on a fair value basis (IFRS 9.4.2.2(a)) or the relation to the entity's performance cannot be viewed as embedded derivative since the non-financial variable is specific to a the contract party and thus the derivative definition is not met (IFRS 5.4.3.5).

adjustments and there would be no reasonable basis for recognition of the interest expense. As a result, we appreciate entities can develop the appropriate accounting policy on how to recognise the value changes in profit or loss and decide whether an interest component would be recognised separately.

If the net approach was adopted we consider that the derivative should be measured through profit or loss. The net approach could be appropriate for derivatives over own equity held in the trading book by banks where such derivatives are used for market making or economic hedging purposes. In such a case revaluation through profit or loss would be fully appropriate because such transaction are not used to extinguish existing or issue new shares from long-term perspective. But this would not be relevant for the NCI puts where we support the gross approach.

Questions to constituents

75 Do you have concerns that the initial and subsequent measurement of the financial liability (or liability component of a compound financial instrument) arising from a contingent settlement provision would ignore probability? Please explain.

76 From the IASB's proposals, do you expect a classification change on how payments to holders are recognised in the financial statements (in the statement of profit or loss or equity)? Will such a change affect your hedge accounting?

77 Do you consider that the clarifications of the terms 'liquidation' and 'non-genuine' are sufficient? If not, what issues remain?

We welcome the requirement in paragraph 25A of the ED that the initial and subsequent measurement of the liability component arising from a contingent settlement provision does not consider probability and estimated timing of occurrence or non-occurrence of the contingent event. This requirement results in a practicable treatment of Additional Tier 1 instruments (with conversion feature into variable number of own shares) leading to a full liability component at inception. There is no need to estimate the discount rate[4] and timing of the contingent event at inception and to periodically re-estimate the timing with potentially numerous catch-up adjustments over the instrument's life.

We do not expect changes in how payments to holders are recognised in the financial statements. So far we have not applied hedge accounting to this kind of instruments. When we decide to apply it we will be able to accommodate to the new requirements.

We consider the clarifications of the terms 'liquidation' and 'non-genuine' as sufficient.

[4] What would be the appropriate spread to the risk-free rate considering deep subordination of the instrument and lack of comparable debt instruments?

Questions to constituents

86 Do you expect changes in classification from the IASB proposals, particularly changes to the classification of financial instruments from equity to liability? What would cause these expected changes to classification?

87 Where local regulation or law is not clear about whether shareholders are part of the governance of the entity, should the IASB consider

(a) mandating a particular treatment, thereby not leaving room for judgement in order to avoid lack of comparability, or

(b) leaving room for judgement based on proposed factors and, if so, which other factors (in addition to those given by the IASB) should be considered? Please explain.

Regarding the requirements on shareholders discretion we do not expect changes in the classification. Applying the guidance for the equity instruments which we issue would be straightforward.

Questions to constituents

139 Are there any significant operational concerns in providing the disclosure requirements? Please explain.

Terms and conditions of financial instruments with both financial liability and equity characteristics

140 Do you agree with the guidance provided on debt-like characteristics and equity-like characteristics (in paragraphs B5B–B5G of IFRS 7), including providing both quantitative and qualitative information? Please explain.

141 Do you consider that there are other characteristics which should be considered? Please explain.

We have analysed the disclosure requirements. Despite a significant increase in the extent of the disclosures we consider that we could prepare the information at a reasonable cost and effort.

However, we have to note that our bank does not use complex funding instruments and does not have a complicated group structure. We acknowledge that financial institutions which are more complex could find the disclosures burdensome e.g. in respect of providing the information on priority on liquidation (which would not even apply to banks which are subject to regulatory resolution measures) or about contractual terms and conditions.

Question to constituents

156 Considering the guidance provided by the IASB, will you be able to allocate profit or loss to 'ordinary shareholders of the parent' and 'other owners of the parent'?

From the requirements it is not clear how the total comprehensive income (in respect of both profit or loss and OCI) attributable to other owners of the parent would be calculated. There are some hints in paragraphs BC248(b) or BC250 of the ED that this could be based on IAS 33 (= most commonly preference dividends). But the illustrative examples in paragraph IG6A of draft Amendments to Guidance on Implementing IAS 1 are confusing in this regard. The balance sheet line item 'Equity attributable to other owners of the parent' increases its carrying amount over years 20X6 and 20X7 due to profit or loss attributable to it (in 20X7 also due to dividends paid (-) and new issuance (+)).

It would be very helpful to understand how the attribution of total comprehensive income was calculated. This is normally obvious for ordinary shareholders of the parent and non-controlling interests as the attribution relates to the interests of common stockholders.

But regarding the other owners of the parent how would the attribution, for example, be calculated for Additional Tier 1 (AT1) instruments issued by banks classified entirely as equity (due to the write down feature)? AT1 instruments do not participate in the issuer's performance other than trough (discretionary) fixed coupon payments. Based on the logic for non-cumulative preference shares in paragraph 14(a) of IAS 33 the total comprehensive income would be attributed to these instruments to the extent of the coupon payments. Also, it would be deducted in the row 'Dividends' of the Statement of changes in equity. As a result, the end of year carrying amount of 'Equity attributable to other owners of the parent' would not be affected. This would be the correct perspective, in our view. But without knowing the answer we cannot assess the impact of the amendments in this area properly.

Question to constituents

174 Do constituents have any concerns on suggested retrospective transition requirements in addition to the ones described above? If so, please describe your concerns and provide suggested solutions.

We do not have concerns regarding the proposed transition requirements.

Question to constituents

189 Do constituents consider that the proposed reduced disclosure requirements for subsidiaries without public accountability, and in particular disclosures on the nature and priority of claims on liquidation, strike a balance between costs for preparers and benefits for the users of financial statements?

Since financial institutions in general are not eligible for the simplified disclosure requirements, which we regret, the proposed amendments are not applicable to subsidiaries in our group and we do not provide comments.