EFRAG Secretariat: F. Poli, J. Waldier,
I. Chatzieffraimidou

Update on the collection of the quantitative data
Issues Paper

Contents

Objective

1 The objective of this paper is to provide an update to EFRAG TEG on the quantitative data collected by the EFRAG Secretariat on investments in equity instruments in the context of the request for technical advice from the European Commission.

Why are we collecting data?

2 Some constituents have expressed concerns about the accounting options for equities under IFRS 9 *Financial Instruments* because:

(a) the fair value through profit or loss ('FVPL') option results in exposure to volatility; and

(b) the fair value through other comprehensive income ('FVOCI') option reduces the return on these investments reported in profit or loss.

3 IFRS 9 is not yet in use and will be effective in Europe only from 2018 and entities with insurance activities have the option to defer its application until 2021. Insurance companies in particular are likely to decide on the use of the FVOCI election only after they complete their testing of the impacts of IFRS 17 *Insurance Contracts.*

4 Quantitative data provide a useful background to the discussion and allow a better definition of the potential problem. The following are examples on how quantitative data could be useful in the discussion:

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

(b) Volatility in profit or loss will be affected if investments currently in available for sale ('AFS') category will be classified to FVPL and these investments are subject to significant fair value changes. The share of investment in equities classified as AFS, the yearly change in the related OCI balance and the expectation on the use of the FVOCI option under IFRS 9 may give an indication of the potential additional volatility in profit or loss;

(c) Impact on the reported profit or loss depends on the size of disposal gains and losses that will not be allowed for recycling, and the impairments reported under the IAS 39 requirements for available-for-sale financial assets. The size of investment in equities, the expectation on the use of the FVOCI option and the size of disposal gains may give an indication of the potential impact on reported profit or loss; and

(d) Cumulated debit OCI balances of equity investments classified in AFS and yearly changes may give an indication of the potential impairment losses.

5 However, when using the data, it is important to consider that:

(a) The sample of respondents is limited and therefore not statistically representative;

(b) The completeness and accuracy of the data provided by the respondents have not been verified;

(c) The data refer to the period between 2014 and 2016 and are not fully representative of the situation as of the date IFRS 9 will be applied;

(d) Asset allocation decisions are driven by multiple factors, such as expected returns of asset classes, liability matching, risk appetite, tax regimes and other regulations; and

(e) The European Commission in its request for advice refers to the impact of IFRS 9 on long-term investors, and the data collection request repeatedly mentions 'long-term portfolios' or 'the proportion of equity instruments considered to be held for the long-term'. However, the long-term notion is neither defined nor relevant in IFRS Standards that make a distinction only between current and non-current assets and liabilities, based on the entities' operating cycle.

Public consultation

Introduction

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

7 EFRAG has received 19 responses with quantitative information for years 2014-2016 and 6 responses with general information only. Respondents came from the following industries and countries:

Industry	Nr. of respondents
Insurance	11
Financial Institutions	9
Non-financials	5
Other	-
Total	***25***

Country	Nr. of respondents
France	8
Germany	7
Belgium	4
Other	6
Total	***25***

8 EFRAG also received two responses from individuals outside Europe, which were not considered in our analysis.

Highlights from the responses

9 Most respondents view themselves as long-term investors in equity instruments.

10 Overall, AFS equity instruments represent 2% of total financial assets and 22% of total equity instruments.

11 Most respondents from all industries currently classify most their equities in the AFS category. In particular, AFS equity instruments represent 23, 15% and 100% of total equity instruments for insurance entities, financial institutions and non-financials respectively. AFS equity instruments represent 4%, 1% and 18% of financial assets for insurance entities, financial institutions and non-financials respectively.

12 For entities that reported the accumulated OCI balance related to AFS equity instruments, overall this amounted to 8% of AFS equity instruments. 3 companies from the insurance industry and 1 company from the non-financial industry had a net debit accumulated OCI balance.

13 For entities that reported the net change for the period of the accumulated OCI balance related to AFS equity instruments, overall this amounted to 1% of profit before tax. 4 companies from the insurance industry had a net debit change for the period of the accumulated OCI balance.

14 5 respondents did not record an impairment on their AFS equity instruments during the period and 12 recorded impairment ranging from 1% to 24% over the profit before tax and from 1% to 3% over the value of AFS equity instruments.

15 3 entities reported that they had no gain or loss on disposal of AFS equity instruments during the period. For entities that reported gain on disposal, overall this amounted to 4% of AFS equity instruments and 20% of profit before tax.

16 Most insurance entities reported that objective evidence of impairment of their AFS equity instruments ranged between 20%-30% (significant) or 6-12 months (prolonged) decline in the fair value of the equity instrument below its cost. Most financial institutions reported 20%-30% and 24-36 months respectively. Non-financials generally did not mention their specific thresholds.

