

EFAMA's comments on EFRAG's Discussion Paper regarding the Impairment and Recycling of Equity Instruments

General Remarks

EFAMA¹ is grateful for the opportunity to comment on EFRAG's discussion paper "*Equity Instruments – Impairment and Recycling*", dated March 2018. The paper at hand sets the views and concerns of the European investment management industry with regards to the impact of IFRS 9 on this industry. Below, we make some general remarks before responding to the EFRAG's Discussion Paper.

(1) Unequal treatment of direct and indirect investments

EFAMA understands that investors investing in investment funds could be subject to significant changes to their financial reporting as a result of IFRS 9. With the introduction of this standard, investments in mandatorily redeemable preferred shares and puttable instruments, that give the holder the right to give the instrument back to the issuer, are obligated to recognize changes in fair value in profit and loss as they arrive ("FVPL"). The definition of "puttable instruments" includes mutual fund units which leads to a significant impact of IFRS 9 for EFAMA's members.

With respect to equity instruments, IFRS 9 provides the entity holding the instruments with the possibility to make an irrevocable election at initial recognition to present changes in fair value in other comprehensive income ("FVOCI election"). This possibility does not exist with respect to mutual fund units even if the respective investment fund is mainly invested in equities. EFAMA would like to underline that this leads to an unequal treatment of direct and indirect investments. EFAMA is concerned that institutional investors, subject to IFRS 9, might withdraw their mutual fund shares as a result of these differences in treatment. Amongst others, this could lead to the following unintended consequences for these institutional investors:

- Higher administrative burdens
- Loss of diversification and hedging of assets
- Higher management costs as these costs can no longer be shared with the other investors of the mutual fund
- Less professional management of the investment portfolio

¹ EFAMA is the representative association for the European investment management industry. EFAMA represents through its 28 member associations and 62 corporate members close to EUR 23 trillion in assets under management of which EUR 15.6 trillion managed by more than 60,000 investment funds at end 2017. Just over 32,000 of these funds were UCITS (Undertakings for Collective Investments in Transferable Securities) funds, with the remaining 28,100 funds composed of AIFs (Alternative Investment Funds). Please visit www.efama.org for further information.

Economically, there is no difference between direct investments in equity and indirect investments via equity funds. For example, most countries within the OECD have a tax system that should, in principle, treat direct investments and investments through a Collective Investment Vehicle (CIV) equally, in order to maintain "the economic efficiency and other advantages CIVs provide"². Likewise, this neutrality should be maintained for accounting purposes.

(2) Identification of long-term portfolios

In its endorsement advice on IFRS 9, EFRAG expressed the view that measuring equity instruments at FVPL might not reflect the business model of long-term investors. EFAMA would like to note that the definition of long-term investors is not always straight forward. In July 2015, EFRAG identified four groups of business models, one of them was the long-term investment business model as used by banks and insurance entities. Based on that analysis, banks would qualify as long-term investors. However, in the March discussion paper, EFRAG noted that banks may also undertake short-term trading activities. Rather than referring to long-term investors EFAMA would, therefore, recommend to refer to long-term portfolios. This would provide investors with the possibility to identify dedicated long-term portfolios within their investments. EFAMA agrees that these long-term portfolios should be protected from any negative consequences of IFRS 9. Long-term portfolios may include equities but also mutual fund units. **Investors should have the possibility to present changes in fair value of the whole portfolio in other comprehensive income** ("FVOCI election") which means that the FVOCI option will be applied to all instruments held in this portfolio.

Q 1.1: 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.

Keeping in mind that funds (as indirect investments in equity) cannot benefit from FVOCI under IFRS 9, we agree with EFRAG's analysis developed paragraphs 2.3 to 2.7, in particular with a view of long-term investments. It is important to note that fund investors intending to hold equity funds on a long-term basis do generally not argue against the fair value principle, but rather believe that the previously existing accounting option (to use FVOCI with recycling) provided a far more accurate picture of their overall activities.

In order to safeguard long-term investments, we also recommend to look at the overall portfolio (i.e. without considering each individual underlying position) while introducing solid impairment provisions on potential losses as an efficient means (to avoiding the potential risk of "earnings management").

Q 2.1: 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 that the concepts of impairment and recycling are linked, as no connection between the two would result in an impact in the profit and loss only at the time of disposition of an equity holding. We, thus, share EFRAG's view on key concepts such as "objectively identifiable adverse changes in the issuer's economic condition", likelihood for a decline in fair value "to reverse in the future" and "prudence" that generally justify a split accounting treatment between P/L and balance sheet.

² OECD report "The granting of treaty benefits with respect to the income of collective vehicles", 23 April 2010, Section I, para. 1

Q 3.1: What are your views on the arguments and analysis presented in Chapter 3 of the DP?

Generally speaking, we doubt whether enhancing presentation and disclosure could be an adequate substitute for improving the depiction of performance in the profit or loss, as the information presented in profit or loss is easier to absorb and to review than information presented in the disclosures.

Q 3.2: Are there other improvements in presentation and disclosure that you would support?

We agree with EFRAG's introductory statement that "financial statements receive more attention than disclosures in the notes". While we agree that such disclosures add value, we consider that aggregate data is sufficient and a consolidated approach towards long-term portfolio would make sense. A disclosure of each individual asset may result in meaningless information and very long notes to the financial statements.

