Equity Instruments - Research on Measurement

1. Why is EFRAG consulting?

As part of its Action Plan on Sustainable Finance, the European Commission ("EC") announced it would ask EFRAG to explore potential alternative accounting treatments to ("FV") measurement for long- term investment portfolios of equity and equity-type instruments.

In June 2018, EFRAG received a request for advice from the EC in relation to the accounting requirements for investments in equity instruments.

The request for advice is part of the EC's initiatives to orient capital flows towards investment in sustainable activities.

The request for advice asks EFRAG to consider alternative accounting treatments to measurement at fair value through profit or loss (FVPL) for equity instruments.

According to the request for advice, such possible alternative accounting treatments should serve the following objectives:

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;

preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

2. The questionnaire

EFRAG has developed this questionnaire in order to gather views from constituents on alternative accounting treatments to IFRS 9 *Financial Instruments* requirements for equity and equity-type instruments held in a long-term investment business model. Such alternative treatments should serve the objectives mentioned above. Respondents are encouraged to read the EFRAG Secretariat background paper available here.

The EFRAG Secretariat background paper provides background information on the request for advice. It explains how the consultation relates to the EC's initiatives on sustainable growth, illustrates the accounting requirements in IFRS 9 and explores some possible alternative measurement approaches.

The possible alternatives in the background paper are to be considered as examples; respondents may suggest other measurement approaches that they consider appropriate.

Additionally, the background paper provides indications of how the concepts of 'long-term investment business model' and "equity-type instrument" may be considered in the context of the questionnaire.

In addition to submitting replies to the questionnaire, constituents can provide their input on the topic and ask questions about the survey by writing to:
Fredre Ferreira (*fredre.ferreira@efrag.org*), or Isabel Batista (*isabel.batista@efrag.org*).

Respondents are encouraged to respond to all questions but are not required to do so. EFRAG will still consider their answers.

EFRAG will disclose the responses, unless a respondent asks for confidentiality.

Please complete this survey by 5 July 2019

3. General information about the respondent

1. Name of the individual/ organisation

Fédération Française de l'Assurance (FFA)

2. Country of operation

France

3. Job title

Director of Financial, Prudential and Accounting Affairs

4. E-mail address

c.tarral@ffa-assurance.fr

5. Are you currently engaging in a long-term investment business model?

Yes

6. How do you define long-term investment business model?

The FFA represents the views of French (re)insurers accounting for some 90% of premiums in France that are long-term investors.EFRAG questionnaire is focusing on the definition of an alternative measurement model for equity and equity like instruments held in a long- term investment business model. Therefore, an appropriate definition of what is a long-term investment business model is essential to appropriately target the related assets.
In line with the views expressed in the report "Betting on the Long-Term" – Rebuilding Investment for the Europe of Tomorrow of the Long-Term Investment Task Force of the Paris Marketplace, the FFA considers that a "long-term" business model cannot be reduced to:
- Investing in certain assets based on the type or the characteristics of assets (for example maturity, duration, liquidity), the nature of the investee or the objective of the investment;
- A type of liability. The existence of long-term liabilities does not within itself equate to long-term investment. However, the existence of stable resources is a prerequisite. Stable resources may result from different sources: long-term insurance liabilities in life (life insurance, pensions products) or non-life businesses (liability and protection products), liabilities resulting from renewable products in other non-life businesses or stable own funds;
- A "hold to maturity" business model. Some stakeholders consider that it is necessary to hold the assets in a portfolio for "x" years (with very much debate on how to define "x") regardless on events in the market to qualify for a long-term business model. This approach is too reductive and would arbitrarily exclude entities that have a long-term investment strategy in place that is not passive.
The FFA considers that long term investors are characterized by an investment strategy primarily determined by the duration and predictability of their resources (liabilities and own funds).
As for example, insurers invest the premiums they collect from policyholders to pay claims and benefits on their policies. Life insurance products, pension products and some lines of non-insurance activities (for example liability and protection products) are long-term as a result of various legal, contractual or behavioral characteristics. Other non-life insurance products also generate predictable liabilities as a result of their renewal conditions. Moreover, insurance companies are required to hold at least own funds to cover their Solvency Capital Requirement (SCR) according to Solvency II and in practice hold own funds largely above this level. The duration of these resources (liabilities and own funds) determines the time horizon over which the insurer can invest, while their predictability determines the liquidity of the investments.
Therefore, investing over a long-term horizon is a natural consequence of the insurance business model. Efficient asset-liability management enables insurers to match the long-term profile of their resources (liabilities and own funds) with appropriate portfolios of assets. The investment strategies of insurers are designed to pay expected claims and benefits to policyholders and to remunerate their shareholders funds while avoiding force selling. However, long-term investment strategies are in most cases not passive. Monitoring of portfolios is essential to ensure that their allocation remains adequate with the profile of the resources (for example, change in their profile or level of risks) and the targeted returns (through investments/sales, appropriate diversification…).