17	Most respondents expected to use the FVOCI election to a different extent.
18	The majority of respondents did not expect to modify their holding period for equities following the introduction of IFRS 9 and there were mixed views about the impact of the requirements on their asset allocation decisions. 12 entities (mainly insurance entities) expected to modify such decisions, although most did not specify to what extent.

Long-term investors in equities

19 Most respondents (21 out of 25, i.e. 11 insurance entities, 8 financial institutions and 2 non-financials) view themselves as long-term investors in equities.

20 Insurance entities provided the following arguments:

(a) The insurance business model matches long-term liabilities/commitments with long-term investments. Asset liability management (especially in Life/Health business) leads to long-term investment strategies due to the underlying (long-term) insurance liability profile. One respondent noted in particular, that the main focus of the asset liability management is on getting stable dividend inflows. Realised gains have only a limited impact and are only linked to growth/small caps;

(b) Insurance entities are constantly investing in the liquid equity sector with a more or less stable percentage of their investment portfolio;

(c) Insurance entities often invest long term in certain strategic equity investments, e.g. in the insurance sector to support their business or in infrastructure investments, which they keep for the long-term due to their illiquidity. These investments normally provide a stable long term cash flow matching long term insurance liabilities; and

(d) Insurance entities need to capture the equity risk premium, thereby achieving higher returns compared to fixed income. The equity risk premium can only be achieved by long-term investing.

21 Financial institutions provided the following arguments:

(a) They invest on strategic corporations in their jurisdiction (often to develop relationships with local communities, business associations, or to provide support for transmission and development projects etc.);

(b) They invest in private equity investments, by taking minority equity stakes or through private equity funds;

(c) They have investments held for a significant period of time due to for example to lock up period, no liquidity and shareholders agreements (which include governance rights); and

(d) They have a limited amount of more strategic equity investments to facilitate their business e.g. an equity holding in a trading platform company.

22 Non-financial entities provided the following arguments:

(a) The law in the respective jurisdiction requires entities to build a portfolio of financial and/real assets to secure the financing of long–term decommissioning costs funding and long-term financing of long-term decommissioning liabilities. One entity referred to a definition, which in the respondent's view, best defines a long-term investor: "An investor acting on its own account, pursuant to a legal requirement to build a portfolio of financial and/or real assets earmarked to the financing of very long-term commitments (10 years and beyond), of which the current portion is small relative to the overall amount. The portfolio is managed according to a long-term strategic allocation, reflecting its business model and according to specific terms suited to this investment horizon"; and

(b) They invest on strategic corporations in their jurisdiction as well as in private equity investments.

The significance of AFS equity instruments

23 The following table presents the total financial assets, equity instruments and AFS equity instruments of the respondents, broken down by industry:

	Average years 2014-2016			
In Eur. bill **(average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Financial assets	2,575	4,750	95	**7,421**
Equity instruments	490	246	17	**753**
AFS equity instruments	111	38	17	**166**
% of AFS equity instruments / equity instruments	*23%*	*15%*	*100%*	***22%***
% of AFS equity instruments / Financial assets	*4%*	*1%*	*18%*	***2%***

24 The following table presents the distribution of the ratio of AFS equity instruments over total equity instruments, which demonstrates that most of the entities that provided data, have a ratio higher than 60%. Overall, AFS equity instruments represent 22% of total equity instruments. The overall ratio is affected by a few companies with a low ratio and large equity instruments base.

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

OCI balances and impairment

25 9 entities did not mention the accumulated (debit)/credit balance related to AFS equity instruments. The remaining 16 companies reported the following:

	Average years 2014-2016			
***In Eur. mill (*average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Accumulated OCI balance (debit)/credit	7,053	7,411	(1,108)	**13,356**
AFS equity instruments	111,120	36,991	14,363	**162,474**
% Accumulated (debit)/credit OCI balance / AFS equity instruments	*6%*	*20%*	*(8%)*	***8%***
Number of companies	*9*	*5*	*2*	***16***

26 The following table presents the distribution of the ratio of the accumulated (debit)/credit OCI balance over AFS equity instruments:

	Number of entities		
***% of Accumulated (debit)/credit OCI balance over AFS equity instruments* (average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**
Debit OCI balance	3	-	1
0%-20%	3	1	-
21%-30%	3	3	-
More than 30%	-	1	1
Not provided	2	4	3
Total	**11**	**9**	**5**

27 9 entities did not mention the net change for the period in accumulated OCI balance related to AFS equity instruments. The remaining 16 companies reported the following:

	Average years 2014-2016			
***In Eur. mill (*average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Change in accumulated OCI balance (debit)/credit	(100)	348	50	**298**
Profit / (loss) before tax	28,202	12,106	7,121	**47,429**
% Change in accumulated (debit)/credit OCI balance / Profit/ (loss) before tax	*0.4%*	*3%*	*1%*	***1%***
Number of companies	*9*	*5*	*2*	***16***

Impairment

28 8 entities did not mention the amount of impairment loss on AFS equity instruments in years 2014-2016. 5 respondents did not record an impairment during that period, while the remaining 12 recorded impairment ranging from 1% to 24% over the profit before tax and from 1% to 3% over the value of AFS equity instruments.

