

21/03/2024

International Accounting Standards Board
commentletters@ifrs.com

Dear Mr. Barckow,

Re: ED Financial Instruments with Characteristics of Equity – Proposed amendments to IAS 32, IFRS 7 and IAS 1

The Swedish Bankers' Association is responding to your invitation to comment on your *ED Financial Instruments with Characteristics of Equity – Proposed amendments to IAS 32, IFRS 7 and IAS 1*.

When reviewing the DP we supported minor technical adjustments and correction of obvious flaws in IAS 32. Our major concern was that the DP was too far-reaching and had an increased focus on contractual terms and disregarded economic compulsion. We also favoured keeping the terminology and refraining from other revisions if no actual change in accounting treatment is intended.

We consider that that the ED is too extensive and we expect that the proposed changes will lead to unwanted changes in the present financial reporting practice of financial instruments with a characteristic of equity. You will find our detailed remarks below.

Question 1 – The effects of relevant laws or regulations

Our view is that equity classification should be reserved for contracts with rights to residual interests in an entity. Contracts that have predetermined payments of cash flows without any references to the residual interest in the entity should be classified as liabilities. We believe that the inclusion of references to laws and regulations may give rise to unintended consequences wherefore we recommend that the IASB keep the present wording until a fundamental review is made of IAS 32.

The proposed requirement to take the overall effects of laws and regulations into consideration when classifying a financial instrument is a significant change compared to current requirements. We consider the reference to law in the definition to be complex and difficult to apply. In many cases, it will not be feasible to determine which contractual rights and obligations that are in addition to, or adjust, what follows by law. Therefore, we do not see that the proposed definition will improve the present classification and measurement of financial assets and liabilities. Since IFRS 9 presently is based solely on contractual rights and obligations, we believe the proposed requirement goes beyond the scope of the FICE-project.

We believe that we understand the intention of the proposed changes in IAS 32 when reading the Basis for Conclusion. However, we consider that the proposed wording fail to clearly explain the intention and that there is a high risk for another outcome than intended in measurement and classification based on the proposed wording.

According to the proposed 15A (a) contractual terms should only be considered if they are in addition to laws or regulations and rights. According to 15A (b) obligations that follows from law should be disregarded if they exist regardless of the contract. Consequently, contracts that only repeat legal requirements and have no terms that goes beyond what follows from law would, based on the proposed wording in the ED, lack contractual obligations. A contract without any obligations should be classified as equity.

We assume that this outcome is not intended and we do not consider it adequate. Based on the proposed definition, we see a risk that financial debt instruments that only repeats what follows from law will be classified as equity, even though they may have fixed payments of interest and a right for the holder of the instrument to request repayment of the notional amount.

Question 2 - Settlement in an entity's own equity instruments

We agree with the proposed clarifications and consider them helpful in clarifying the balance between adjustments that intend to preserve the relative economic interest and time value of money and those that adjust the value of the settlement in an entity's own equity instruments beyond that point. While there may be challenges in practice in demonstrating whether an adjustment has the effect of fixing the exercise price in terms of present value, we believe that this

assessment should be made by the reporting entity in line with the principle-based approach.

Question 4 - Contingent settlement provisions

The Swedish Bankers' Association's view is that only contracts that contain a residual interest in the entity should be recognised in equity. Instruments that have predeterminable cash flows should be classified as debt instruments. This is regardless of the inherent risk in the contracts and regardless of those legal requirements, for solvency purposes, formally may require the issuer to insert clauses in the contract that hinder holders of the instruments to require settlement of the contract. These clauses are inserted to give the issuer a possibility to cancel interest payments in a stressed financial position and is included in the pricing of the instruments as a credit risk add-on.

When the conceptual framework was reviewed, we considered that the classification of financial instruments should be based on going concern and contractual obligations with expected cash flows. A focus on expected cash flows aligns the measurement of debt instruments with how the instruments are priced in the fixed income market, and how the holders classify the instruments in their portfolios (fixed income or equity portfolios).

The proposal in the ED seems to be an rule-based construct to achieve a certain outcome without any economic substance and does not represent how the instruments are considered by market participants.

Further, the proposed model is not of European Public good, since financial institutions that manage the interest and fx-risk in the coupons of the affected instruments will get an artificial P&L volatility. The reason for this is that hedge accounting is not allowed for market risks recognised in equity.

Going forward, issuers will have incentives to stop managing the inherent market risks, which will make financial institutions more economically sensitive for stressed market conditions, increase the probability that they will need to cancel the coupon payments which in turn will have a negative impact on the riskiness of the financial instruments with contingent settlement provisions. That will in turn negatively impact the pricing of the instruments which will affect the profitability of the financial institutions in Europe, that is already low, which in turn affects financial stability and increases the risk that taxpayers in Europe may need to support affected banks in stressed market conditions.

If the IASB maintains the proposals in the ED, the answer to question 4 is that:

- we agree that probabilities should not be considered, but that,
- hedge accounting should be allowed for fixed-income instruments whose coupons and/or notional amounts are classified as equity.

Question 5 - Shareholder discretion

We agree with the IASB that this area is judgemental and appreciate the effort to provide guidance regarding in which capacity the shareholders are acting.

However, we consider it difficult to give guidance in this area that would reduce the need for judgement and therefore urge the IASB to test the proposals before including the amendments in IAS 32.

Question 6 - Reclassifications of financial liabilities and equity instruments

We consider that it may be cases in which passage-of-time-changes should render a reclassification wherefore we disagree with the prohibition to reclassify passage-of-time changes. Passage-of-time changes may be reflective of the substance of the contractual terms for the remaining life of the instruments and should in those cases render a reclassification.

Further, based on the inclusion of law and regulation, as part of the classification, we are uncertain how "external to the contract" should be defined going forward.

Question 7 - Disclosure

When the conceptual framework was reviewed, we considered that the classification of financial instruments should be based on going concern if that is the expectation regarding the entity that prepare its financial statements. Based on that logic it is most relevant to prepare disclosures based on that presumption.

Regardless of that presumption when preparing disclosures, we do not consider the proposed disclosure requirements about nature and priority of claims against the entity in liquidation workable for consolidated financial statements

of groups that comprise a large number of legal entities. To provide waterfall disclosures separately for each material subsidiary is not feasible in a normal financial report, it would have to be presented separately in a spreadsheet outside of the financial statements. Consolidating the information in a meaningful way, would imply an assumption that all legal entities within the group are liquidated simultaneously and that the actual outcome is not impacted by internal transfers between different entities in the liquidation process.

In practice, the order in which the liabilities can be settled will be dependent on a number of circumstances that determine the speed in which it is possible to liquidate entities in different countries and the insolvency law in those countries.

With regards to systematically important regulated entities the disclosures will be misleading as those entities are normally not liquidated. Financial institutions that are considered too big to fail will enter into resolution and local recovery and resolution legislation will determine in which order claims are written down. That order is likely to differ from the liquidation order.

Question 9 - Transition

Normally, we support retrospective application of new and amended standards for financial reporting. However, we have agreed with the prospective approach both in IAS 39 and IFRS 9 when circumstances motivates that.

Since a mixed measurement basis is applied for financial instruments, entities are likely to have adjusted their measurements principles accordingly, including the application of hedge accounting, to give a true and fair view of their performance.

The proposed requirements are likely to cause changes in the classification of some financial instruments which, applied retrospectively, will affect P&L in a way that neither represent the actual historical performance nor the expected future performance of the concerned reporting entities. We therefore recommend that changes that alter the classification between liabilities and equity should be possible to apply prospectively.



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Yours sincerely,

SWEDISH BANKERS' ASSOCIATION

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