7. Are you currently engaging in investment of sustainable activities?

Yes

8. How do you define sustainable activities?

As of today, we note that there is no shared view on the definition of sustainable activities. However, there is ongoing work to define it in the future regulation on disclosures relating to sustainable investments and sustainability risks (amending Directive (EU) 2016/2341) at European level.

4. Question 1

9. IFRS 9 allows an entity to account equity instruments either at FVPL or, if applicable, at fair value through other comprehensive income (FVOCI) without impairment and without reclassification (“recycling”) to P&L upon disposal of valuation gains or losses previously recognized through OCI ("IFRS 9 requirements" for equity instruments).
When defining an accounting treatment alternative to IFRS 9 requirements for equity instruments held in a long-term investment business model, which characteristics would you require to identify a *long-term investment business model*?

Other

If you have indicated "Other" please provide details

As explained in detail in our response to 5. General information, a "long-term" strategy cannot be reduced to an expected holding period, an actual holding period or the long-term nature of the liabilities that fund the assets. We consider that long-term investors, such are insurers, are characterized by an investment strategy primarily determined by the duration and predictability of their resources (liabilities and own funds).
Indeed, investing over a long-term horizon is a natural consequence of the insurance business model. Efficient asset-liability management enables insurers to match the long-term profile of their resources (liabilities and own funds) with appropriate portfolios of assets. These investment strategies are designed to pay expected claims and benefits to policyholders and to remunerate their shareholders funds while avoiding force selling. However, long-term investment strategies are in most cases not passive. Monitoring of portfolios is essential to ensure that their allocation remains adequate with the profile of the resources (for example, change in their profile or level of risks) and the returns targeted returns (through investments/sales, appropriate diversification…).

5. Question 2

10. In your view, is an alternative accounting treatment to IFRS 9 requirements needed to properly portray the performance and risks of equity instruments held in a long-term investment business model?

Yes

6. Question 3

11. Explain the reasons for your reply to question 2, including the key operational challenges in developing a different accounting treatment to IFRS 9 requirements

