UKEB
UK Endorsement Board

Summary of the Financial Instruments Working Group meeting held on 29 November 2023 from 2pm to 5pm

Meeting agenda

Item no.	**Item**
	Welcome
1	IASB presentation: *Dynamic Risk Management*
2	Technical discussion: *Financial Instruments with Characteristics of Equity*
3	Horizon scanning
4	Any other business

Attendees

Present	
Name	**Designation**
Peter Drummond	Chair, Financial Instruments Working Group (FIWG)
Alan Chapman	FIWG member
Brendan van der Hoek	FIWG member
Conrad Dixon	FIWG member
Helen Shaw	FIWG member
Kumar Dasgupta	FIWG member
Mark Randall	FIWG member
Mark Spencer	FIWG member (by dial-in)

Richard Crooks	FIWG member
Robbert Labuschagne	FIWG member
Sarah Bacon	FIWG member (by dial-in)
Stacey Howard	FIWG member
Ian Mitchell	Observer (by dial-in)

In attendance	
Name	**Designation**
Pauline Wallace	Chair, UK Endorsement Board (UKEB)
Sandra Thompson	Board member, UK Endorsement Board (by dial-in)
Seema Jamil-O'Neill	Technical Director, UK Endorsement Board (UKEB)

Apologies: Fabio Fabiani (FIWG member).

IASB project team members were present for the first agenda item 'IASB presentation: *Dynamic Risk Management'* only.

Relevant UKEB Secretariat team members were also present.

Welcome

1. The Chair of the Financial Instruments Working Group (FIWG) welcomed members, the observer and those in attendance to the meeting, and thanked the IASB staff members for their attendance.

IASB staff presentation – *Dynamic Risk Management*

2. IASB staff presented an update on the Dynamic Risk Management (DRM) Project, which is expected to result in an exposure draft in 2025. The presentation noted the following:

    a) The objective of the project is to provide hedge accounting requirements which better reflect the effect of dynamic interest rate risk management activities ("macro hedging").

    b) The requirements focus on business activities that give rise to interest rate repricing risk.

c) The IASB proposes use of a DRM model to underpin the macro hedge accounting methodology. Key components of the model include:

   i. an entity’s risk management strategy;

   ii. an entity’s current net open risk position (CNOP);

   iii. an entity’s target (risk) profile;

   iv. designated derivatives;

   v. benchmark derivatives; and

   vi. the entity’s risk mitigation intention (RMI).

d) Performance assessments would be required. The resulting DRM adjustment (aligned portion) would be recognised as an asset or a liability in the entity’s balance sheet. The remaining effect (misaligned portion) would be recognised in profit or loss.

3. In the ensuing discussion the following points were made:

   a) Members agreed that alignment of the model to how interest rate risk is managed in practice is important.

   b) It was noted that a risk management strategy may not remain stable over time, and members discussed the implications of this for the DRM model. IASB staff noted that the project would explore how and why risk management strategy may change over time, and what degree or characteristics of change might trigger a termination of macro hedge accounting under the DRM model.

   c) Members discussed the concept of CNOP, noting some portfolios would have revolving balances, for example each month some mortgages redeem and some new mortgages are written. The IASB staff noted that for such portfolios the transactions would not be designated at asset level, allowing the CNOP to be determined based on expectations of the portfolio in a business-as-usual environment.

   d) The IASB staff noted that, in relation to the RMI, the proposed model would require an entity’s intention to be evidenced by risk management action such as the purchase of corresponding derivatives to hedge the position.

   e) Members discussed the hedge performance assessment requirements. In relation to the assessment against the target risk profile (i.e. range of risk limits) the IASB staff noted it would only be required prospectively. In addition, an entity is required to perform prospective and retrospective assessments to ensure that the results indicate that no new risk has been

created via the use of derivatives (for example, by a normally positive result falling below zero, even if this is within the specified target range).

f) One member enquired whether references to measurement on a cumulative basis implied a life-to-date measurement. The IASB staff confirmed they intended a life-to-date approach.

g) One member enquired whether the needs of insurance companies had been considered in the project. The IASB staff confirmed that work was ongoing, and that the application to insurance companies would be considered prior to creation of an exposure draft.

4. The Chair thanked the IASB project team for the presentation.

Technical discussion – Financial Instruments with Characteristics of Equity (FICE)

5. Papers summarising and setting out questions on the IASB's proposals on the effects of laws, shareholders' discretion, disclosures and presentation, and transition had been provided to FIWG members. The papers had been drafted based on the IASB's tentative decisions before publication of an Exposure Draft (the ED). The Chair invited views on the IASB's proposals.

Effects of laws

6. The IASB had tentatively proposed requiring entities to consider, in classifying a financial instrument, only enforceable contractual terms that give rise to rights and obligations in addition to, or more specific than, those established by applicable law. The IASB staff clarified that in applying this requirement, entities do not separate a single obligation into two liabilities (i.e. a financial and a non-financial liability).

7. IASB staff papers had provided two examples of how laws could affect the classification of financial instruments: laws requiring a statutory minimum dividend and laws stipulating bail-in features.

