Alain Deckers
Head of Unit, Corporate reporting, audit and credit rating agencies,
European Commission
DG Financial Stability, Financial Services and Capital Markets Union
1049 Brussels

Xx January 2020

Dear Mr Deckers,

Re: Request for technical advice

Following your request for advice sent on 1 June 2018 ("the EC request"), EFRAG is pleased to provide its reply on possible alternative accounting treatments to measurement at FVPL for equity instruments.

EFRAG has been requested by the EC "to consider alternative accounting treatments to measurement at FVPL for equity instruments. Possible accounting treatments should properly portray the performance and risks of long-term investment business models in particular for those equity and equity type investments that are much needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on climate change."

EFRAG advises that the European Commission recommend to the IASB an expeditious review of the non-recycling treatment of IFRS 9, testing whether the revised Conceptual Framework would justify the recycling of FVOCI gains and losses when realised. In addition, the IASB should also consider the necessity and features of a robust impairment model, including reversals of impairment.

The following pages illustrate the basis for this conclusion, together with EFRAG's recommendations with reference to the impairment model and the treatment of equity-type instruments.

In the course of developing its response to the EC request, EFRAG considered both a technical assessment of the possible alternative accounting treatments (presented in the *Supporting Material* attached to this letter) and the outcome of a public consultation (presented in the *Feedback Statement* attached to this letter).

On behalf of EFRAG, I am happy to discuss our reply with you, other officials of the European Commission or the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

Attachments

- *Supporting Material*
- *Feedback Statement*

Annex: Basis for conclusions

1 Responding to the EC request is challenging, as there remains the need for definitions of long-term investment business model as well as for sustainable investments as, at this stage, there are no accounting definitions to appropriately support the exercise requested by the EC. The following key messages emerged from the 2019 public consultation:

a. there was no consensus on a definition for LTIBM. A few respondents provided a definition close to their business model, e.g. a model in which the company acquires assets in order to match long-term insurance or savings-related liabilities. Many respondents considered it unnecessary to define LTIBM but preferred to rather focus on whether equity instruments are held for (non)-trading purposes. A few insurers suggested that the focus should be on efficient asset-liability management aimed at matching the investments with long-term insurance/savings liabilities; and

b. on sustainable investment, there were no fully-fledged definitions proposed during the consultation that could be used in standard setting. Many respondents considered that sustainable activities should not be a distinguishing feature in accounting. EFRAG notes the ongoing work of the EC around its taxonomy for sustainable finance which may provide a useful basis in this regard in the future.

2 EFRAG notes that the EC Action Plan (March 2018) to achieve sustainable growth aims at mobilising more private capital for sustainable projects (such as transport, energy and resource management infrastructure) and considers that availability of private capital plays a key role to reach the objectives set out in the action plan. Investments in infrastructure are financed through multiple channels. Direct and indirect equity holdings by institutional investors (including insurance entities and banks) play a relevant role in this context. IFRS 9 has changed compared to IAS 39 the accounting treatment for equity instruments previously classified in the AFS category and some stakeholders have raised concerns that these changes may not be conducive to long-term investing in equity instruments.

3 In a context where IFRS 9 has been recently implemented and is substantially still not applied by the insurance sector, its potential impact on long term investment cannot be assessed on the basis of actual data. Therefore, no compelling evidence has come to the attention of EFRAG that accounting is an impediment or not to long term investment.

4 EFRAG notes that asset allocation decisions are driven by a plurality of factors and that it is difficult to disentangle the impact of accounting requirements from other factors such as expectation on future returns by class of assets or other regulations, including taxes and prudential requirements. Furthermore, EFRAG notes the work of ESMA, EIOPA and EBA in response to the EC request on Sustainable Finance where the ESAs are assessing potential sources of undue short-termism. EFRAG notes as well the ongoing debate on how to enhance broader corporate reporting on the basis of the lessons learnt from the first year of application of the Non-Financial Reporting Directive (hereafter 'NFRD'), in order to enhance the consistency and comparability of non-financial information disclosed throughout the Union.