We believe that it is necessary to amend current IFRS 9 accounting for equity instruments (i.e. FV PL by default or choice for FV OCI without recycling) held by long-term investors as:
- FVPL measurement for equity instruments is a source of volatility in the profit or loss for long term investors, in contradiction with their long-term investment strategies and;
- Current IFRS 9 FVOCI measurement does not appropriately portray the performance of these assets.
Therefore, in line with our previous views and lastly those expressed in our response to the EFRAG Discussion Paper – Impairment and Recycling, we support the reintroduction of the recycling for equity instruments at FV OCI together with an appropriate impairment model.
Reintroducing the recycling for equity instruments measured at FV OCI accompanied by an appropriate impairment model is necessary to appropriately portray the performance of these assets for the following reasons:
- Gains and losses upon disposal of equity instruments measured at FV OCI are part of the investor's performance as dividends are. Current IFRS 9 FV OCI measurement does not allow to report properly the performance of these instruments as part of their performance will never be recognized in profit and loss. We do not see any valid conceptual reason to present these gains and losses differently that the other components of the performance of these assets. As acknowledged by the IASB during the discussions on IFRS 9 and by an Academic literature review published, by EFRAG "there is an understanding that investors and other users of financial statements information can more easily, quickly and completely review and absorb information presented in profit and loss". Therefore, reporting consistently all components of the performance of equity instruments in profit and loss will provide complete and appropriate information to users about this performance. In addition, it ensures consistency with the accounting treatment of debt instruments accounted for at FVOCI for which both interests and gains and losses upon disposal are recognized in profit and loss.
- Many users of financial statements are interested by additional information that distinguishes between realised and unrealised gains and losses as they give different values to these two categories of items. Recognising gains and losses when equity instruments at FVOCI are sold in profit and loss would give a clear information to users about the disinvestment decisions taken by the management. As such, users will be in a better position to assess the stewardship of the management;
- The reintroduction of an impairment model will enhance the relevance of the profit and loss as the primary source of information about an entity's financial performance as all the components of the performance of the investments (dividends, impairment, reversal, gains and losses when the asset is sold) will be recognized in the same place.
Appropriately portraying the performance of equity instruments held by long-term investors will remove the accounting disincentives that exist in IFRS 9 for investing in these instruments which are detrimental to the financing of the economy and long-term growth, and contrary to the objectives of the Commission as part of the European strategy for a Capital Markets Union. It will permit to avoid disinvestment in these assets and even unleash insurers' investment capacity in these assets which will be positive for the long-term financing of economy, facilitating at the same time the mitigation of the effects of climate change.
We do not expect any particular operational challenges in reintroducing recycling and an impairment model. Refer to Question 4 for our detailed proposals

7. Question 4

12. With reference to equity instruments held in a long-term investment business model, if you support measurement at FV through other comprehensive income with reclassification to P&L upon disposal of the valuation gains or losses previously recognized through OIC (so called “recycling”), which impairment model would you suggest and how it would work in practice?

We believe that a robust impairment model can be developed without undue costs by using IAS 39 as a starting point.
Nevertheless, we also recognize that improvements are needed to address the diversity in practice in the application of IAS 39 due to the lack of guidance on the notion of "significant" and "prolonged" and the prohibition of reversal.
an impairment model similar to that of IAS 39 with targeted changes aimed at addressing the commonly acknowledged drawbacks of the "original" IAS 39 impairment model (hereafter an "IAS 39 modified" impairment model).
Therefore, we suggest an impairment model similar to that of IAS 39 for equity instruments with targeted changes aimed at addressing the commonly acknowledged drawbacks of the "original" IAS 39 impairment model: e.g. subjectivity in the application of "significant or prolonged" or "too late" recognition of impairment.
To meet this objective:
- Regarding "significant or prolonged", we do not oppose the use of quantitative triggers to define what is a significant or prolonged decline in fair value (e.g. by defining a specific percentage decline from the acquisition cost and a specific time period where the fair value has been below the acquisition cost). However, these quantitative triggers should be rebuttable to allow to take into account certain facts and circumstances. Introducing these quantitative triggers will have the merit to ensure discipline in the application of the impairment model of equity instruments;
- Regarding the "too late" recognition, we consider that allowing reversals of equity impairment using symmetric quantitative rebuttable thresholds will be beneficial. The IAS 39 impairment model for equity instruments has presumably favored late recognition of impairment by prohibiting its reversal. It will also ensure consistency with the other IFRSs that allow reversals except for goodwill;
- Specific qualitative and quantitative disclosures on impairment including the description of the specific facts and circumstances in which the quantitative triggers have been rebutted will ensure transparent information for users.

8. Question 5

13. Should the different accounting treatment be restricted to equity instruments held in a long-term investment business model?

For more detail, please refer to paragraphs 4.3 to 4.29 of the Background paper.

No

14. Please explain your answer

As long-term investors, we consider that the reintroduction of the recycling together with an "IAS 39 modified" impairment model should not be restricted to a specific class of equity instruments. We believe that this accounting model should be applicable for all equity instruments that are eligible to the FV OCI option under IFRS 9.

