Problem definition phase report
Issues Paper

Contents

Executive summary

Background and objective

1 Following the endorsement of IFRS 9 *Financial Instruments* the European Commission ('the EC') requested EFRAG to investigate the potential effects of IFRS 9's requirements on accounting for investments in equity instruments on long-term investment. In the first phase of the project, EFRAG was asked to collect quantitative data on the current holdings of equity instruments and their accounting treatment; and enquire whether, and to what extent, entities expect that the new accounting requirements will affect their decisions in relation to investment in equity instruments.

2 The objective of this report is to present EFRAG's findings in relation to the problem definition phase of the EC's request. The findings are mostly based on:

(a) a public consultation conducted in 2017, which resulted in 26 respondents from the insurance, the financial services and non-financial sectors for years 2014-2016; and

(b) a review of a sample of annual financial statements of 2016 and 2015, which covered 30 and 38 entities respectively from various industries.

3 The request from the EC has a second phase, for which EFRAG aims to issue a separate report by the end of the first half of 2018 following a public consultation,

Findings: current holdings of equity instruments and accounting treatment

Long-term investing and amount and classification of equity instruments

4 Most respondents to the public consultation view themselves as long-term investors in equity instruments. Ten respondents indicated that all their equity instruments classified as available for sale ('AFS') are held for the long-term.

5 The total amount of equity instruments held on average for years 2014-2016 by respondents is 753 billion Euros, out of which 166 billion Euros are classified as AFS.

6 Most respondents to the public consultation currently classify at least 60% of their equity instruments as AFS. Equity instruments classified as AFS represent 23%, 15% and 100% of total equity instruments for insurance entities, financial institutions and non-financials respectively. Holdings of equity instruments are highly concentrated in a small number of the respondents.

7 The total amount of equity instruments held by the entities in the sample of the review of 2016 financial statements was 315 billion Euros, out which 57 billion Euros classified as AFS. Most entities included in the sample of annual financial statements classify at least 55% of their equity instruments as AFS. Equity instruments classified as AFS represent 16% and 88% of total equity instruments for insurance entities and non-financials respectively. For the sample of credit institutions included in the data received by the European Banking Authority, the percentages amount to 19%, 6% and 19% of total equity instruments in 2014, 2015 and the period ended 30 September 2016, respectively.

8 Most of the equity instruments of the respondents from the insurance and the financial services industry are direct equity holdings, while the non-financials hold the majority of their equity holdings classified as AFS indirectly, i.e. through a collective investment vehicle. In particular, 77% of the equity instruments classified as AFS held by respondents in the insurance industry and 95% of the ones held by the non-financials, are direct equity holdings, while for the non-financials the relevant percentage is 24%.

OCI balances and changes in the period

9 Respondents reported a net accumulated other comprehensive income ('OCI') balance related to equity instruments classified as AFS amounting to 8% of their total equity instruments classified as AFS. Four respondents had a net debit accumulated OCI balance amounting to 13 billion Euros.

10 Entities in the sample of the 2016 annual financial statements reported a net accumulated OCI balance related to equity instruments classified as AFS amounting to 11% of their total equity instruments classified as AFS. Two companies in the sample had a net debit accumulated OCI balance.

11 Respondents reported a net change for the period of the accumulated OCI balance related to equity instruments classified as AFS amounting to 7% of earnings before tax (in absolute terms).

Impairment losses and assessment of impairment losses on equity instruments classified as AFS

12 Five respondents did not recognise any impairment loss on equity instruments classified as AFS during the period. 12 recognised impairment losses amounting to 3 billion Euros, which ranged from 1% to 24% of those respondents' earnings before tax. Respondents from the insurance industry had higher impairment intensity.

13 Eight entities in the sample of annual financial statements of 2016 did not recognise any impairment loss on equity instruments classified as AFS and 19 entities recognised impairment losses amounting to 2 billion Euros or 4% of earnings before tax.

14 Most respondents and entities included in the sample of annual financial statements use a combination of 'significant' and 'prolonged' decline in fair value to assess impairment of equity instruments. The range of quantitative thresholds varies across industries.

Disposal of equity instruments classified as AFS

15 Three respondents reported no disposal gain or loss on equity instruments classified as AFS during the period. For entities that reported the net gain on disposal, this amounted to 5 billion Euros and 19% of earnings before tax.

16 Five entities in the sample of annual financial statements of 2016 recognised a total net gain from disposal of equity instruments classified as AFS of 0,6 billion Euros, which represents 3% of earnings before tax.

Findings: anticipated effects of the new accounting requirements

17 Most respondents indicated that a variety of factors, including business, economic and regulatory factors, affect their decisions to invest and hold equity instruments or other classes of assets.

18 Most respondents from all industries expect to use the election in IFRS 9 to designate investments in equity instruments for measurement at fair value through other comprehensive income ('FVOCI') to some extent. The choice to use the election depends on different factors, including the business purpose of the investment, the expected volatility of the equity instrument and the economic linkage to other items.

19 The majority of respondents do not expect to modify their holding period for equities following the introduction of IFRS 9.

20 Respondents reported mixed views about the impact of the requirements on their asset allocation decisions. 12 entities (mainly insurance entities) expect to modify such decisions, although most did not specify to what extent. Some respondents indicated that they might shift some of their investment into different asset classes, including unquoted equities, as possible alternatives to quoted equities.

