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

Insurance Europe / European CFOF

2. Country of operation

Europe

3. Job title

4. E-mail address

reporting@insuranceeurope.eu

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

Yes

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

The insurance industry supports a definition of Long-Term Business Model that reflects the nature of the exposure to investment risk, rather than numerical thresholds (the insurance sector supports the holistic approach to long-term investment).
Defining "Long term" is not be related to:
1. defining certain assets as long-term, e.g. based on their maturity or duration, on other investment characteristics
2. having specific investment objectives (profit-oriented, social, etc.)
3. restricting individual assets to be held to maturity or for a certain number of years as there are valid instances (changes in liability profile, concerns about individual performance/risks relating to individual assets or sectors, better opportunities for returns/diversification from other assets sectors) for selling assets, especially in consideration of insurers' duty towards their customers/shareholders.
The long-term business model of insurers is related to the nature of the liabilities combined with liquidity and other aspects of asset liability management (ALM) which enables or even requires long-term investment strategy
Specifically:
1. The nature of the liabilities and the liquidity of the insurer allow the insurer to avoid forced-selling, which in turn gives the insurer the flexibility to choose whether to sell, what to sell and when to sell specific assets and groups of assets.
2. The coherent asset-liability matching and management over the long-term allows a long-term/sustainable investment approach and a change in the risk exposures from short term price movements to long-term under-performance.

Understanding of the nature of insurers' business model and recognition of the role of long-term business model in the economy comes along the requirement of an accounting framework tailored to long-term business models. In its current form, the ban on recycling for FVOCI equities under current IFRS 9 creates, for many insurers, problematic and indeed unnecessary disincentives to maintain and increase investments in long-term and/or illiquid assets.

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

Yes

8. How do you define sustainable activities?

We support an entity-specific approach to the definition of whether and how sustainability is considered. In addition, we recognise that the discussion on this topic (e.g. EU taxonomy) is currently ongoing at the European Commission level. We recommend abstaining from defining "sustainable activities" for financial reporting purposes. Finally, we note that sustainability is not explicitly defined by the IASB nor the EC for the purpose of the EU endorsement of IFRS standards.

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*?

The characteristics/ business model of the investor
The long-term nature of the liabilities that fund the assets

If you have indicated "Other" please provide details

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 continue to strongly support the reintroduction of recycling for equities measured at fair value through other comprehensive income (FVOCI). Its reintroduction is necessary to ensure that the profit and loss account of long-term investors who use FVOCI correctly reflects their financial performance. It is also important that equity-like instruments, such as undertakings for collective investments in transferable securities (UCITS), be eligible for recycling. Allowing recycling would remove the existing accounting disadvantage for long-term equity investments under IFRS 9 and respond to the concerns already identified in EFRAG's final endorsement advice on IFRS 9 of 15 September 2015. These have also been expressed in the European Parliament's resolution of 6 October 2016 on IFRS 9 regarding direct and indirect equity investments undertaken by long-term investors like insurance companies However, a reintroduction or recycling and impairment for equity instruments should not limit the possibility for companies to continue measuring equity instruments at Fair value through profit or loss (FVTPL) where this provides the appropriate representation of their performance.
Indeed, the prohibition of recycling means that gains or losses on disposal from the sale of equity instruments measured at FVOCI are not reported in profit and loss. This is in contrast to the treatment in IAS 39 and creates the false impression that the cumulative gains and losses at the time of disposal of equity instruments are not relevant or economically significant, and therefore not a part of the financial performance. In fact, yields from capital gains have been larger historically than dividends and are therefore equally, if not more relevant. They are also a fundamental reason for investing in equities and such long-term investments are a key element of the insurance business model.

Finally, the current FVPL accounting treatment under IFRS 9 is not appropriate when the OCI option is elected under IFRS 17. Ensuring a level playing field for the treatment of all equity investments is needed – also considering the link to IFRS 17.

The systematic deficiency with the IFRS 9 regarding the recycling ban on equities as identified by EFRAG in its endorsement advice on IFRS 9 should be approached by the IASB ahead of IFRS 17's effective date. A recycling approach would be more preferable to the current status quo.

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 support the inclusion of rebuttable quantitative impairment triggers in an impairment model determined by management (including reversals).

We acknowledge that some of the negative fair value changes might have a permanent nature and it would be more appropriate, and in line with the principle of prudence of the revised Conceptual Framework for Financial Reporting, to reflect such fair value changes in profit and loss. An appropriate impairment model would allow fair value losses which are likely to be permanent to be identified. However, it is important that reversals of impairments are also possible. The notion of 'once impaired always impaired' would not reflect correctly the economic reality and would be incorrect from a transparency perspective. The prohibition under IAS 39 to reverse in profit and loss previously booked impairment losses ('once impaired always impaired' rule) leads to an asymmetric treatment of significant and prolonged decreases and increases in the fair value of equity instruments Therefore, improvements to the IAS 39 impairment model are needed.