29 The distribution of the absolute ratio of impairment losses over profit/(loss) before tax is shown in the following table:

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

Disposal of AFS equity instruments

30 11 entities did not mention the gain or loss on disposal of AFS equity instruments, and 3 entities reported that they had no gain or loss on disposal during the years 2014-2016. The remaining 11 companies reported the following:

	Average years 2014-2016			
***In Eur. mill (*average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**	**Total**
Gain/(loss) on disposal	3,731	763	115	**4,609**
Profit/(loss) before tax	19,821	3,287	273	**23,381**
AFS equity instruments	85,876	17,896	2,400	**106,172**
% Gain/(loss) on disposal / AFS equity instruments	*4%*	*4%*	*5%*	***4%***
% of Gain/(loss) on disposal / Profit/(Loss) before tax	*19%*	*23%*	*42%*	***20%***
Number of companies	*7*	*3*	*1*	***11***

31 The distribution of the ratio of gain/(loss) on disposal of AFS equity instruments over AFS equity instruments is shown in the following table:

	Number of entities		
***% of net gain on disposal over AFS equity instruments* (average years 2014-2016)**	**Insurance**	**Financial institutions**	**Non-financials**
Below 1%	1	1	2
3%	3	2	-
5%-6%	2	-	1
10-12%	1	1	-
Not provided	4	5	2
Total	**11**	**9**	**5**

32 The distribution of the absolute ratio of gain/(loss) on disposal of AFS equity instruments over profit/(loss) 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**
0%	-	1	2
2%-15%	4	1	-
20%-30%	2	1	-
31%-45%	1	1	1
Not provided	4	5	2
Total	**11**	**9**	**5**

Main factors that influence the asset allocation of long-term investors in equities

33 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).

34 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 and regulatory aspects; and

(f) Stabilisation of investment income.

35 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.

Main factors that influence the average holding period and disposal decisions for investments in equity instruments of long-term investors in equities

36 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.

37 <u>Financial institutions</u> 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 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.

38 <u>Non-financial entities</u> 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 capital gains/losses (Under the current IAS 39): The entity will seek to compensate capital 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.

Factors considered to assess whether equity instruments are impaired

39 Respondents generally noted that they assess objective evidence of impairment for equity instruments based on quantitative thresholds for 'significant' or 'prolonged' decline in the fair value. Some consider also other impairment triggers

mentioned by IAS 39 based on individual analysis of the equity instrument issuers´ business.

40 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.

41 The following tables summarise the application of the two criteria:

	Number of companies		
Significant criterion % of decrease of the fair value below cost	**Insurance**	**Financial institutions**	**Non-financials**
20%-30%	4	3	-
40%-50%	1	1	1
80%	2	1	-
Not responded	4	4	4
Total	**11**	**9**	**5**

	Number of companies		
Prolonged criterion (in months)	**Insurance**	**Financial institutions**	**Non-financials**
6-12	4	2	-
24-36	3[1]	3	-
>36	-	-	1
Not responded	4	4	4
Total	**11**	**9**	**5**

Expected use of the FVOCI category and its expected effects on asset allocation and disposal decisions

42 Most respondents (17 entities – 7 insurance entities, 7 financial institutions and 3 non-financials) expected to use the FVOCI election. Not all of them indicated what percentage of their equity instruments they expected to designate to the FVOCI category. The distribution of the responses is shown in the following table:

% of equity instruments for which FVOCI is expected to be used	**Nr. of respondents**	**Industry**
0.1%-10%	4	Insurance and financial institutions
25%-30%	2	Financial institutions
60%-80%	3	Non-financials and insurance
100%	3	Insurance
Not responded	5	All industries
Total	***17***	

[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.

43 The majority of respondents did not expect to modify their holding period for equities following the introduction of IFRS 9. Only 5 entities (3 insurance entities, 1 financial institution and 1 non-financial) expected to shorten their holding period. Some of them noted that the lack of recycling may lead them to consider disposing certain investments, while others noted that the volatility in profit or loss under the FVPL model might cause earlier disposal of certain equity instruments. One respondent stated the average holding period will be shorter, without explaining further.

