MALAYSIAN INSTITUTE OF ACCOUNTANTS
FINANCIAL REPORTING STANDARDS IMPLEMENTATION COMMITTEE (“FRSIC”)

FRSIC Issue No. 68 [2017]
Classification of Financial Instrument with Non-Viability Clauses (From Holder’s Perspective)

The issue:

The submitter would like to seek further guidance from FRSIC on whether financial instruments that contain loss absorption feature will pass the ‘solely payments of principal and interest’ (SPPI) test as required by paragraph 4.1.1(b) of MFRS 9. The guidance is sought specifically on capital instruments issued by financial institutions under Bank Negara Malaysia (BNM)’s capital adequacy rules intended to be eligible for regulatory capital treatment in Malaysia.

The loss absorption feature could result in the par value of such instruments being written off or converted into a fixed number of the issuer’s ordinary shares. The loss absorption would be triggered when the regulators determine and declare the issuer to be non-viable. The clauses that provide for the loss absorption feature and non-viability declaration are included in the principal terms and condition of the financial instruments in the contracts entered into between issuers and holders.

For asset classification purposes in an entity’s financial reporting, MFRS 9 requires the entity to consider whether an instrument is simple (i.e. where the contractual cash flows 2 are ‘solely payments of principal and interest’ on the principal amount outstanding upon terms that are consistent with a basic lending arrangement), or complex (i.e. where its contractual terms introduce exposure to risks or volatility in the contractual cash flows that is unrelated to a basic lending arrangement, and therefore do not give rise to contractual cash flows that are ‘solely payments of principal and interest’ on the principal amount outstanding).

If the loss absorption feature is a contractual requirement of the instrument, then the instrument would fail the test of qualifying as a basic lending arrangement. However, if the loss absorption feature is a statutory requirement, then the instrument would not fail the test of qualifying as a basic lending arrangement. MFRS 9 only covers accounting requirements arising from contractual terms but not statutory requirements.

Accordingly, there are two views on the issue which are as follows:

- View 1: The loss absorption and non-viability clauses are contractual terms and hence, the instrument fails the SPPI test;

Dewan Akauntan, Unit 33-01, Level 33, Tower A, The Vertical, Avenue 3
Bangsar South City,No.8, Jalan Kerinchi, 59200 Kuala Lumpur, Malaysia
Website: www.mia.org.my | Tel: + 603 2722 9000 | Fax: + 603 2722 9100

- View 2: The loss absorption and non-viability clauses are statutory requirements under the law and regulatory guideline and hence, the instrument passes the SPPI test.

Current accounting practice as observed by the Submitter:

Not applicable.

Reasons for the FRSIC to address the issue:

To provide guidance on the issue to preparers upon adoption of MFRS 9.

Submitter's proposal or recommendation to address the issue:

To seek legal opinion whether the loss absorption and non-viability clauses are statutory requirements under the law and regulatory guideline and hence, the financial instrument passes the SPPI test.

Submitted on:

24 August 2017

Corresponding Guidance:

PROJECT WAS DISCONTINUED.

FRSIC deliberated and decided to discontinue the issue.

The Malaysian Accounting Standards Board (MASB), BNM and 3 legal counsels, as arranged by the Securities Commission (SC), had a meeting on 14 December 2017 to discuss the issue. It was concluded that financial instruments that contain the loss absorption and non-viability clauses as described above would pass the SPPI test after considering the following points:

(a) No loss absorption could happen until and unless BNM had determined that the feature should be triggered only in accordance with provisions under the capital adequacy rules;

(b) If BNM's capital adequacy rules were to change or be revoked such that the loss absorption feature was no longer required to be adopted by financial institutions, the loss absorption feature would immediately become inapplicable and there was no possibility of the feature being triggered by a decision made by BNM for reasons unrelated to its capital adequacy rules;

(c) In typical legal documentation for such capital instruments, the purpose of the issuance (i.e. eligibility for regulatory capital treatment under BNM's capital adequacy rules) would be clearly stated in the recitals and hence, an investor of the capital instrument invests in the capital instrument on that basis. The loss absorption feature embedded into the

Dewan Akauntan, Unit 33-01, Level 33, Tower A, The Vertical, Avenue 3
Bangsar South City,No.8, Jalan Kerinchi, 59200 Kuala Lumpur, Malaysia
Website: www.mia.org.my | Tel: + 603 2722 9000 | Fax: + 603 2722 9100

contract is in substance a regulatory requirement, instead of a contractual requirement, as they are purely a manifestation of BNM's capital adequacy rules. Their existence is purely to facilitate compliance with those rules. Only the regulatory authority i.e. BNM has the power/right to trigger their enforceability in accordance with the capital adequacy rules.

The above conclusion is only applicable to capital instruments issued in Malaysia which are subject to the Malaysian law. For financial instruments issued by financial institutions or other issuers with similar provisions described above but not under the BNM capital adequacy rules, there would be a need to seek legal opinion if such provisions are contractual or statutory requirements.

Dewan Akauntan, Unit 33-01, Level 33, Tower A, The Vertical, Avenue 3
Bangsar South City,No.8, Jalan Kerinchi, 59200 Kuala Lumpur, Malaysia
Website: www.mia.org.my | Tel: + 603 2722 9000 | Fax: + 603 2722 9100