21 Respondents that expect to modify their asset allocation decisions explained that they view disposal gains as part of their performance and the prohibition to recycle results in accounting mismatches.

Chapter 1 – Background and objective of this report

The accounting requirements in IFRS 9 for equity instruments

22 IFRS 9 *Financial Instruments* was issued by the IASB in July 2014 and is effective for annual periods beginning on or after 1 January 2018. In accordance with IFRS 9, equity instruments are measured at fair value with changes in fair value recognised in profit or loss ('FVPL'). At initial recognition, an entity may make an irrevocable election to present changes in the fair value in other comprehensive income ('OCI') provided that the equity instrument is neither held for trading nor contingent consideration recognised by an acquirer in a business combination to which IFRS 3 *Business Combinations* applies ('the FVOCI election'). The entity may apply the election on an instrument-by-instrument basis.

23 If the entity applies the FVOCI election, it shall not assess the instrument for impairment losses and it shall not reclassify gains or losses into profit or loss upon derecognition of the instrument ('recycling'). Dividends are recognised in profit or loss.

24 This accounting treatment is different from the treatment of instruments classified as available for sale ('AFS') under IAS 39 *Financial Instruments: Recognition and Measurement*. AFS instruments under IAS 39 are carried at fair value with changes in fair value recognised in OCI. However, when an entity assesses that an instrument is impaired, the decrease in value from the original cost is reclassified to profit or loss as an impairment loss. Impairment losses shall not be subsequently reversed. Upon derecognition, the cumulative difference in OCI is recycled to profit or loss.

25 In the Basis for Conclusions on IFRS 9, the IASB noted that one of the primary reasons for not allowing recycling is that it would create the need to assess these equity instruments for impairment. The IASB also observed that the application of impairment requirements of equity instruments classified as AFS in IAS 39 were very subjective.

EFRAG's endorsement advice on IFRS 9

26 In its Endorsement Advice on IFRS 9, EFRAG noted that the default requirement to measure all equity investments at FVPL may not reflect the business model of long-term investors, including entities undertaking insurance activities and entities in the energy and mining industries. EFRAG noted that the election to recognise changes in fair value in OCI was not likely to be attractive to long-term investors because the prohibition on recycling gains and losses may not properly reflect their performance.

27 Based on the limited evidence available at the time, EFRAG assessed that it was unlikely that these entities would change their investment strategy as a result of the implementation of IFRS 9. EFRAG noted that broader economic considerations such as the need for entities undertaking insurance activities to obtain a yield on their asset portfolio sufficient to meet their obligations to policy holders are likely to outweigh any accounting concerns in deciding whether or not to invest in equity investments.

Request from the European Commission

28 The European Commission ('EC') completed the endorsement process of IFRS 9 with the adoption of Commission Regulation No 2016/2067 on 22 November 2016. During the endorsement process, the European Parliament and some Member States called for close monitoring of the impact of IFRS 9 to ensure that it serves the European Union's ('EU') long-term investment strategy.

29 In May 2017, EFRAG received a request from EC for technical advice on the issue. The request has two distinct phases.

Problem definition phase

30 In problem definition phase, which is addressed in this report, the EC asked EFRAG to collect quantitative information about current holdings of equity instruments and their accounting treatment. In particular, the EC referred to the following information:

(a) the total amount of equity instruments held by insurance companies and other long-term investors and what proportion was deemed to be long-term;

(b) the criteria used to classify their equity portfolios as long-term and what information is disclosed about their long-term business model and the long-term portfolios in the financial statements;

(c) the accounting classification of the equity instruments (held for trading or AFS) and the amount of fair value changes recognised in OCI in relation to the equity instruments considered to be held for the long-term;

(d) the gross and net amounts of disposal gains and losses recycled through the profit and loss and the amount of equity instruments portfolio disposed of in the period, as well as the factors leading to dispose equity instruments held for the long-term;

(e) the relative size of the fair value changes, and disposal gains and losses to the annual profit or loss; and

(f) the amount of impairment losses on the equity instruments in the AFS category and the criteria applied to assess impairment.

31 The EC also requested EFRAG to obtain information of the entities' expectations in relation to:

(a) the extent to which they plan to use the FVOCI election and the factors that will influence their choices; and

(b) the anticipated effects of the new requirements in IFRS 9 on their decisions to invest in equity instruments or other categories of financial assets and their holding periods (including quantification where possible.

Possible solutions phase

32 In the possible solutions phase, on which EFRAG aims to report by the end of the first half of 2018, EFRAG is asked to assess, from a conceptual perspective, the significance of an impairment model to the re-introduction of recycling. If EFRAG concludes that an impairment model is a precondition to re-introduce recycling, then EFRAG is asked to consider how the existing impairment model under IAS 39 for equity instruments could be improved or propose other impairment approaches, possibly by looking at other national or third-country GAAPs.

33 EFRAG is also asked to consider if, in the absence of a robust impairment model, alternative presentation or disclosure requirements could be used to provide users with the necessary information to make the adjustments deemed necessary to the reported profit or loss.

Objective of this report

34 The objective of this report is to present EFRAG's findings in relation to the problem definition phase of the EC's request.

Chapter 2 – How the data can contribute to the debate

35 Quantitative data provide a useful background to the discussion and allow a better definition of the problem. During EFRAG's consultation on its research agenda, constituents indicated that accounting research should be evidence-based at each step: identification of the issue, analysis and discussion of possible solutions.

