

EFRAG Discussion Paper Equity Instruments Impairment and Recycling - Technical response

Our reference:	ECO-FRG-18-075	Date:	24 May 2018
Referring to:	EFRAG's discussion paper on equity instruments - impairment and recycling		
Related documents:			
Contact person:	Philippe Angelis, Policy Advisor, Financial Reporting	E-mail:	angelis@insuranceeurope.eu
Pages:	5	Transparency Register ID no.:	33213703459-54

Question 1 – Recycling gains or losses on disposal

Q1.1 What are your views on the arguments presented in paragraphs 2.3 – 2.10? Do you consider that the reintroduction of recycling would improve the depiction of the financial performance of long-term investors? Alternatively, do you consider that the existing requirements of IFRS 9 provide an adequate depiction? Please explain.

The reintroduction of recycling is necessary to ensure the profit and loss account provides a true and meaningful representation of the financial performance for all long-term investors. This is of particular importance for insurers for whom long-term investment is a core feature of their business model. We agree that in a long-term investment business model, both dividends receipts and gains on disposal from the sale of equity instruments are important elements of realisation of the fair value of the financial instruments. In fact, on average capital gains can account for a greater part of returns than dividends. We agree that the period of disposal provides a clear basis to identify the period in which recycling should occur.

Due to the prohibition of recycling, the cash flows relating to gains on disposal from the sale of equity instruments, which are measured at FVOCI, are not reported in profit and loss anymore (in contrast to IAS 39). As a result, the general principle to show in a transparent way all realised gains and losses in the profit and loss account has been left out under IFRS 9. **This creates the false impression that the cumulative gains and losses at the time of disposal of equity instruments are not relevant or economically insignificant, and therefore not a part of the financial performance.** In fact, capital gains on average have been larger than dividends and are fundamental to insurer's rationale of investing in equities. On average since 1930, returns on capital have been more significant (5,5%) than from dividends (4.1%)¹. From a company perspective, the lack of recycling can therefore create an unnecessary distortion in the presentation of the financial performance of long-term equity investments using, FVOCI.

¹ Source: Ned Davis Research, Columbia Management Investment Advisers, LLC.

For insurers the problem can be exacerbated because the equity investments can be backing insurance liabilities. Increases in the liabilities will in some cases need to go through P&L and are economically matched by the combination of dividends and capital gains. Therefore, to avoid accounting mismatch in such cases the ability to recycle equity capital gains through P&L is needed.

In addition, many users of financial statements are interested in having additional information distinguishing realized from unrealized gains and losses. Recognizing gains and losses of equity instruments measured at FVOCI in the P&L would give users information about the economically motivated disinvestment decisions made by management and would thus put investors in a better position to assess the stewardship of management.

The only way to correctly assess performance is by showing the accumulated gains or losses in profit and loss at the period of disposal. From a long-term investment perspective this makes sense, because the temporary fair value increases and decreases during the holding period of long-term equity investments do not reflect the actual performance that will be realized upon disposal. Therefore, we fully support the FVOCI option in IFRS 9 for eligible instruments and urge that the recycling ban is abolished by the IASB. They should be fixed sufficiently ahead of 1 January 2021, i.e. the effective date of IFRS 17 Insurance Contracts to allow for cost-efficient joint and aligned implementation of both standards.

Question 2 – Conceptual relationship between recycling and impairment

Q2.1 What are your views on the arguments presented in paragraphs 2.11 – 2.17? Do you consider that, from a conceptual standpoint, recycling should be accompanied by some form of impairment model? Please explain.

We agree with the arguments presented by EFRAG in paragraph 2.12 and recognise the need of accompanying the reintroduction of recycling with the development of an impairment model for FVOCI equities. A robust impairment model together with the ability to reverse such impairments would increase the relevance of the profit and loss account as a primary source of information of a company's performance.

We acknowledge that some of the negative fair value changes might have a permanent nature and it would be more appropriate and in line with the principle of prudence of the revised Conceptual Framework for Financial Reporting to reflect such fair value changes in profit and loss. An appropriate impairment model would allow fair value losses which are likely to be permanent to be identified. However, it is important that reversals of impairments are also possible. The notion of 'once impaired always impaired' would not reflect correctly the economic reality and from a transparency perspective would be incorrect (see Q6.1). Therefore, improvements to IAS 39 are needed.

Question 3 – Enhancing presentation and disclosure requirements

Q3.1 What are your views on the arguments and analysis presented in Chapter 3 of the DP?
Q3.2 Are there other improvements in presentation and disclosure that you would support?