5 EFRAG received 63 responses to its consultation aimed at collecting constituents' views on the request by the EC. The number of responses confirms that this is a topic that generates considerable debate in Europe, specifically but not exclusively for the financial sector. The European industry associations of Insurance, Saving Banks and Asset Managers, in their capacity as investors, offered their views in response to this consultation. EFRAG also received letters from the European

associations of auditors and financial analysts. The European Security Market Authority, the European Central Bank (ECB) and 8 European National Standard Setters also provided their positions.

6 The respondents expressed mixed views on whether an alternative accounting treatment is needed to portray risks and performances of equity and equity-type instruments held in a LTIBM. 70% respondents considered that an alternative accounting treatment was relevant to the objective of reducing or preventing detrimental effects on long-term investments. However, 30% of respondents either did not consider that an alternative accounting treatment is needed or did not reply to this issue.

7 79% of those that support an alternative treatment (corresponding to 53% of the total respondents) favour FVOCI model with recycling and impairment with a scope similar to the FVOCI option under IFRS 9. EFRAG notes that the concerns expressed by these respondents are not new and that similar concerns were highlighted in its endorsement advice on IFRS 9.

8 Substantially all the respondents from the insurance and asset management industry and a large majority of the banks and corporates supported the need for an alternative treatment. Users and standard setters were split. The users that support an alternative (half of the users that responded) mainly would support FVTPL for all equity instruments. Standard Setters that supported an alternative prefer FVOCI with recycling; standard setters that do not support an alternative, mainly believe that more evidence is needed before a change. Respondents from the accounting/audit profession and the two regulators that responded to the public consultation did not consider that an alternative treatment is needed, mainly because at this stage there is no evidence to support such a need.

9 As noted above FVOCI with recycling and impairment is the preferred alternative of those that responded to EFRAG public consultation supporting an alternative treatment for equity instruments.

10 With reference to FVOCI without recycling EFRAG is aware that the current situation in IFRS 9 is considered to be the result of a compromise, as illustrated in the Basis of Conclusions to IFRS 9:

(a) Fair value provides the most useful information about equity investments to users. However, presenting fair value gains and losses in profit or loss for some equity investments may not be indicative of the performance of the entity, particularly if the entity holds those equity instruments for non-contractual benefits, rather than primarily for increases in the value of the investment [IFRS 9.BC5.22];

(b) the IASB considered a gain or loss on those investments should be recognised once only; therefore, recognising a gain or loss in other comprehensive income and subsequently transferring it to profit or loss is inappropriate [IFRS 9.BC5.25] and

(c) recycling of gains and losses to profit and loss was prohibited as it would create the requirement to assess the equity instrument for impairment, which had created application problems [IFRS 9.BC5.25].

11 EFRAG notes that the IFRS conceptual framework (§7.19), which was revised after the issuance of IFRS 9, sets that in principle, income and expenses included in OCI in one period are reclassified from OCI into the statement of profit or loss in a future period when doing so results in the statement of profit or loss providing more relevant information, or providing a more faithful representation of the entity's financial performance for that future period. If there is no clear basis for identifying the period in which reclassification would have that result, or the amount that should

be reclassified, the Board may, in developing Standards, decide that income and expenses included in other comprehensive income are not to be subsequently reclassified. EFRAG notes that IFRS 9 non-recycling has been justified by the IASB on the basis of the lack of an impairment approach that would have to accompany recycling. IFRS 9 does not offer a conceptual reason to exclude recycling on the basis of any of the two reasons listed above.

12 Incidentally, beyond EFRAG's own questioning, the Accounting Standard Advisory Forum of the IASB met the 17 December 2019 to discuss inputs received on the topics to consider in the forthcoming public consultation on Agenda of future projects of the IASB, planned for the second half of 2020. It is worth noting that the input collected shows that stakeholders recommend the IASB to test against the revised Conceptual Framework the IFRS standards that permit or require non-recycling. The problem was highlighted both in general terms and with reference to equity instruments that are accounted for using the FVOCI option in IFRS 9.

13 The EFRAG 2019 consultation conducted to collect input to this advice indicated that a majority of respondents supported a change to IFRS 9. Reasons given related to the view that FVPL creates volatility in profit or loss which does not permit an appropriate reflection of the business model of long-term investors, although it should be noted that many defined "long-term" as other than held-for-trading. On the other hand, FVOCI without recycling has not been identified as a workable alternative. Finally, some conclude that the requirements in IFRS 9 could discourage investment in equity instruments. Quantitative evidence is still lacking at this stage to determine if this view is correct or not.