36 The following are examples of how quantitative data could be useful:

(a) the size of the equity investment portfolio may give an indication of the potential impact of a change in asset allocation;

(b) profit or loss will be impacted by the prohibition to recycle disposal gains and losses and the lack of recognition of impairment losses. The size of these amounts could be used to assess the future impacts;

(c) profit or loss will also be impacted if investments currently in the AFS category under IAS 39 will in future be carried at FVPL, especially if these investments are subject to significant fair value changes. The amount of equity instruments classified as AFS, the yearly change in the related OCI balance and the expectation on the use of the FVOCI election may give an indication of the potential additional impact in profit or loss.

37 All the data included in the report refer to annual periods for which IFRS 9 is not yet effective. IFRS 9 will be effective for annual periods beginning or on after 1 January 2018. Insurance entities are allowed to defer the application of IFRS 9 until 1 January 2021.

Chapter 3 – Sources of information

38 It is difficult to find comprehensive data for equity holdings by IFRS preparers in Europe. The main sources for this report are the public consultation and the review of a sample of annual financial statements. The total equity holdings for the two samples are indicated in paragraphs 55 and 61 below. To provide a context for these data, the next paragraphs provide quantitative information from other public sources.

39 The European Central Bank ('ECB') statistics bulletin includes information on balance sheets of credit institutions and other financial corporations (including investment funds, insurance corporations and pension funds).

40 The ECB data are aggregated and not consolidated. They do not include entities outside Eurozone or non-financial institutions. Some of the largest European pension funds are located in countries outside the Eurozone, such as Norway, Sweden and Denmark. A breakdown of the total between IFRS and non-IFRS preparers is not available.

41 As of 31 December 2016, credit institutions and other financial institutions held 1,2 trillion Euros and 4,4 trillion Euros in equity instruments. These entities also held 4,7 trillion Euros of investment fund shares.

42 The European Insurance and Occupational Pensions Authority ('EIOPA') provided aggregated data on 629 individual insurance undertakings of the EU and the European Economic Area ('EEA') using IFRS Standards based on their 2016 accounts. The data provided are included in the following table:

	2016 year end			
In billion Euros (year 2016)	**Life**	**Non-life**	**Both life and non-life**	**Total**
Equities	41	36	10	**87**
Number of individual undertakings	*145*	*375*	*109*	***629***

43 The amount of equities excludes financial assets held for unit-linked contracts or in collective investment undertakings or participations.

44 The European Banking Authority ('EBA') provided aggregated data on financial assets held by approximately 150 financial institutions from 28 member states of the EU and one country of the EEA for the period 30 September 2014 to 30 September 2016.

45 The data provided are included in the following table:

In billion Euros	**2014**	**2015**	**30.09.2016**
Equity instruments	699	668	603
AFS equity instruments	130	38	116
Total AFS instruments	2.681	2.807	2.732

Public consultation

46 In July 2017, EFRAG launched a public consultation via a web-based questionnaire with an invitation to respond no later than 30 September. The consultation was open to all constituents.

47 In the absence of a definition of 'long-term investors' or 'long-term investments' in IFRS Standards, participants were asked to indicate whether they consider themselves as long-term investors. Most of the respondents indicated that they view themselves as such.

48 EFRAG received 19 responses with quantitative information for years 2014-2016 and seven responses with general information only. Respondents came from the following industries and countries:

Industry	**Number of respondents**	**Number of respondents with quantitative data**
Insurance	11	9
Financial Institutions	10	6
Non-financials	5	4
Total	***26***	***19***

Country	**Number of respondents**	**Number of respondents with quantitative data**
France	8	7
Germany	7	6
Belgium	4	1
Other	7	5
Total	***26***	***19***

49 EFRAG also received two responses from individuals outside Europe, which did not provide quantitative information and were not considered in the analysis.

Review of annual financial statements

50 EFRAG also reviewed two samples of annual financial statements. The first review was conducted at an early stage and included the 2015 annual financial statements of 38 European listed entities. The entities were identified by using a data aggregator and sorting the entities by market capitalisation.

51 The first sample included 12 companies from the insurance industry, 12 banks and 14 non-financials. The 38 companies in the sample had a total market capitalisation of approximately 2,7 trillion Euros. The review focused on the significance of the equity instruments classified as AFS and how entities apply the IAS 39 impairment requirements.

52 The second sample included the 2016 annual financial statements of 30 European listed entities. The entities were identified by using a data aggregator and sorting the entities by total assets. Respondents to the public consultation were excluded from the sample.

53 The sample included 19 companies from the insurance industry and 11 companies from the mining, oil and gas and utilities industry. Both industries are generally considered to hold equities for the long term. The 30 companies in the sample had total assets of approximately 4,7 trillion Euros and market capitalisation of approximately 1 trillion Euros. EFRAG focused on the same reporting items for which information was requested in the public consultation.

Other available sources

54 EFRAG has considered the findings of the following reports:

(a) the *Investment Behaviour Report* published in November 2017 by EIOPA, a survey analysing trends in the investment behaviour of European insurers over the past 5 years and based on the submissions from 87 large insurance groups and 4 solo undertakings across 16 EU Member States;

(b) the *Report on the results of the EBA impact assessment of IFRS 9* published in November 2016, that includes submissions from a sample of 58 institutions across the EEA;

(c) the 2017 *European Asset Allocation Survey* published by Mercer, that includes data from 1,240 institutional investors across 13 countries in Europe; and

(d) the 2015 *Pension Fund Statistics* published by Pensions Europe, that refers to pension funds in the private sector from 21 European countries.

