IFRS 9: Non-viability Contingent Conversion Feature

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The Office of the Superintendent of Financial Institutions (Canada) released an Advisory relating to non-viability contingent capital (NVCC) as part of Canada's implementation of Basel III. Capital instruments, other than common shares, issued by federally regulated deposit-taking institutions, must have a clause requiring a full and permanent conversion into common shares of the deposit-taking institutions upon a trigger event. This requirement ensures that investors in non-common share regulatory capital instruments bear losses before taxpayers when the government determines that it is in the public interest to rescue a non-viable bank. The triggering event is determined by the regulator.

IFRS 9 *Financial Instruments* provides guidance to the holders of financial instruments and measures financial assets at:

- amortized cost;
- fair value through other comprehensive income; or
- fair value through profit or loss.

This determination is based on both:

- the entity's business model for managing the financial assets; and
- the contractual cash flow characteristics of the financial asset (i.e., the solely payments of principal and interest or SPPI test).

The SPPI test is a contractual cash flow test that is based on the contractual terms of a basic, "plain vanilla" lending arrangement.

Generally, investments in equity instruments would be expected to fail the SPPI test since they do not have contractually specified cash flows and do not exhibit characteristics of a typical lending arrangement. Therefore, such investments would be recorded at fair value through profit or loss. However, there is an irrevocable election available that allows investments in equity investments to be recorded at fair value through other comprehensive income under IFRS 9. Paragraph BC5.21 in the Basis for Conclusions to IFRS 9 notes that the definition of equity is provided in IAS 32 *Financial Instruments: Presentation*, with the implication being that there should be symmetry in the application of definitions between issuers and holders as the definition of an equity instrument under IFRS 9 is based on the guidance in IAS 32. For this reason, the issuer's liability or equity classification of an instrument may be an important consideration for the application of IFRS 9 to the holder's accounting for the instrument.

Paragraph 4.3.2 of IFRS 9 indicates that hybrid contracts with financial asset hosts are not bifurcated into their different components; instead, the holder of the instrument applies the IFRS 9 classifications to the entire hybrid contract. Embedded features may result in the instrument failing the SPPI test and, therefore the financial asset in its entirety would need to be recorded at fair value through profit or loss.

Fact Pattern 1

- Bank A issues preference shares bearing a one per cent non-cumulative dividend that is payable at the discretion of the issuer.
- The preference shares include an NVCC provision and as such, the preference shares are convertible into a variable number of Bank A common shares if the regulator announces that Bank A is, or is about to become, non-viable, or if a federal or provincial government publicly announces that Bank A has accepted or agreed to accept a capital injection, or equivalent support, to avoid non-viability. The contingent conversion feature has a floor price (i.e., if the fair value of Bank A's common shares falls to the floor price, then on conversion the number of common shares issued will be determined by reference to that floor price).
- The contingent event of the occurrence of non-viability of Bank A is considered to be genuine and beyond the control of both issuer and holder.
- Bank A considers that the preferred shares have an equity host as well as a liability element given the contingent feature that would, if triggered, require conversion into a variable number of shares. The probability of occurrence of a non-viability event affecting Bank A and requiring conversion of the preferred shares into a variable number of common shares is considered extremely remote. As a result, on initial accounting for the issuance of the NVCC preferred shares, Bank A concluded that the fair value of the liability element was nominal and the entire proceeds on issuance of the shares were assigned to equity in Bank A's financial statements.

Issue 1: What is the appropriate accounting classification for the holder of the NVCC shares?

View 1A – Equity through fair value through profit or loss or fair value through other comprehensive income under the irrevocable election for equity instruments.

Under this view, these shares do not have terms that would be typical of a lending arrangement, from the holder's perspective, because there are no contractually required cash flows and the terms of the instrument fail the SPPI test. As a result, the shares must be carried at fair value through profit or loss unless they qualify for the irrevocable election by the holder to carry them at fair value through other comprehensive income.

Proponents of this view think that this election is available for these NVCC preferred shares and note that the instruments are equity shares by their nature because there is no mandatory redemption and distributions are discretionary. The theoretical liability element, being the contingent conversion into a variable number of shares, is considered to be an event that is so remote that this element has negligible value. Consistent with the classification by the issuer, the holder should also consider the instruments to be equity. Therefore, provided that the investment is not held for trading by the holder, the NVCC shares can be classified as fair value through other comprehensive income at initial recognition.

View 1B – Hybrid or compound instrument through fair value through profit or loss (No fair value through other comprehensive income option).

Proponents of this view think that these instruments include both a liability component and an equity component, irrespective of the conclusion that the liability component is negligible. Therefore, since the instruments are not equity instruments in their entirety, the instrument fails the SPPI test and the fair value through other comprehensive income election is not available to the holders of these instruments.