One of the key concerns expressed by the IASB is that the impairment model under IAS 39 was not effective. We propose the introduction of quantitative triggers to define what is a significant or prolonged decline in fair value. This could be done by defining a specific percentage decline from the acquisition cost and a specific time period over which the fair value has been below the acquisition cost. However, these quantitative triggers should be rebuttable to take into consideration certain facts and circumstances. The impairment model would also need to allow reversals of equity impairments using symmetric quantitative rebuttable thresholds. The IAS 39 impairment model for equity instruments has favored late recognition of impairment by prohibiting reversals. Finally, for further details on our positions regarding recycling and design of an impairment model for equities we refer to our Insurance Europe detailed comments provided on the EFRAG's Discussion Paper "Equity Instruments – Impairment and Recycling" (March 2018) of 24 May 2018.

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

For reasons of comparability and objectivity the same model should apply to all equity investments accounted for under the FVOCI category in line with the IASB's original decision not to determine what constitutes a "strategic investment" for this purpose.

We do not believe it is appropriate or needed to create a subgroup of equity investments for which the recycling ban should be abolished. Any potential impairment approach seen as a precondition to the reintroduction of recycling should apply to all equity instruments eligible for the irrevocable FVOCI option in 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

We believe that EFRAG should amend its considerations and assess if long term investments in equity instruments are accounted for consistently under IFRS 9, irrespective of whether they are held directly or indirectly via an investment vehicle (e.g. an investment fund or limited partnership).

Under IAS 39, investments through an investment fund are usually accounted for as equity instruments (such as UCITS) classified as Available for Sale (AFS), with recognition of changes in fair value in OCI. Under IFRS 9, those investments are considered to be debt instruments and have to be accounted for at FVPL since these would normally not meet the "solely payments of principal and interest" (SPPI) criteria. This significant change in accounting treatment creates volatility in the statement of profit and loss that is not consistent with the long-term investment perspective of these instruments. It would also create accounting mismatches if the corresponding liabilities are not accounted for at FVPL under IFRS 17. In case no changes are proposed in the accounting treatment of indirectly held equity instruments, we expect the attractiveness of these types of investments to decrease significantly. Therefore, we ask the EFRAG to consider this detrimental accounting treatment for indirect investments in equity instruments in order to allow insurance companies to continue to invest in this asset category from a long-term investment perspective and in the context of a well-diversified asset portfolio. IFRS 9/IAS 32 accounting rules should not disincentive related long term equity investments of insurers, irrespective if they are held directly or indirectly.

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.

100

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.

As explained in question 3, while we do not argue for a different treatment per se, we call for the existing accounting disadvantage created by the ban on recycling in IFRS 9 to be removed.

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.

We would opt for the FVOCI treatment with recycling and impairment or Fair value through profit or loss (FVTPL) depending on which one provides the appropriate representation of their performance.

For insurers, it would depend on the nature of the assets and liabilities. However, not having a recycling option would create an accounting disincentive for many insurers to hold this asset in a portfolio backing fixed liabilities.

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

1. The investor's inability to dispose of the shares

23. Which accounting treatments do you support?

Other

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.

We would opt for the FVOCI treatment with recycling and impairment or Fair value through profit or loss (FVTPL) depending on which one provides the appropriate representation of their performance.

For insurers, it would depend on the nature of the assets and liabilities. However, not having a recycling option would create an accounting disincentive for many insurers to hold this asset in a portfolio backing fixed liabilities.

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.

We would opt for the FVOCI treatment with recycling and impairment or Fair value through profit or loss (FVTPL) depending on which one provides the appropriate representation of their performance.

For insurers, it would depend on the nature of the assets and liabilities. However, not having a recycling option would create an accounting disincentive for many insurers to hold this asset in a portfolio backing fixed liabilities.

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

1. The fact that the shares are unlisted

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 would opt for the FVOCI treatment with recycling and impairment or Fair value through profit or loss (FVTPL) depending on which one provides the appropriate representation of their performance.

For insurers, it would depend on the nature of the assets and liabilities. However, not having a recycling option would create an accounting disincentive for many insurers to hold this asset in a portfolio backing fixed liabilities.

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.

We would opt for the FVOCI treatment with recycling with impairment.

The current fair value measurement treatment of investments under IFRS 9 needs to be aligned with the current fulfilment measurement of insurance liabilities according to IFRS 17 and the Asset-Liability Management (ALM) practices of insurers.