Q3.1

We support the perspective taken in paragraph 3.7. However, we have strong reservations regarding the approach of Chapter 3. We believe it is not in line with the IASB's core presumption that presentation and disclosure solutions cannot replace the proper recognition and measurement in the primary financial statements (IAS 1.18 and paragraph 3.24). The financial statements should be able to provide the most meaningful view of performance - information disclosed in the notes should provide additional information and transparency where needed.

Furthermore, we disagree with the implicit recommendation in the third scenario under which all equity instruments would be accounted for at FVPL. As reinforced in our response to [Question 1](#) we fully support the FVOCI option in IFRS 9 for the eligible instruments.

Q3.2

Additional disclosure requirements are not a suitable substitute for allowing recycling

If recycling for equity instruments in IFRS 9 is reintroduced together with an impairment model, we suggest to disclose in the notes of the financial statements a description of the impairment rules used for equity instruments classified at FVOCI and an explanation of the aggregated impairment amounts for the reporting period. Any new disclosure requirements should however be kept to the minimum necessary to achieve the objective, i.e. to provide transparency about impairment losses recognised by the reporting entity.

Question 4 – Two proposed models

- Q4.1 What should be, in your view, the general objective and main features of a robust model for equity instruments (relevance, reliability, comparability...)?
- Q4.2 Which, if either, of the two models do you prefer? Please explain.
- Q4.3 Do you have suggestions for a model other than those presented in the DP? If so, please, describe it and explain why it would meet characteristics such as relevance, reliability and comparability.

Q4.1

The general objective and the main features of a robust impairment model for equity instruments would have the following characteristics:

- **It should be capable of distinguishing between permanent declines in the fair value of the underlying equities versus their short-term market-driven fair value changes.**
- **A robust impairment model should also be understandable, and its design should ensure that reliable information is provided to users of financial statements.**
- **A robust impairment model should allow for conclusions regarding the level of comparability of the information provided by reporting entities.**
- **If the relevance condition is met, it would capture the need for prudent information in the case of financial instruments.**

Q4.2

The appropriate approach would be in line with the second model - similar to IAS 39 for financial instruments classified as AFS (available for sale) with less subjectivity (paragraphs 4.12 – 4.18). This model allows differentiating between permanent declines in fair value and short-term fair value changes. We do not favour the revaluation model because of the potential volatility in profit and loss unrelated to the insurance business model.

The impairment model similar to IAS 39 has several conceptual advantages:

- It would distinguish between permanent declines in the fair value of the underlying equities versus their short-term market-driven fair value changes;
- It would avoid the unintended volatility in profit and loss, when the current fair value is below the original cost (paragraph 4.11);
- It would allow the application of an impairment approach for equity instruments that is consistent with the impairment approach used for debt instruments measured at FVOCI.

The revaluation model would result in situations where accounting rather than real economic volatility would be reported in profit and loss. In addition, this model lacks relevance, as there is no assessment of the factors causing impairment or consideration of the characteristics of the equity portfolios.

Q4.3

No, we do not have any further specific suggestions.

Question 5 – Quantitative impairment triggers

- Q5.1 Do you support the inclusion of quantitative impairment triggers in an impairment model? If so, should an IFRS Standard specify the triggers, or should management determine them?
- Q5.2 If you do not support quantitative impairment triggers, how would you ensure comparability across entities and over time?

Q5.1

We support the inclusion of rebuttable quantitative impairment triggers in an impairment model determined by management. IFRS 9 could however provide additional guidance on the meaning of “significant” or “prolonged”. Our experience in the past with the impairment model under IAS 39 showed that such guidance might be beneficial.

Consistent with the principle-based nature of the IFRS-Standards, it should be up to the reporting entity to specify the impairment triggers (paragraph 4.18 b) and to disclose the applied valuation rules, including the quantitative impairment triggers, in the notes to the financial statement (see also [Question 3](#)).

Q5.2

Not applicable since we support the inclusion of quantitative impairment triggers specified by reporting entities, which will help to ensure comparability across entities and over time.

Question 6 – Subsequent recovery in fair values

Q6.1 How should subsequent recoveries in fair values be accounted for?

Q6.2 If subsequent recoveries in fair values are recognised in profit or loss, which of the approaches in paragraphs 5.2 – 5.10 do you support and why?

Q6.1

The prohibition under IAS 39 to reverse in profit and loss previously booked impairment losses (‘once impaired always impaired’ rule) leads to an asymmetric treatment of significant and prolonged decreases and increases in the fair value of equity instruments. Therefore, recognising subsequent recoveries in profit and loss is necessary to provide relevant information to the users of financial statements. It would also be generally in line with reversal of impairments in IFRS for other types of financial instruments. (paragraph 5.3).