Chapter 4 – Findings: current holdings of equity instruments and accounting treatment

Long-term investing

Findings from the public consultation

55 Most respondents to the public consultation (22 out of 26, i.e. 11 insurance entities, nine financial institutions and two non-financials) explained that they view themselves as long-term investors in equities. These respondents provided the following explanations:

(a) they hold equity instruments for the long-term to match the duration of long-term liabilities/commitments, such as insurance or decommissioning liabilities. These entities maintain part of their portfolio continually invested in equity instruments;

(b) they view some of their investments as strategic in nature. For example, they hold investments to develop relationships in local communities, access specific markets or to provide access to services that support their business;

(c) some of their equity investments are not immediately liquid due to shareholders' agreements and lock-up periods; and

(d) only a long-term investment strategy allows to capture the equity risk premium and achieve higher returns than investing in fixed income. This applies even more when investing in private equity.

Amount and classification of equity instruments

Findings from the public consultation

56 The following table presents total equity instruments classified as AFS and total equity instruments reported by respondents in each industry:

	Average years 2014-2016			
In billion Euros (**average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
AFS equity instruments	111	38	17	**166**
Equity instruments	490	246	17	**753**
% of AFS equity instruments / equity instruments	*23%*	*15%*	*100%*	***22%***
Number of entities	*9*	*6*	*4*	***19***

57 The amount of equity instruments may include equities held for unit-linked contracts for some respondents.

58 Equity instruments classified as AFS were concentrated in a small number of respondents. The following table presents two ways of illustrating the level of concentration of equity instruments classified as AFS in each industry.

59 First, the two entities from each industry with the highest amount of equity instruments classified as AFS account for 59%, 77% and 90% of the total equity instruments classified as AFS of the insurance, financial and non-financial entities. The same entities represent 51%, 63% and 89% of the total equity instruments.

60 Second, three insurance entities, two financials and one non-financial account for at least 70% of the total equity instruments classified as AFS. The same entities represent 55%, 63% and 75% of the total equity instruments.

	Average years 2014-2016		
In billion Euros (**average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**
Concentration of AFS equity instruments in ‘top 2’ entities	59%	77%	90%
% of equity instruments represented by the ‘top 2’ companies	51%	63%	89%
Number of entities accounting for at least 70% of AFS equity instruments	3	2	1
% of equity instruments represented by these companies	55%	63%	75%

61 The following table presents the relative weights of direct and indirect equity holdings in the AFS category.

	Average years 2014-2016			
In billion Euros (**average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Direct equity holdings	86	18	4	**108**
Indirect equity holdings	25	1	13	**39**
AFS equity instruments (of those who provided the breakdown)	**111**	**19**	**17**	**147**
% of direct AFS equity instruments / AFS equity instruments	*77%*	*95%*	*24%*	***73%***
% of indirect AFS equity instruments / AFS equity instruments	*23%*	*5%*	*76%*	***27%***

62 The following table presents the distribution of the ratio of equity instruments classified as AFS over total equity instruments. Most respondents have a ratio higher than 60% but the overall ratio is 22% due to a few companies with large holdings mostly measured at FVPL.

	Number of entities			
% of AFS equity instruments over total equity instruments **(average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Less than 5%	1	1	-	**2**
10%-20%	1	1	-	**2**
30%-40%	-	-	1	**1**
60%-85%	1	4	-	**5**
90%-100%	6	-	3	**9**
Not provided	2	4	1	**7**
Total	**11**	**10**	**5**	**26**

Findings from the review of annual financial statements

63 The following tables summarise total equity instruments, the portion classified as AFS and the distribution of the ratio from the sample of 2016 annual financial statements, by industry:

	Year 2016		
In billion Euros (year 2016)	**Insurance**	**Non-financials**	**Total**
AFS equity instruments	49	8	**57**
Equity instruments	306	9	**315**
% of AFS equity instruments / equity instruments	*16%*	*89%*	***18%***
Number of entities	*19*	*11*	***30***

	Number of entities		
***% of AFS equity instruments over total equity instruments* (year 2016)**	**Insurance**	**Non-financials**	**Total**
Less than 5%	3	1	**4**
10%-25%	1	1	**2**
30%-45%	3	1	**4**
55%-85%	5	1	**6**
86%-100%	5	6	**11**
Not provided	2	1	**3**
Total	**19**	**11**	**30**

64 In terms of concentration, the two insurance entities with the largest portfolio of equity instruments classified as AFS hold 43% of the total portfolio for the sample of insurance entities. The percentage is 74% for the non-financials.

65 The following table presents the total equity instruments classified as AFS from our review of the financial statements of 2015, broken down by industry.

	Year 2015			
In billion Euros (year 2015)	**Insurance**	**Financials**	**Non-financials**	**Total**
AFS equity instruments	59	74	7	**140**
Number of entities with AFS equity instruments	*10*	*11*	*11*	***32***

66 In terms of concentration, the two entities from each industry with the highest amount of equity instruments classified as AFS, account for 50%, 62% and 40% of the total equity instruments classified as AFS of the insurance, financials and non-financial entities respectively.

Findings from other sources

67 Based on the data provided by the EBA, equity instruments classified as AFS represent 19%, 6% and 19% of the total equity instruments as at 31 December 2014, 31 December 2015 and 30 September 2016 respectively.