9. Question 6

15. As per IFRS 9, equity-type of instruments, such as units of investment funds, do not meet the definition of equity instrument of IAS 32 Financial Instruments: Presentation, therefore are not eligible for the option to mesure them at fair value through comprehensive income ("FVOCI"). At the same time, they are not eligible for measurement at amortised cost (as they have contractual cash flows that are not Solely Payments of Principal and Interest, “SPPI” instruments). As such, IFRS 9 requires to account for them at FVPL; no FVOCI option is granted ("IFRS 9 requirements for equity-type instruments").

Should the different accounting treatment referred to in the previous questions be extended to instruments that are "equity-type"?

For more detail please refer to paragraph 4.30 to 4.39 of the Background paper.

Yes

16. Please explain your answer

Insurers do not only directly invest in equity instruments. They also invest indirectly in equity instruments through equity-type instruments, such as units of investment funds. However, these instruments will be measured at FVPL under IFRS 9. As such, short term volatility caused by market fluctuations will impact the performance of the insurer even if these assets are not held for trading.
It is of utmost importance to not create economic competitive disadvantage when the same assets are held through different mechanisms. Otherwise, we expect the attractiveness of these types of investments to decrease significantly while they are also a privileged channel for the financing of the economy and long-term growth.
Therefore, for the same reasons stated above for equity instruments (e.g. to give an appropriate picture of the performance of these assets and to avoid accounting disincentives that may be detrimental for the long-term financing of the European economy), we consider that equity-like instruments such as investment funds should also be eligible to FV OCI (together with the reintroduction of recycling and of an "IAS 39 modified" impairment model), and thus without waiting for the outcome of the IASB's FICE project.

10. Question 7

17. If so, which characteristics would you require to define the "equity-type" instruments?

Units of funds and other instruments that meet the 'puttable exception' in IAS 32

18. If you have indicated "Other" please provide details

11. Question 8

19. With reference to equity and equity-type instruments held in a long term investment business model, please rate how relevant a different accounting treatment is to the objective of reducing or preventing detrimental effects on investment in sustainable activities in Europe.

75

12. Question 9

20. Are there other characteristics that would justify an accounting treatment different than IFRS 9 requirements for equity instruments and equity-type instruments held in a long-term investment business model? Please provide examples.

Additional comments on Question 8
Long term investment strategies are driven by a plurality of factors including accounting and prudential treatments. However, accounting treatment is a key driver in the asset allocation decisions of investors as financial information remains an important input for users and for financial markets. Short term volatility induced by mandatory FV PL measurement for equity-like instruments and the prohibition of recycling that hampers the depiction of the performance of equity instruments measured at FV OCI in IFRS 9 are detrimental to investment in those instruments. For example, in case of adverse market conditions, the change in value of equity- like instruments impacts immediately the P/L even if these instruments are not held for trading and the entity does not intend to sell them. As such, we cannot exclude the possibility that some stakeholders may envisage to withdraw from this category of assets to protect their future P/L performance.

13. (untitled)

The following pages include 7 illustrative examples of long term investment. For each scenario, you are invited to answer the questions on the page which follows.

Please consider that for Scenario A, B, C and D IFRS 9 requires to either measure the investment at FVTPL or to elect the option for measurement at FV through other comprehensive income, without reclassification to P&L, upon disposal, of the valuation gains or losses previously recognized through OCI, and without impairment.

14. Illustrative example A - Wind farm with predetermined useful life

21. For scenario A - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

Please note that this example is not representative of the type of investments that our members would invest in due to the investor's inability to dispose of the shares.

22. Which element in the scenario is more relevant for your reply?

23. Which accounting treatments do you support?

In case you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have selected “Other”, please illustrate the accounting treatment you would support and why.