Q6.2

As indicated above, a symmetric approach for significant and prolonged losses and recoveries in the fair value of equity instruments should be applied. Therefore, the ongoing reversal approach, as described in paragraph 5.7, would be the preferred approach. As with impairments, quantitative triggers may be introduced to determine when an increase in value is considered as sustainable and when previous impairments may be reversed.

Regarding the need for further analysis in paragraph 5.10, we would like to note that in case of recovery in fair value followed by a new decline in fair value in another period that it should be considered automatically as an impairment. Any other treatment of such a decline in fair value would not fit to the preferred ongoing reversal approach. Only a decline in fair value after full recovery would be subject to a new assessment.

Question 7 – Other

Q7.1 Do you consider that the same model should apply to all equity instruments carried under the FVOCI election? If not, why not and how would you objectively identify different portfolios?

Q7.2 Do you have comments on these other considerations?

Q7.3 Are there other aspects that EFRAG should consider?

Q7.1

For reasons of comparability and objectivity, the same model should apply to equity investments accounted for under the FVOCI category (paragraphs 4.23 – 4.29). , in line with the IASB’s original decision not to determine what constitutes a “strategic investment” for this purpose.

Q7.2

We support the idea to include a rebuttable presumption into the impairment model with (entity-specific) quantitative thresholds. Rebuttable presumptions would allow acknowledging entity-specific and instrument-specific characteristics. In case a rebuttable presumption is applied, this should be disclosed in the notes of the financial statement (see also [Question 3](#)).

We agree with the observation that the unit of account for the measurement of financial instruments is the individual instrument (paragraph 5.14).

However, we do not believe that the impairment model should specify a particular cost formula for an individual investment when it has been acquired in multiple tranches (paragraphs 5.20 – 5.22).

Finally, the variable fee approach model under IFRS 17 does not address the concerns resulting from the IFRS 9 treatment of equity instruments under FVOCI because it only applies to a limited number of insurance contracts. The need for recycling applies potentially across a much wider range of contracts and portfolios. The fact that the variable fee approach permits to better reflect this link for the direct participation contracts should not be seen as an argument to avoid solving the recycling issue resulting from the current measurement of equity instrument at FVOCI.

Q7.3

The changes we support for the accounting for equity instruments at FVOCI under IFRS 9 and for equity like instruments such as UCITs (refer to Q8.1) should be implemented on a timely basis through a change at IASB level, so they are in place as early as possible and before the 1 January 2021. They cannot therefore be postponed and wait until the outcome of the IFRS 9 PIR review.

Such targeted and narrow-scoped modifications of IFRS 9 would remove the existing accounting disincentive and thus have a positive effect for the investment in equities of long-term investors, at a time where long-term investment is desperately needed in Europe.

We reiterate the need to explicitly clarify the consequences of any changes to accounting for equity instruments in IFRS 9 for interim financial reporting. We believe that in the case of an impairment model with the preferred ongoing reversal approach no issues would arise in that respect.

Question 8 – Other aspects of IFRS 9’s requirements on holdings of equity instruments
--

Q8.1 Are there other aspects of IFRS 9’s requirements on accounting for holdings of equity instruments, in addition to those considered in the DP, which in your view are relevant to the depiction of the financial performance of long-term investors? Please explain.
--

We believe that EFRAG should amend its considerations and assess if long-term investments in equity instruments are accounted for consistently under IFRS 9, irrespective of whether they are held directly or indirectly via an investment vehicle (e.g. an investment fund or limited partnership).

Under IAS 39, investments through an investment fund are usually accounted for as equity instruments (such as UCITs) classified as Available for Sale (AFS), with recognition of changes in fair value in OCI. Under IFRS 9, those investments are considered to be debt instruments and have to be accounted for at FVPL since these would normally not meet the “solely payments of principal and interest” (SPPI) –criteria. This significant change in accounting treatment creates volatility in the statement of profit and loss that is not consistent with the long-term investment perspective of these instruments. It would also create accounting mismatches if the corresponding liabilities are not accounted for at FVPL under IFRS 17.

In case no changes are proposed in the accounting treatment of indirectly held equity instruments, we expect the attractiveness of these types of investments to decrease significantly. Therefore, we ask the EFRAG to consider this detrimental accounting treatment for indirect investments in equity instruments in order to allow insurance companies to continue to invest in this asset category from a long-term investment perspective and in the context of a well-diversified asset portfolio.

IFRS 9/IAS 32 accounting rules should not disincentive related long-term equity investments of insurers, irrespective if they are held directly or indirectly.