14 The feedback from the consultation summarised above shows an expectation from the financial sector, including from the insurance sector, that the accounting treatment is relevant to the objective of reducing or preventing detrimental effects on long term investment. In addition, the feedback has shown that there is a strong view from insurance entities, banks, asset managers and self-defined long-term investors, but also from corporates, that an alternative accounting treatment is needed for equity instruments in IFRS 9 to properly portray the performance and risk of equity instruments held in a long-term investment business model. As mentioned above, users and standard setters were split.

15 Actual impact does not exist at this point in time to confirm whether the views reported above are correct or not, in particular as European entities from the insurance sector that are as well institutional investors do not apply the standard yet. However, most respondents are justifying their views on the basis of conceptual, managerial and strategic reasons.

Impairment model (including the EFRAG advice to the EC of November 2018)

16 In the above-mentioned consultation, many respondents, approximately 30%, considered that an improved version of the IAS 39 impairment model could be used as a way forward. These respondents considered that a robust impairment model can be developed without undue costs by using IAS 39 as a starting point but with additional guidance to reduce subjectivity. A few other respondents highlighted that additional impairment requirements have proven to be difficult to agree upon and would introduce additional complexity into financial reporting which is unlikely to be to the benefit of users of the information.

17 In its advice of November 2018, EFRAG noted that the reintroduction of recycling for equity instruments carried at FVOCI would require a robust impairment model.

18 53% of the total respondents to the 2019 consultation and 79% of those that support the need for an alternative accounting treatment proposed the introduction of

recycling using the impairment model in IAS 39 as a basis for a new model with improvements. EFRAG supports such an approach in principle.

19 EFRAG noted also that the IASB concluded that the IAS 39 impairment model was unduly subjective, and ESMA 's findings confirmed that it was not applied consistently in practice. EFRAG notes that the SEC has previously indicated that under US GAAP the use of only quantitative indicators may lead to inappropriate recognition of impairment (both too late and too early).

20 As a consequence, EFRAG suggests improvements to the IAS 39 approach such as clarifying the terms 'prolonged' and 'significant decline'. In response to the previous EFRAG survey[1], there was no consensus on how to reach an appropriate balance between relevance and comparability. Some respondents stressed the need to achieve sufficient comparability which could likely be achieved only if the Standard included general quantitative thresholds or rebuttable presumptions. Some respondents to the 2019 consultation proposed thresholds such as longer than six months and more than 20% or below cost for longer than 12 months or more than a specified quantitative trigger. Others oppose this because they believe that the impairment solution should prioritise relevance over comparability, and therefore that each entity should set its own thresholds. EFRAG considers that a degree of rigour in the use of the election or the impairment model would be essential to ensure comparability and therefore suggests combining quantitative indicators and the exercise of judgement within appropriate limits and with appropriate disclosures in the notes.

21 EFRAG also concluded[2] that contrary to the IAS 39 model, the new impairment model should allow to reverse impairment losses. If a decline in the value of an equity instrument is recognised in profit or loss because it results from an adverse change in the economic condition of the issuer, subsequent recoveries in value that result from a reversal of that adverse change should similarly be recognised. This was confirmed in the current consultation as mentioned above.

Treatment of the equity-type instruments

22 Furthermore, EFRAG is sympathetic to the concerns around the accounting at FVPL only for investments in units of funds under IFRS 9. EFRAG supports that similar fact patterns should be treated similarly, and some mutual funds and puttable instruments respond to movements in market variables similarly to equity instruments even though these do not meet the definition of an equity instrument in IAS 32. Any changes to the accounting for these instruments aimed at allowing for direct and indirect equity instruments to be treated similarly for accounting purposes would require careful consideration to evaluate the challenges of developing an appropriate standard setting solution and considering knock-on effects to the classification and measurement model under IFRS 9. Possible consequences could include structuring opportunities and operability of assessing the nature of the underlying assets and business model at the level of the fund itself. Suggestions of relevant criteria have been made by stakeholders in order to select units of funds that could become eligible to the equity accounting treatment and prevent unintended consequences.

[1] EFRAG previous the European Commission dated 28 November 2018

[2] EFRAG previous the European Commission dated 28 November 2018