15. Illustrative example B - Unlisted single equity instrument

24. For scenario B - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors’ insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

Please refer to our responses to Questions 2&3

25. Which element in the scenario is more relevant for your reply?

26. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

We understand that EFRAG considers that the nature of the investee's operation is sustainable as start-up company manufacturing electronic scooters to be used in the e-scooter sharing industry.
Regardless of the characteristics of the equity investment (sustainable or not, listed or not), we consider that all equity investments should be eligible to a FV OCI measurement with recycling together with an "IAS 39 modified" impairment model as described in Question 4.

16. Illustrative Example C - Open portfolio of equity instruments held with a view to service a long-term insurance liability

27. For scenario C - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

Please refer to our responses to Questions 2&3

28. Which element in the scenario is more relevant for your reply?

1. The link to a long-term obligation (insurance contracts)
2. The fact that the entity holds a portfolio of equity instruments

29. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

This example illustrates one common fact pattern found in insurance companies.
However, in practice the objective of an insurance company is not limited to be able to match cash flows ("to use the proceeds from the portfolio to serve the cash flows from a long-term obligation of issued insurance contracts e.g. to match cash flows").
This objective of an insurance company is also to achieve an adequate overall return on its portfolios for the benefits of its policyholders (for example by allowing the company to propose competitive tariffs) and its shareholders (through dividends). Reporting all components of the performance of these investments in profit and loss (including gains and losses on disposals and impairment) will provide complete and better information to users about the overall performance of the entity. As such, we support a FVOCI measurement model with recycling and an "IAS 39 modified" impairment model as described in our response to Question 4.
Please note that some consider that the variable fee approach (VFA) under IFRS 17 will address the concerns related to the treatment of equity and equity-like instruments under IFRS 9. However, we believe that this is not sufficient as:
• the variable fee approach is only applicable to a specific category of contracts. It will not alleviate the concerns for the equity and equity-like instruments backing contracts measured under the general model or for reinsurance contracts (not eligible to the VFA);
• as mentioned above, resources of insurers are made both of insurance liabilities and own funds. Therefore, insurers have also equity and equity-like instruments beyond that are backing their insurance liabilities that may also be monitored with long term investing strategies. An appropriate depiction of the performance of these instruments is also needed;
• the fact that the VFA approach under IFRS 17 alleviates some of the concerns caused by IFRS 9 should not be an obstacle to achieve a high quality IFRS 9 per se by solving its intrinsic issues.

17. Illustrative Example D - Open portfolio of equity instruments held with a view to service a long-term liability

30. For scenario D - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

Please refer to our responses to Questions 2&3

31. Which element in the scenario is more relevant for your reply?

1. The link to a long-term obligation
2. The fact that the entity holds a portfolio of equity instruments

32. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

Refer to our response to Example C. The fact that the liability is an obligation for a financial obligation does not change our reasoning. We support a FV OCI measurement with recycling and an "IAS 39 modified" impairment model as described in our response to Question 4.

18. Illustrative example E - Long-term investment held indirectly through a unit fund - listed

33. For scenario E - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

Refer to our responses to Questions 6&7

34. Which element in the scenario is more relevant for your reply?

1. The investor's assessment of the long-term nature of its investment

35. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

We support a FV OCI measurement with recycling and an "IAS 39 modified" impairment model as described in our response to Question 4.

19. Illustrative example F - Long-term investment held indirectly through a unit fund – non listed

36. For scenario F - In your view, is a different accounting treatment needed in order to meet the following two objectives? (i) properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change; and (ii) preferably enhance investors' insight in the long-term performance of investments, as opposed to recognising point-in-time market-based value changes in reported profit or loss during the duration of the equity investment.

Yes

If yes, please explain why.

Refer to our responses to Questions 6&7

37. Which element in the scenario is more relevant for your reply?

1. The investor's assessment of the long-term nature of its investment

38. Which accounting treatments do you support?

Other

If you would support an Accounting treatment other than the examples explored in the EFRAG Secretariat Background paper and/or you have indicated "other", please illustrate the accounting treatment you would support and why.

We support a FV OCI measurement with recycling and an "IAS 39 modified" impairment model as described in our response to Question 4.

20. Thank You!

Thank you for taking our survey. Your response is very important to us.