68 Based on the report on the EBA impact assessment on IFRS 9, equity instruments classified as AFS represent on average 2% of the total financial assets for the entities included in the sample.

OCI balances and changes in the period

Findings from the public consultation

69 16 respondents provided data on the accumulated (debit)/credit OCI balance for equity instruments classified as AFS. Respondents generally did not provide separately the gross debit and credit balance:

	Average years 2014-2016			
In billion Euros (**average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Net accumulated OCI balance (debit)/credit	7	7	(1)	**13**
AFS equity instruments (of those disclosed)	111	37	14	**162**
% Net accumulated (debit)/credit OCI balance / AFS equity instruments	*6%*	*19%*	*(7%)*	***8%***
Number of companies	*9*	*5*	*2*	***16***

70 The following table demonstrates that the two entities in each industry with the highest amount of equity instruments classified as AFS account for 56%, 86% and 75% of the total net accumulated OCI balance (in absolute terms) of the insurance, financial and non-financial entities respectively.

	Average years 2014-2016		
In billion Euros (**average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**
Net accumulated OCI balance (in absolute terms) for the 'top 2' entities	16	6	2
% of net accumulated OCI balance (in absolute terms) represented by the 'top 2' companies	56%	86%	75%

71 The following table presents the distribution of the ratio of net accumulated (debit)/credit OCI balance over equity instruments classified as AFS. Three companies from the insurance industry and one company from the non-financial industry had a net debit accumulated OCI balance amounting in total to 13 billion Euros.

	Number of entities			
***% of Accumulated (debit)/credit OCI balance over AFS equity instruments* (average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Debit OCI balance	3	-	1	**4**
0%-20%	3	1	-	**4**
21%-30%	3	3	-	**6**
More than 30%	-	1	1	**2**
Not provided	2	5	3	**10**
Total	**11**	**10**	**5**	**26**

72 Ten respondents to the public consultation did not mention the net change for the period in accumulated OCI balance related to equity instruments classified as AFS. The remaining 16 companies reported the following (respondents generally provided the net balance):

	Average years 2014-2016			
***In billion Euros (*average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Net change in accumulated OCI balance (debit)/credit	(0,1)	0,3	0,1	**0,3**
Profit / (loss) before tax (of those disclosed)	28	12	7	**47**
Number of companies	*9*	*5*	*2*	***16***

73 If all equity instruments currently classified as AFS were to be carried at FVPL, all changes in the accumulated OCI balance would affect profit or loss in the period. The following table illustrates the impact in absolute terms (i.e. by aggregating the changes in absolute terms):

Net change in accumulated OCI balance in absolute terms	3	0,3	0,1	**3,4**
Earnings before tax in absolute terms (of those disclosed)	28	15	7	**50**
% Net change in accumulated OCI balance / Earnings before tax (both in absolute terms)	11%	2%	1%	**7%**

74 Four out of 16 respondents had a net debit change for the period of the accumulated OCI balance.

Findings from the review of annual financial statements

75 The following table illustrates the net accumulated OCI balance in relation to equity instruments classified as AFS for the 14 entities (six non-financial entities and eight insurance entities) that disclosed the information in their 2016 financial statements:

	Year 2016		
In billion Euros **(year 2016)**	**Insurance**	**Non-financials**	**Total**
Net accumulated OCI balance (debit)/credit	4	(0,2)	**4**
AFS equity instruments (of those disclosed)	35	2	**37**
% Net accumulated (debit)/credit OCI balance / AFS equity instruments	*11%*	*(10%)*	***11%***
Number of companies	*8*	*6*	***14***

76 Two entities had a net debit accumulated OCI balance.

Impairment losses on equity instruments classified as AFS

Findings from the public consultation

77 As a reminder, impairment losses will not be recognised under the new requirements.

78 Nine respondents did not report the amount of impairment losses on equity instruments classified as AFS. Five respondents did not recognise any loss during that period; the remaining 12 recognised losses of 3 billion Euros, which ranged from 1% to 24% over the earnings before tax.

79 The following table illustrates the distribution of the ratio of impairment losses over earnings before tax. Insurance entities reported higher impairment losses.

	Number of entities			
% of impairment loss over profit / (loss) before tax **(average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
0%-9%	4	5	4	**13**
10%-24%	4	-	-	**4**
Not provided	3	5	1	**9**
Total	**11**	**10**	**5**	**26**

Findings from the review of annual financial statements

80 12 insurance entities and seven non-financial entities disclosed the amount of impairment losses on equity instruments classified as AFS in their annual 2016 financial statements. Two insurance entities and six non-financials entities in the group did not recognise any impairment.

In billion Euros (year 2016)	Year 2016 Insurance	Non-financials	Total
Impairment loss on AFS equity instruments	1	1	**2**
AFS equity instruments (companies that provided the information)	33	3	**36**
% impairment loss over AFS equity instruments (companies that provided the information)	*3%*	*22%*	***4%***
Profit / (loss) before tax (companies that provided the information)	(1)	0,9	**(0,1)**
Earnings before tax in absolute terms (companies that provided the information)	32	20	**52**
% impairment loss over earnings before tax in absolute terms (companies that provided the information)	*3%*	*5%*	***4%***
Number of companies	*12*	*7*	***19***

Findings from other sources

81 Based on the data provided by the EBA, impairment losses on equity instruments classified as AFS represent 1% of the equity instruments classified as AFS as at 31 December 2015.

