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Update on the collection of the quantitative data
Issues Paper

Objective

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

Background

Why are we collecting data?

2 It has been claimed that both of the available accounting options for equities under IFRS 9 *Financial Instruments* have a limited appeal for investors and create an incentive to reduce the amount of investment in equities:

(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 It is not possible to directly test these claims since IFRS 9 is not yet in use. It 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 problem. The following are examples on how quantitative data could be useful in the discussion:

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

(b) volatility in profit or loss will be increased if investments currently in available for sale ('AFS') category will be classified to FVPL, even more so if 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. The size of investment in equities, the expectation on the use of the FVOCI option and the size of disposal gains give an indication of the potential impact on reported profit or loss; and

(d) the more current levels of fair values are below original cost, the more a robust impairment model would be needed. Cumulated debit OCI balances of equity investments classified in AFS and yearly changes may give an indication of the potential impairment losses.

Limitations

5 It is difficult to assess if and to what extent accounting requirements affect asset allocation decisions. Economic factors, tax regimes and other regulations are likely to influence these decisions, possibly to a bigger extent than accounting Standards. In its endorsement advice on IFRS 9, EFRAG assessed that, based on limited evidence, it was unlikely that entities would change their investment strategy as a result of the implementation of IFRS 9.

6 EFRAG added that the requirements for equities may not best reflect the business model of long-term investors. The European Commission in its request for advice also 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'.

7 However, the long-term notion is neither defined nor relevant in IFRS Standards. IFRS Standards make a distinction only between current and non-current assets and liabilities, based on the entities' operating cycle. Non-current assets are commonly interpreted to be assets expected to be realised on more than twelve months from the reporting date, but the EFRAG Secretariat does not consider that 'long-term' is intended to have this meaning.

8 Neither IAS 39 *Financial Instruments: Classification and Measurement* nor IFRS 9 require to identify a 'long-term' portion of equity portfolios. Both Standards require FVPL for instruments held for trading, which are defined as assets acquired principally for the purpose of selling them in the short term. The EFRAG Secretariat is not sure that 'long-term' is intended to include all investments that are not held for trading.

9 Due to the above, information on 'long-term' equity investments exists only if entities have decided to make such identification on a voluntary basis, and may be inhomogeneous because of different identifying criteria.

10 The same applies to 'long-term investors' that are not defined for accounting purposes. Finally, long-term investments is not equivalent to investments of long-term investors – some entities may have different portfolios.

Sources of quantitative data

Data previously presented to EFRAG TEG

11 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) obtained some 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, by the European Banking Authority ('EBA');

(d) 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

(e) 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.

12 The results mentioned in the previous paragraphs have been presented to EFRAG TEG at [its meeting in March 2017](). 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.

13 As at September 2016, the entities in the sample had 603 billion Euros of total equities, out of which 116 billion Euros were included in AFS. The recycling gains recognised over the 9 quarters amounted to 46.8 billion Euros for all entities. On average, entities recognised impairment losses for less than 1% of the total equities in AFS per quarter.

Additional data collected

Public consultation

14 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.

15 At the date of the writing, we have received four responses with quantitative information and one response with general information only. Three respondents are insurance companies, one bank and one industrial company. We received two responses from individuals outside Europe, which were not considered in our analysis below.

16 Most respondents view themselves as long-term investors and currently classify most or all their equities in AFS. Equities represent between 7% and 15% of total financial assets for the financial institutions. These entities recognised impairment losses on equities between 3% and 11%, and recycling gains between 14% and 33% of their pre-tax result, respectively. The industrial company did not seem to have impaired or disposed its equities in the period.

17 In terms of expected behaviours, three respondents expected to use the FVOCI election to different extent. Four of them did not expect to change their holding period for equities, while there were mixed views about the impact of the requirements on their asset allocation decisions.

Review of financial statements

18 The EFRAG Secretariat used a data aggregator to extract a list with all European listed companies. The list included the name of the company, the country of incorporation, the primary industry, its market capitalisation, and its total assets as of 31 December 2016.

19 We sorted the companies into two industry groups:

(a) insurance industry; and

(b) companies in the mining and oil and gas industry.

20 For purposes of the review, we selected 24 companies from the first industry group and 12 from the second one with the highest total assets as of 31 December 2016. The 36 companies in the sample had total assets of approximately 8 trillion Euros.

21 The results of the financial statements analysis are summarised below. The extent to which the required information is available is mixed, although in some cases information may not be available because the amounts were deemed immaterial.

22 Information is mostly available for the total amount of equity instruments, and the split between those that are carried at fair value through profit or loss and those in available-for-sale. Other information is frequently not available, such as the cumulated OCI credit and debit balances on AFS equity instruments, the amounts of securities disposed of in the period and the recycling gains/losses on disposals.

The significance of AFS equity instruments

23 As the following table illustrates, equity instruments represent a small portion of total AFS financial assets for insurance companies, but more than one fifth of total equity instruments. For non-financials, almost all equity instruments are classified in the AFS category, and AFS equity instruments are almost half of the total AFS financial assets.