8. In the discussion, the following points were made regarding the example of an instrument in a jurisdiction where there was a statutory minimum dividend:

a) It was possible that the same instrument could be classified differently in different jurisdictions.

b) Prohibiting disaggregation of the obligation was considered a pragmatic solution. Nonetheless, that approach was not necessarily consistent with requirements for componentisation elsewhere in international accounting standards.

c) As the UK has no statutory dividend requirement, UK entities were unlikely to be affected, although it could affect their foreign subsidiaries.

9. Regarding the example of an instrument with bail-in features, FIWG members considered the clarification was broadly consistent with how these instruments had been accounted for in the UK. Bail-in clauses in UK instruments were not currently expected to lead to a change in classification.

10. Overall, the group considered that the proposals would not lead to significant change in practice in the UK.

Shareholders' discretion

11. At present, a financial instrument such as a non-redeemable preference share with distributions to holders that are at the discretion of the issuer's shareholders may be classified differently depending on whether the issuer's shareholders are considered to act in their capacity as investors, leading to the instruments being classified as debt, or as a body on behalf of the entity, leading to the instruments being classified as equity.

12. The IASB has proposed a factor-based approach to help an entity apply judgement when classifying these types of financial instruments as financial liabilities or as equity.

13. In the discussion, the following points were made:

    a) The proposals introduced better guardrails in this complex area. However, they could also be read as supporting a range of diverse existing practices, due to the continuing extent of judgement involved. This was especially the case in the most complex scenarios.

    b) This issue was especially likely to arise in the private equity sector. There may be application challenges in scenarios such as when an individual or entity is the manager or director of a company in which he or she owns shares.

14. FIWG members agreed that a bright-line approach would not be welcome in this area.

15. It was not expected that there would be significant changes in UK practice following the introduction of these requirements.

Disclosures and presentation

16. The IASB had tentatively proposed detailed presentation and disclosure requirements. Members were uncertain as to the extent to which the disclosure proposals would give rise to changes in UK practice.

17. During the discussion, the following points were made:

    a) Many banks and building societies were already making many of these disclosures. There was a potential for additional voluminous disclosures, but aggregation would probably mitigate this risk.

    b) The focus on key judgements was cautiously welcomed, although members noted that IAS 1 *Presentation of Financial Statements* paragraph 122 already contained a general disclosure requirement.

    c) Concern was expressed over the practical ability to distinguish reserves attributable to ordinary shareholders from those attributable to other shareholders. This requirement could be especially difficult to apply to private equity vehicles with different classes of ordinary share capital allocated in accordance with a formula.

Transition

18. The IASB had tentatively decided to require full retrospective application, unless specific transition relief applied. During the discussion the following general points arose:

    a) Full retrospective application may require entities to reassess all their issued financial instruments. This is likely to be particularly challenging for older financial instruments, which will need to be reassessed in the light of the law at the time the instrument was issued.

    b) If instruments were required to be retrospectively reclassified from equity to liability, it would be necessary to measure their fair value at inception of the instrument, which could prove onerous. In addition, on transition entities may want to hedge risks arising from those financial liabilities (which was not permitted while classified as equity).

    c) If instruments were required to be retrospectively reclassified from liability to equity, and hedge accounting had previously been applied, hedge accounting would no longer be possible. Questions could arise as to the treatment of any resulting hedging balances.

    d) Given sufficient lead time entities could potentially prepare for transition by starting or discontinuing existing hedging arrangements, but doing so could be burdensome, and potentially costly, for preparers. Some form of relief up to the transition date in cases when a hedged instrument changed classification would therefore be welcome.

    e) A comparison was drawn with the introduction of IFRS 17, which was required to be applied retrospectively unless it was impracticable to do so, in which case the standard permitted two possible approaches.

f) Consideration should be given to transitional relief, similar to that provided in IFRS 17 *Insurance Contracts*[1], whereby the 'fair value option'[2] in IFRS 9 *Financial Instruments* could be newly applied or disapplied to a financial asset or a financial liability when the first application of the amendments gave rise to an accounting mismatch.

g) It was noted that when applying a factor-based assessment of shareholders' discretion retrospectively, it would be difficult not to incorporate an element of hindsight into the assessment.

19. Overall, FIWG members were concerned that full retrospective application could prove difficult and onerous in practice. Additional cost to preparers will depend on the extent to which their current practice is aligned with the proposals.

Horizon scanning

20. The Chair invited views from the group on potential agenda items for FIWG meetings in 2024. The following topics were suggested:

a) the proposals on *FICE* as set out in the ED;

b) the IASB research project *Power Purchase Agreements*; and

c) the IASB's ongoing redeliberations on the *Amendments to the Classification and Measurement of Financial Instruments* following public consultation on the IASB Exposure Draft.

AOB

There being no other business, the meeting closed.

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1 IFRS 17 paragraph C29.

2 IFRS 9 paragraphs 4.1.5 (option to designate a financial asset at fair value through profit or loss) and 4.2.2 (option to designate a financial liability at fair value through profit or loss).