Assessment of impairment losses

Findings from the public consultation

82 Most respondents referred to the use of quantitative thresholds for ‘significant’ and ‘prolonged’ decline in the fair value. Some also apply the other indicators mentioned in IAS 39 to the issuer of the equity instruments.

83 Two respondents also use a third impairment trigger – a combination of ‘significant’ and ‘prolonged’ decline based on lower thresholds than when each of them is used in isolation.

84 The following tables summarise the range of thresholds used:

Significant criterion (% decrease of the fair value below cost)	**Number of companies** **Insurance**	**Financial institutions**	**Non-financials**	**Total**
20%-30%	4	3	-	**7**
40%-50%	1	2	1	**4**
80%	2	1	-	**3**
Not responded	4	4	4	**12**
Total	**11**	**10**	**5**	**26**

	Number of companies			
Prolonged criterion (in months)	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
6-12[1]	4	2	-	**6**
18	-	1	-	**1**
24-36	3	3	-	**6**
>36	-	-	1	**1**
Not responded	4	4	4	**12**
Total	**11**	**10**	**5**	**26**

Findings from the review of annual financial statements

85 None of the non-financial entities in the sample of 2016 financial statements disclosed their thresholds for assessing a significant or prolonged decline in the fair value of equity instruments. Nine out of 19 insurance companies indicated thresholds with a range between 25%-30% (significant) or 6-12 months (prolonged) decline in the fair value of the equity instrument below its cost.

86 The following tables summarise the range of thresholds in the sample of 2016:

	Number of companies
Significant criterion (% decrease of the fair value below cost)	**Insurance**
25%-30%	5
40%-50%	2
80%	1
Not disclosed	10
Determined quarterly	1
Total	**19**

	Number of companies
Prolonged criterion (in months)	**Insurance**
6-12	7
18	1
24-36	2
>36	-
Not responded	9
Total	**19**

87 The insurance entities included in the sample of 2015 annual financial statements disclosed thresholds with a range between 20%-30% (significant) or 6-12 months (prolonged). Banks disclosed a range between 40%-50% (significant) or 18-36 months (prolonged) decline in the fair value.

88 The following tables summarise the range of thresholds in the sample of 2015:

[1] One of the companies stated that an equity instrument was considered impaired, if the fair value of equity instruments has been below the carrying amount for four consecutive quarters on the date of the statement of financial position.

Significant criterion (% of decrease of the fair value below cost)	**Number of companies**		
	Insurance	**Financial institutions**	**Non-financials**
No AFS equity instruments or not specified	2	1	3
Not disclosed	5	4	9
20%	3	1	1
25%-30%	2	1	1
40%-50%	-	5	-
Total	**12**	**12**	**14**

Prolonged criterion (in months)	**Number of companies**		
	Insurance	**Financial institutions**	**Non-financials**
No AFS equity instruments or not specified	2	1	3
Not disclosed	4	4	9
6	3	2	1
9-12	2	-	1
18-20	-	3	-
24-36	1	2	-
Total	**12**	**12**	**14**

Disposal of equity instruments classified as AFS

Findings from the public consultation

89 As reminder, disposal gains and losses will not be recognised in profit or loss under IFRS 9.

90 12 respondents did not mention the net gain on disposal, and three reported that they had none over the period. The remaining 11 entities reported the following:

	Average years 2014-2016			
In billion Euros **(average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Net gain on disposal	4	0,8	0,1	**5**
Profit/(loss) before tax (of those that provided the information)	20	3	0,3	**23**
% of Net gain on disposal / Profit/(Loss) before tax	*20%*	*27%*	*33%*	***22%***
Earnings before tax in absolute terms (of those that provided the information)	20	6	0,3	**26**
% of Net gain on disposal / Earnings before tax (in absolute terms)	*20%*	*13%*	*33%*	***19%***
Number of companies	*7*	*3*	*1*	***11***

91 The distribution of the ratio of gain/(loss) on disposal of equity instruments classified as AFS over earnings before tax is shown in the following table:

	Number of entities			
% of net gain on disposal over profit / (loss) before tax **(average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
0%	-	1	2	**3**
2%-15%	4	1	-	**5**
20%-30%	2	1	-	**3**
31%-45%	1	1	1	**3**
Not provided	4	6	2	**12**
Total	**11**	**10**	**5**	**26**

Findings from the review of annual financial statements

92 Four insurance and five non-financial entities disclosed separately the net gain on disposal of equity instruments classified as AFS in their 2016 financial statements. The insurance entities reported a cumulative net gain of 0,5 billion Euros. Four of the non-financials entities had no gains and one had a gain of 0,1 billion Euros. The following table illustrates the ratio of the gain over earnings before tax.

	Year 2016		
In billion Euros **(year 2016)**	**Insurance**	**Non-financials**	**Total**
Net gain on disposal	0,5	0,1	**0,6**
Profit / (loss) before tax (companies that disclosed the net gain on disposal)	8	(5)	**3**
Earnings before tax in absolute terms (companies that disclosed the net gain on disposal)	8	13	**21**
% net gain on disposal over earnings before tax in absolute terms (companies that disclosed gain/loss on disposal)	*6%*	*0,8%*	***3%***
Number of companies	*4*	*5*	***9***

Findings from other sources

93 Based on the data provided by the EBA, gains on disposal of equity instruments classified as AFS amount to 5 billion Euros, 6 billion Euros and 11 billion Euros as at 31 December 2014, 31 December 2015 and 30 September 2016 respectively.