31 December 2016 (in million Euros)	**Insurance**	**Non-financials**	**Total**
AFS equity instruments	131,807	22,656	154,463
Total equity instruments	623,206	23,702	646,908
Total AFS	2,472,248	49,684	2,521,933
% of AFS equity instruments over total equity instruments	***21%***	***96%***	***24%***
% of AFS equity instruments over total AFS	***5%***	***46%***	***6%***

OCI balances and impairment

24 Around half of the non-financial entities and half of the insurance entities disclosed the accumulated OCI credit and debit balances on AFS equity instruments. The following table presents the summarised data of the ones which disclosed:

31 December 2016 (in million Euros)	**Insurance**	**Non-financials**	**Total**
Accumulated debit OCI balance	(547)	(130)	(677)
% of Accumulated debit OCI balance over AFS equity	***(1%)***	***(86%)***	***(1%)***
% of Accumulated debit OCI balance over profit before tax	***(3%)***	***(2%)***	***(2%)***
Accumulated credit OCI balance	29,229	318	29,547

% of Accumulated credit OCI balance over AFS equity instruments	***25%***	***20%***	***25%***
% of Accumulated credit OCI balance over profit before tax	***78%***	***28%***	***77%***

25 Eight (8) non-financial entities disclosed the amount of impairment loss on equity instruments in year 2016. Seven (7) of them did not record an impairment.

Year 2016 (in million Euros)	**Insurance**	**Non-financials**	**Total**
Impairment loss on AFS equity instruments	3,259	649	3,908
AFS equity instruments (companies that disclosed impairments)	115,920	17,650	133,570
Profit / (loss) before tax (companies that disclosed impairments)	22,013	5,274	27,287
% of impairment loss over profit / (loss) before tax (companies that disclosed impairments)	***14.8%***	***12.3%***	***14.3%***
% of impairment loss over AFS equity instruments (companies that disclosed impairments)	***2.8%***	***3.7%***	***2.9%***

Disposal of AFS equity instruments

26 Six non-financial entities and six insurance entities disclosed the gain or loss on disposal of AFS equity instruments during the year 2016. Five of the non-financials reported zero gain or loss and one realised a gain on disposal of 143m Euros in year 2016. The six insurance entities reported a net gain/loss on disposal of AFS equity instruments amounting to 3,621 Euros.

Year 2016 (in million Euros)	**Insurance**	**Non-financials**	**Total**
Net gain on disposal	3,621	143	3,764
AFS equity instruments (companies that disclosed disposals)	77,251	664	77,195
Profit / (loss) before tax (companies that disclosed disposals)	27,132	(3,541)	23,591
% of net gain on disposal over profit / (loss) before tax (companies that disclosed disposals)	13%	(4%)	16%
% of net gain on disposal over AFS equity instruments (companies that disclosed disposals)	5%	22%	5%

Disclosure of accounting policy for impairment of equity instruments

27 Only one out of the twelve non-financial entities disclosed their thresholds for assessing a significant or prolonged decline in the fair value of their equity instruments. This company disclosed that objective evidence of impairment was 50% (significant) or 36 months (prolonged) decline in the fair value of the equity instrument below its cost. Specifically for equity instruments held by legal requirements to cover the decommissioning obligation of the entity, the thresholds were 40% and 60 months respectively.

28 14 out of 24 insurance companies disclosed their thresholds for assessing a significant or prolonged decline in the fair value of their equity instruments. For those which provided a disclosure, we found that objective evidence of impairment ranged

from 20% to 80% (significant) or from 6 to 36 months (prolonged) decline in the fair value of the equity instrument below its cost.

Other sources

29 The EFRAG Secretariat has consulted other sources publicly available. These sources include data only from some industries and/or countries, and may not refer exclusively to IFRS preparers. These sources/surveys may include some of the respondents to the EFRAG public consultation.

30 The Mercer 2017 asset allocation survey, that includes data from 1,240 institutional investors[1] across 13 countries in Europe, reports information on asset allocation by class of assets. The weight of equity marginally decreased 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 persisting low yields. However, this may have driven the increase in other investments that represent now 15% of the total allocation.

31 Other investments include private equity, growth-oriented fixed income, real assets – property, infrastructure and natural resources - and hedge funds. Their increase reflects a more dynamic asset allocation, with almost 60% of the surveyed plans engaging in a strategic review once a year.

32 Pensions Europe publishes statistics on its organisation members. The 2015 statistics refer to pension funds in the private sector from 21 European countries. The organisation members have total assets of 3,623 billion Euros. Equities total 1,137 billion Euros, approximately 31% of total assets. The largest asset class is bonds with 48%.

33 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.

Question for EFRAG TEG

34 Does EFRAG TEG have any suggestion on how to analyse the quantitative data once the public consultation is completed?

[1] The authors of the study note that most of the participants to the survey are stable over time, which allows to compare historical data and identify trends.