Q 4.1: What should be, in your view, the general objective and main features of a robust model for equity instruments (relevance, reliability, comparability...)?

The general objective and main features of a robust model for equity instruments' accounting standards should truthfully reflect the economic reality of a company's activities. In this regard, comparability is only a secondary issue, as it is almost impossible to effectively compare divergent activities correctly. Thus, under the guise of standardisation such common standards should not result in providing unclear or distorting views. Eventually, transparency is in our opinion a more relevant concept to ensure comparability.

Q 4.2: Which, if either, of the two models do you prefer? Please explain.

While we understand the advantages of using the already existing IAS 39 framework, we believe that a better solution would be to more clearly define principles for the investor to apply to each long-term portfolio and which are adaptable to each company's situation.

Q 4.3: 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.

We would, again, like to highlight the important notion that long-term portfolios may include equities as well as other instruments such as funds. The FVOCI option with recycling should apply at the level of a (well identified) long-term investment portfolio and not only to equities held directly by the investor.

Q 5.1: 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?

We do not support the inclusion of quantitative impairment triggers in an impairment model, as quantitative thresholds are usually too prescriptive to allow for a fair representation of all business models regarding long-term investments. We rather support the notion that (under the oversight of the auditors) the management of the company should determine adequate impairment principles that will apply to dedicated portfolios. The suggestion to use a rebuttable presumption (as proposed in paragraph 5.12) could work as a reference for a warning, but should not be connected to an automatic quantitative trigger.

Q 5.2: If you do not support quantitative impairment triggers, how would you ensure comparability across entities and over time?

It is fair to assume that the impairment rules determined by the investor would not change on a frequent basis. Such a stable approach should enable useful comparisons over time. For the transversal comparisons with other entities (which in turn follow a different approach), accounts should provide transparency on the methodology (key points of the model, explicit triggers, cumulative or alternative criteria, etc.) and its financial results. While it would be excessive to require the full disclosure of the chosen methodology, we could envisage that any significant changes should be reported.

Q 6.1: How should subsequent recoveries in fair values be accounted for? Please explain.

A symmetric approach seems logical: if an event triggers an impairment, the discontinuation of this event justifies the recovery to be taken into account in the same (and reverse) manner.

Q 6.2: 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?

In our view, the investing entity will define its investment strategy, choose its accounting treatment (provided there is an option) and determine all the internal policy rules for impairment and recovery. We favour to provide some flexibility as long as there is some stability in the investment strategy and policy and some consistency in their implementation.

Furthermore, we believe that the discussions regarding a “unit of account” are very important. As already mentioned, we are in favour of an approach at the level of the portfolio that would enable all types of investors to dedicate a proportion of their investment to be long-term or undetermined maturity investments and accounted for under FVOCI with recycling. In this case, the impairment test would be conducted at the level of the portfolio, by aggregating all individual changes in fair value of each position which would, in turn, encourage diversifications in the investment policies.

Q 7.1: 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?

The same model should not apply to all equity instruments carried under the FVOCI election, as we strongly believe that the accounting policy should be determined from the level of the portfolio.

The investment objective determines the overall investment portfolio. Thus, before opting for FVOCI, the investor should decide on clear internal rules for investment and accounting (including impairment). It is common practice for prudential reporting to identify different portfolios. It should not be more difficult to proceed in a similar manner for accounting. Portfolios should have a long-term or undetermined horizon objective and their holding should predominantly be in equity and equity-like instruments.

Again, we must insist that funds having an investment objective that invest predominantly in equities should be included in the long-term portfolio and benefit from the option for FVOCI with recycling. In such a scenario, a fund's prospectus will give a sufficient information on the investment strategy to determine whether the fund will qualify as an equity-like instrument.

While we understand EFRAG's comments made in paragraph 5.19 on the transfers from one portfolio to another one, we believe there are means to resolve such issues. For example, it is possible to restrict this practice to transactions made at arm's length on an organised market place, or towards a portfolio that would be subject to fair value profit and loss.

EFAMA is of the opinion that in case of portfolios being used to hedge a long term commitment, both, the portfolio and the long-term commitment should be subject to the same accounting rules.

Q 7.2: Do you have comments on these other considerations?

EFRAG is correct to mentioning other issues at the end of this discussion paper. We support its proposal in paragraph 5.32 to consider fair value net of the hedging gains or losses. The example used in the paragraph underlines, on the one hand, the excessive and often undue volatility of the automatic application of a threshold without a proper assessment of "significant and prolonged". On the other hand, it brings forward a strong argument in favour of the reversal impairment approach.

Q 7.3: Are there other aspects that EFRAG should consider?

No comments

Q 8.1: 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.

EFAMA would like to raise the issue of the classification of CIVs as debt instrument under IAS 32. Since it was not part of the IFRS 9 scope, many investor clients of EFAMA members do not understand the drastic change in accounting that has been introduced for equity funds.

We are grateful in advance for your attention to the concerns expressed in this response and we welcome the opportunity to discuss these with you in further detail. In case there is any additional information that we can provide, please contact EFAMA at info@efama.org or [+32 \(0\) 2513 3969](tel:+3225133969).

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