Chapter 5 – Findings: anticipated effects of the new requirements in IFRS 9

94 This section is based on the public consultation and the follow-up interviews with respondents. Other sources are mentioned where relevant. Respondents were asked a number of questions on their current asset allocation process and how this could be impacted by the new requirements in IFRS 9 on the treatment of equity instruments.

What factors affect the decisions to invest in equity instruments or other classes of assets?

95 Insurance entities mainly referred to the following factors:

(a) asset liability management (mainly duration and liquidity but also currency and inflation);

(b) strategic asset mix/allocation and economic return/risk expectation;

(c) Solvency II capital requirements and accounting rules;

(d) capital protection and limiting volatility;

(e) financial environment;

(f) tax treatment;

(g) market liquidity transaction costs; and

(h) balanced utilisation of risk capital (mid- to long-term focus).

96 Financial institutions mainly referred to the following factors:

(a) (long-term) return on investments (both direct and indirect);

(b) company's strategy, business needs and plans;

(c) strategic activities for the respective jurisdiction's economy (e.g. start-ups);

(d) financial structure of the investee and its ability to generate cash flows and create value (especially for SMEs);

(e) capital requirement, legal, regulatory aspects and other trends in the financial sector; and

(f) stabilisation of investment income.

97 Non-financial entities mainly referred to the following factors:

(a) asset liability management/matching (duration and liquidity);

(b) long-term return/risk expectation; and

(c) discount rate of decommissioning liabilities: the annual performance of the asset portfolio should at least be equivalent to the prevailing discount rate applied to compute the decommissioning provision.

What factors affect the average holding period and disposal decisions?

98 Insurance entities mainly referred to the following factors:

(a) asset liability management/matching (duration, currency and sensitivity to inflation): As far as possible, changes in the value of investments should cover changes in technical liabilities, as this stabilises the entity's positions in fluctuating capital markets. Disposals are typically needed in order to rebalance the portfolio, not only realise gains, but also to safeguard the long-term asset liability management strategy (e.g. interest rebalancing);

(b) long-term economic return expectations and actual performance (e.g. in the case of long-term underperformance shift to other investment strategies);

(c) major changes in risk appetite;

(d) strategy (business support);

(e) shortage of available risk capital;

(f) liquidity and transaction costs;

(g) economic environment and regulation, including changes in Solvency II capital requirements;

(h) asset manager's rebalancing needs for investment strategies (for tactical reasons or passive benchmark tracking); and

(i) stabilisation of investment result via unrealised gain reserves.

99 Financial institutions mainly referred to the following factors:

(a) strategy and business plan of the entity, including changes in business model/ business activities or investee no longer needs financial support;

(b) opportunities to make profits;

(c) investment performance and liquidity;

(d) qualitative characteristics of the investment (instrumental or institutional, listed or not, life cycle of the entity and relative strength vis a vis other shareholders);

(e) permanent losses or low profit with high capital costs;

(f) capital requirements, legal and regulatory aspects; and

(g) political environment.

100 Non-financial entities mainly referred to the following factors:

(a) asset liability management/matching (duration and liquidity) and discount rate of decommissioning liabilities;

(b) changes in expected short term performance;

(c) stabilisation of gains/losses under the current IAS 39 requirements. The entity will seek to compensate losses by gains in order to limit the impact on the profit or loss or crystallise gains rather than losses, by selling equity instruments with an underlying unrealised gain. This way the effect of the accrual of the decommissioning provision (recorded in profit or loss) could be partly offset by the financial income resulting from the portfolio (dividends on equity instruments, bond coupons and selective capital gains); and

(d) rebalancing discipline, adjustment of investment strategy to economic and market cycles, plus-value taking discipline.

Expected use of the FVOCI election

Findings from the public consultation

101 18 respondents (seven insurance entities, eight financial entities and three non-financials) expect to use the FVOCI election. The following table summarises the replies:

% of equity instruments for which the FVOCI election is expected to be used	Nr. of respondents	Industry
Less than 1%	1	Insurance
5%-10%	3	Two financial institutions and one insurance
25%-35%	3	Financial institutions
60%-80%	4	Two non-financials, one insurance and one financial institution
100%	3	Insurance
Not specified percentage	4	Three financial institutions, two insurance, one non-financial
Total	***18***	

102 Seven of 11 insurance entities expect to use the FVOCI election mainly for strategic or long-term investments. One stated that it will use the election for financial investments that are intended to back its own funds and some type of long-term insurance products (for example, annuities). Another noted that their choice will be based on the dividend yield of the equity investment.

103 Another insurer that currently carries all its investments in equity instruments as FVPL noted that the choice of the election will probably be affected by the type of insurance products. The entity indicated that its own products have participation features where the benefits to the policyholders is linked to the fair value changes of the equity portfolio. For investments backing these products, the FVOCI election is not likely to be used.

104 Eight of ten financial institutions expect to use the FVOCI election mostly for strategic investments or investments providing services for their business. Two of them also indicated that they will not use the election for equity investments within their insurance business.

105 One financial institution stated that they will use the election for those investments for which dividends provide the bigger portion of total returns. Another stated that the choice will be based on the expected volatility.

106 Three of five non-financials expect to use the FVOCI election. The choice will be made based on the following factors:

(a) expected volatility and earnings potential;

(b) economic linkage to other items;

(c) the business purpose for holding the investment; and

(d) the expected holding period.