However, many long-term investors need to report only realised gains or losses on financial instruments in the P&L in order to provide an appropriate depiction of performance. For these companies, unrealised fair value changes which are not caused by impairments (on financial instruments) or changes due to variations in the discount rate (on insurance liabilities) are irrelevant for the purpose of performance reporting in periods before disposal of the financial instrument and should be considered as "market noise". Therefore, the availability of the two-sided (for IFRS 9 and IFRS 17) OCI option is necessary for some insurers - the missing part for the alignment of insurance liabilities (IFRS 17) and financial instruments (IFRS 9) is the recycling option for FVOCI equities.

Some believe 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, the VFA approach will only partially address the concerns because:
The variable fee approach is only applicable to a limited number 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 (which are not eligible for the VFA) and also held with a long-term horizon
Insurer's resources are made both of insurance liabilities and own funds. Therefore, insurers also have equity and equity-like instruments beyond backing their own funds that are also monitored with long term investing strategies.
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.

However, a reintroduction or recycling and impairment for equity instruments should not remove the possibility for companies to measure equity instruments at Fair value through profit or loss (FVTPL) where this provides the appropriate representation of their performance.

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

1. The link to a long-term obligation (insurance contracts)

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.

We would opt for the FVOCI treatment with recycling with impairment.

The current fair value measurement treatment of investments under IFRS 9 needs to be aligned with the current fulfilment measurement of insurance liabilities according to IFRS 17 and the Asset-Liability Management (ALM) practices of insurers.

However, many long-term investors need to report only realised gains or losses on financial instruments in the P&L in order to provide an appropriate depiction of performance. For these companies, unrealised fair value changes which are not caused by impairments (on financial instruments) or changes due to variations in the discount rate (on insurance liabilities) are irrelevant for the purpose of performance reporting in periods before disposal of the financial instrument and should be considered as "market noise". Therefore, the availability of the two-sided (for IFRS 9 and IFRS 17) OCI option is necessary for some insurers - the missing part for the alignment of insurance liabilities (IFRS 17) and financial instruments (IFRS 9) is the recycling option for FVOCI equities.

Some believe 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, the VFA approach will only partially address the concerns because:
The variable fee approach is only applicable to a limited number 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 (which are not eligible for the VFA) and also held with a long-term horizon
Insurer's resources are made both of insurance liabilities and own funds. Therefore, insurers also have equity and equity-like instruments beyond backing their own funds that are also monitored with long term investing strategies.
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.

However, a reintroduction or recycling and impairment for equity instruments should not remove the possibility for companies to measure equity instruments at Fair value through profit or loss (FVTPL) where this provides the appropriate representation of their performance.

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.

Generally, we would opt for the FVOCI treatment with recycling and impairment. .

This is however ultimately dependent on the nature of the long-term liability, i.e. its respective accounting treatment (e.g. cost, full fair value). The ALM-strategy is best reflected if the assets and liability accounting is not causing artificial volatility nor leading to accounting mismatches in both balance sheet and performance reporting.

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

1. The link to a long-term obligation

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.

Generally, we would opt for the FVOCI treatment with recycling and impairment. .

This is however ultimately dependent on the nature of the long-term liability, i.e. its respective accounting treatment (e.g. cost, full fair value). The ALM-strategy is best reflected if the assets and liability accounting is not causing artificial volatility nor leading to accounting mismatches in both balance sheet and performance reporting.

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.

We would opt for the FVOCI treatment with recycling and impairment or Fair value through profit or loss (FVTPL) depending on which one provides the appropriate representation of their performance.

For insurers, it would depend on the nature of the assets and liabilities. However, not having a recycling option would create an accounting disincentive for many insurers to hold this asset in a portfolio backing fixed liabilities.

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 would opt for the FVOCI treatment with recycling and impairment or Fair value through profit or loss (FVTPL) depending on which one provides the appropriate representation of their performance.

For insurers, it would depend on the nature of the assets and liabilities. However, not having a recycling option would create an accounting disincentive for many insurers to hold this asset in a portfolio backing fixed liabilities.

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.

We would opt for the FVOCI treatment with recycling and impairment or Fair value through profit or loss (FVTPL) depending on which one provides the appropriate representation of their performance.

For insurers, it would depend on the nature of the assets and liabilities. However, not having a recycling option would create an accounting disincentive for many insurers to hold this asset in a portfolio backing fixed liabilities.

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 would opt for the FVOCI treatment with recycling and impairment or Fair value through profit or loss (FVTPL) depending on which one provides the appropriate representation of their performance.

For insurers, it would depend on the nature of the assets and liabilities. However, not having a recycling option would create an accounting disincentive for many insurers to hold this asset in a portfolio backing fixed liabilities.

20. Thank You!

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