44 There were mixed views about the impact of the requirements on the respondents' asset allocation decisions. 12 entities (8 insurance entities, 3 financial institutions and 1 non-financial) expected to modify such decisions, although most did not specify to what extent. These entities indicated that they may replace part of their equity portfolio with assets such as real estate, infrastructures, credit investments, loans, bonds, or non-listed renewables. Some may also invest more in non-listed entities or private equity, where most of the return from the investment is realised through dividends; or invest less in start-ups.

45 Three respondents noted that they consider shifting significant parts of their equity portfolio from listed to non-listed/private equity. Some of them observed that returns from private equity investments are mostly collected as dividend pay-out.

Other comments

46 Two respondents (non-financials) disagreed with the fact that mutual funds or Undertakings for the Collective Investment of Transferable Securities ('UCITS') should be carried at FVPL, irrespective of the underlying instruments held. One of them noted that UCITS would be placed at a clear disadvantage compared to direct holdings and this could trigger massive arbitrages towards either direct holdings or mandates or dedicated funds and it would eventually go against the objective of long standing European policies to reduce market fragmentation across the European Union. This respondent suggested delaying the application of IFRS 9 to long-term investors until at least a valid impairment mechanism is in place for equity instruments and equity UCITS.

47 Due to the fact that holdings in mutual funds must be measured at FVPL under IFRS 9, being ineligible for the FVOCI election and not meeting the SPPI criterion, one respondent expected to look for new ways of funding collective investment financial assets. Infrastructures equities could be favoured, as they are somewhat less volatile than other equities and often provide a more important part of then return though dividend. But this asset class is too narrow for this to be very significant, so that bond allocation will certainly have to be increased anyway.

48 Two respondents claimed that the lack of recycling for equities in IFRS 9 creates an accounting mismatch with the measurement of insurance liabilities under IFRS 17.

49 One respondent noted that it would like to be able to treat funds as equity instruments under IFRS 9.

Question for EFRAG TEG

50 Does EFRAG TEG have any suggestion on how the EFRAG Secretariat can use the data in the context of the request for advice?

Other sources of quantitative data

51 In relation to the collection of data, the EFRAG Secretariat has already:

(a) investigated the potential use of the FVOCI designation in its 2013 field test on classification and measurement of financial assets (37 participants, half of them from the banking sector and the other half from the insurance and other industries);

(b) received the same information from 4 members of the EFRAG FIWG;

(c) reviewed the financial statements of 2015 of 45 public entities in Europe (15 insurance companies, 15 banks and 15 non-financials) to collect the relevant data (percentage of AFS equity instruments over total assets and percentage of level 3 AFS equity instruments over total AFS equity instruments) and investigate how these entities apply the IAS 39 impairment requirements, and in particular how they articulate the 'significant or prolonged' criterion; and

(d) reviewed other publicly available sources, including:

(i) the EBA impact assessment; and

(ii) the ESMA report *Review of Accounting Practices: Comparability of IFRS Financial Statements of Financial Institutions in Europe* on the 2012 financial statements of 39 major European financial institutions.

52 The results mentioned in the previous paragraphs have been presented to EFRAG TEG at its meeting in March 2017.

53 The EFRAG Secretariat has contacted the European Supervisory Authorities. The EBA provided aggregated data on total equity instruments, total AFS instruments and related OCI balances held by approximately 150 financial institutions from 28 member states of the European Union and one country of the European Economic Area for the period 30 September 2014 to 30 September 2016. As of September 2016, the entities in the sample had 603 billion Euros of total equities, out of which 116 billion Euros were included in AFS.

54 The main data from the EBA were the following:

(a) AFS equity instruments represented 18.2% of total equity instruments and 4.4% of total AFS instruments;

(b) The net accumulated AFS OCI reserve represented 1.2% of total AFS instruments; and

(c) The gain on derecognition of total AFS instruments represented 0.5% of the value of AFS instruments per quarter.

55 Lastly, the EFRAG Secretariat used a data aggregator to extract a list with all European listed companies and selected 24 companies from the insurance industry and 12 from the mining and oil and gas industry (companies with the highest total assets as of 31 December 2016 per industry group). The 36 companies in the sample had total assets of approximately 8 trillion Euros.

56 The EFRAG Secretariat reviewed the financial statements of the entities to identify quantitative data similar to the data requested in the public consultation. The paper has been brought to the EFRAG TEG-CFSS meeting in September 2017, but was not presented in the session. Information was mostly available for the total amount of equity instruments, and the split between those carried at FVPL and AFS. Other information was frequently not available, such as the accumulated OCI credit and debit balances on AFS equity instruments, the amounts of equity instruments disposed of in the period and the related gains/losses.