Findings from other sources

107 The *Report on the results of the EBA impact assessment of IFRS 9* indicates that 19% of participants expect to move equity instruments classified as AFS category to FVPL because of the prohibition on recycling.

Expected effects on holding period of equity investments

108 The majority of respondents (18 entities) do not expect to modify their holding period for equities following the introduction of IFRS 9. Only four entities (three insurance entities and one financial institution) expect to shorten their holding period to avoid the potential volatility.

Expected effects on asset allocation decisions

Findings from the public consultation

109 There were mixed views about the impact of the requirements on the respondents' asset allocation decisions. 12 entities (eight insurance entities, three financial institutions and one non-financial) expect to modify their asset allocation decisions, although most did not specify to what extent.

110 Insurance entities provided various reasons for a potential change in asset allocation decisions. They referred mainly to contracts with participation features, where there is a clear link between realised profits and the amount promised to the policy holder. One respondent mentioned that in the case of contracts with participation features, the share of profit of the shareholder is recognised in profit or loss over the total contract term, while for equity instruments at FVOCI the investment income will never be recognised in profit or loss. The lack of recycling is therefore perceived to create an accounting mismatch with the measurement of insurance liabilities.

111 Some insurers indicated that they are considering shifting significant parts of their equity portfolio from listed to non-listed/private equity entities. Some observed that returns from non-listed investments are mostly collected as dividends. One insurer suggested that unlisted investments are less volatile. One respondent noted that it will invest less in small caps/growth stocks.

112 Other classes of alternative assets mentioned were real estate, infrastructure and entities in the renewables industry, as less volatile than other equities.

113 Some insurers also expect to replace part of their investments in equity instruments with credit investments, loans or bonds.

114 One insurer noted that their asset allocation decisions are not affected by accounting requirements.

115 One financial institution explained that the FVPL category is not favoured, due to the short-term volatility. Their analysis is still ongoing, but they might consider changing their asset allocation. Moreover, they are considering to introduce a non-GAAP measure that would include disposal gains and losses in the reported performance.

116 Another financial institution responded that they expect to reduce by half their exposure in equity instruments and invest more in investments such as private equity, real estate or infrastructures.

117 When referring to the insurance part of their business, another financial institution responded that they will possibly invest more in real estate or debt instruments.

118 One financial institution indicated that its asset allocation decisions are not affected by accounting requirements.

119 One non-financial entity expects to gradually reduce the weight of equity instruments in its overall portfolio over the next few years. Alternatively, it will consider turning to instruments issued in the United States, as it considers them as less volatile; or to unlisted investments, such as real estate, private equities or infrastructure.

Findings from other sources

120 Other available sources indicate that asset allocation is changing for a variety of reasons that do not relate to accounting, notably the search for yield in the prevailing economic environment.

121 The *2017 European Asset Allocation Survey* indicates that the weight of equity instruments decreased marginally to 30% of the total assets (representing approximately 330 billion Euros), with domestic equity representing 11%. The decrease was mostly driven by the reduction of the exposure by UK defined-benefit plans. From 2007, the weight of equities for UK plans in the survey decreased from 61% to 29% in line with a strategy of de-risking. Bonds have stayed relatively stable at 51%. The figures therefore do not seem to support the shift from bonds to shares that some predicted due to the persistent low yields. However, this may have driven the increase in other investments that now represent 15% of the total allocation. Their increase reflects a more dynamic asset allocation, with almost 60% of the surveyed plans engaging in a strategic review once a year.

122 The *Investment Behaviour Report* identifies the following trends in Europe:

(a) a trend towards lower credit rating quality fixed income bonds with lower credit rating quality, while at the same time, there were many sovereign and corporate downgrades during the period;

(b) a trend towards more illiquid investments such as non-listed equity and loans excluding mortgages and a decrease in (the value of) property investments;

(c) an increase of the average maturity of the bond portfolio;

(d) an increase of the weight of new asset classes, such as infrastructure, mortgages, loans, real estate;

(e) a small decrease in the debt portfolio and a small increase in ‘other investments’ between 2015 and 2016. Equity allocation has remained unchanged. Changes in all three main investment categories from 2011 to 2016 have only been marginal; and

(f) the volume of non-unit linked and non-index linked assets has significantly increased in the last years. The majority of the insurers mentioned the intention to further extend the product range and the selling of more such products in the next three years.

123 The *2015 Pension Fund Statistics* indicates that the investment in equity instruments of the member organisations amount to 1.137 billion Euros, approximately 31% of total assets. The largest asset class is bonds with 48%.

124 The explanatory note to the statistical data indicates that the search of yield has resulted in a shift from traditional asset classes towards riskier investments. Tax incentives are deemed essential to encourage pension funds to make investments in alternative assets such as infrastructure. Finally, the environment of low interest rates influences asset allocation as the duration gap increases when long-term rates fall.

Other concerns

125 Some respondents raised concerns about the treatment of mutual funds or Undertakings for the Collective Investment of Transferable Securities ('UCITS'). It is currently understood that these instruments do not pass the solely payments of principal and interest test under IFRS 9 and that they also do not qualify as 'equity instruments' and therefore the FVOCI election would not be available. As a consequence, these assets would need to be carried at FVPL.

126 One respondent noted that UCITS would be placed at a clear disadvantage compared to direct holdings and this could go against the objective to reduce market fragmentation. The respondent noted that they will consider switching from UCITS to mandates (direct investments) or dedicated funds that they will control.