The Group's Discussion

Most Group members agreed that these NVCC preferred shares include both a liability and equity component, irrespective of the conclusion that the liability component is negligible. Group members noted that as these instruments fail the SPPI test, the fair value through other comprehensive income election would not be available to holders of these instruments and, therefore, the instruments would be recorded at fair value through profit or loss (View 1B).

One Group member noted that there is diversity in views on whether there is an equity host associated with these instruments. Another member noted that although the IFRS Interpretations Committee considered five alternatives for how the issuer might account for these instruments, the views highlighted above are the predominant views in Canada.

One Group member noted that generally, in Canada, the fair value of the liability component is considered to be nominal, given that the prospects of a non-viability event occurring are slim.

Fact Pattern 2

Similar to fact pattern 1, except Bank A issues subordinated debt.

- Bank A issues a subordinated debt with a face value of $100 with a maturity date of 2024. The debt bears five per cent interest.
- The subordinated debt includes an NVCC provision and, as such, is convertible into a variable number of Bank A common shares if the regulator announces that Bank A is, or is about to become, non-viable, or if a federal or provincial government publicly announces that Bank A has accepted or agreed to accept a capital injection, or equivalent support, to avoid non-viability.
- The contingent event, being the occurrence of non-viability of Bank A, is considered to be genuine and beyond the control of both the issuer and holder.
- Bank A considers the likelihood of a non-viability event occurring to be extremely remote.
- Although the debt is contingently convertible into common shares, Bank A notes that the conversion is into a variable number of shares, with the number of shares varying predominantly based on the fair value of the common shares. In other words, Bank A would need to deliver its common shares to the value of unpaid principal and interest. The contingent conversion feature has a floor price (i.e., if the fair value of Bank A's common shares falls to the floor price, then on conversion the number of common shares issued will be determined by reference to that floor price).

- Bank A records the NVCC debt as a liability in its entirety under IAS 32. The conversion feature is considered to be an alternate settlement feature and not an embedded derivative.

Issue 2: What is the appropriate accounting classification for the holder of the NVCC debt?

View 2A – The debt instrument is valued at fair value through profit or loss (i.e., the instrument would fail the SPPI test).

Proponents of this view note that the SPPI test is not met because the conversion feature is an exposure that is not consistent with a basic lending arrangement.

Proponents of this view interpret paragraph BC4.189 in the Basis for Conclusions to IFRS 9 to mean, a financial asset must be measured at fair value through profit or loss if a remote (but genuine) contingency would result in contractual cash flows that are not solely payments of principal and interest.

In addition, paragraph BC4.190 in the Basis for Conclusions to IFRS 9, states, in part, that:

> "contingently convertible instruments and bail-in instruments could give rise to contractual cash flows that are not solely payments of principal and interest and indeed are structured for regulatory purposes such that they have contractual characteristics similar to equity instruments in particular circumstances. Consequently, the IASB believes that amortised cost does not provide relevant or useful information to users of financial statements about those financial instruments, in particular if the likelihood of that future event occurring increases."

Therefore, the NVCC debt investment is measured at fair value through profit or loss and the fair value through other comprehensive income election is not available.

View 2B – The debt instrument may be accounted for at amortized cost or fair value through other comprehensive income, depending on the business model (i.e., the instrument would not fail the SPPI test).

Proponents of this view note that the instruments are debt instruments that Bank A has classified wholly as liabilities. Even if an NVCC event occurred, holders would get the value of their principal and interest receivable in shares. Unlike a fixed conversion option, whereby holders would receive a fixed number of shares, the fair value of the proceeds that the holders would receive in the form or shares will equal the cash payment that they would otherwise be entitled to. As such, the NVCC debt instruments do not fail the SPPI test and, depending on the business model, the holder may measure this investment at amortized cost or fair value through other comprehensive income.

The Group's Discussion

Most Group members supported the view that NVCC debt instruments would fail the SPPI test because they would not be considered a basic lending arrangement. Some members noted that the reason for this view is the existence of the share settlement along with the stipulated floor price that could limit the number of common shares such that the holder may not receive full value in a conversion event. As a result, these instruments should be measured at fair value through profit or loss (View 2A). One member expressed a concern that in the event that a financial institution becomes non-viable and the debt is converted into common shares, the value of the common shares may not represent the value of the debt instrument. The member noted that the value of the common shares received in exchange for the debt instruments could be minimal, or hold no value, given the precarious financial position at the date of the triggering event. One member noted that the probability of the triggering event for the conversion may be remote should factor into the analysis.

Another Group member noted that similar floor features are not uncommon in other financial instruments that are convertible or can be settled in a variable number of common shares.

The Group's discussion raises awareness about this item. No further action was recommended to the AcSB.

(For a full understanding of the discussions and views expressed, listen to the audio clip).