European Securities and Markets Authority

The Chair

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Mr Jean-Paul Gauzès
President
European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
1000 Brussels
Belgium

Ref: EFRAG Discussion Paper *Equity Instruments – Impairment and Recycling*

Dear Mr Gauzès,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the consultation on EFRAG's Discussion Paper (DP) *Equity Instruments – Impairment and Recycling*. We are pleased to provide you with the following comments reflecting the view of European securities regulators, to improve the transparency and enforceability of financial information, with the objective of enhancing investor protection and promoting financial stability in the European market.

With its DP, EFRAG aims at collecting input on the treatment of equity instruments designated at Fair Value through Other Comprehensive Income (FVOCI) in accordance with IFRS 9 *Financial Instruments*, in order to respond to the request for technical advice from the European Commission (EC) on the accounting treatment of equity instruments from a long-term perspective. The European Parliament, in its resolution on IFRS 9, called on the EC to ensure that IFRS 9 serves the EU's long-term investment strategy and reduces pro-cyclicality and incentives for excessive risk-taking[1].

ESMA notes that this topic falls into a broader discussion on how accounting for long-term investment portfolios of equity instruments contributes to the transition to a more sustainable economy, as highlighted in the January 2018 final report of the High-Level Expert Group (HLEG) on Sustainable Finance[2]. Building on this report, the EC recently published its action plan on financing sustainable growth[3] encompassing, amongst others, actions in the area of disclosure and accounting, including an evaluation on the impact of IFRS 9 on long-term

[1] http://www.europarl.europa.eu/oeil-mobile/fiche-procedure/2016/2898(RSP)
[2] https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf
[3] https://ec.europa.eu/info/publications/180308-action-plan-sustainable-growth_en

investments. This discussion is also important as it addresses the issue of improving the attractiveness of financial markets and financing of the economy for the long-term.

ESMA acknowledges the relevance of this debate as transparent and timely reporting of information on the performance and risks underlying financial instruments held by issuers remain key factors to promote investor protection and financial stability for the long-term. In this respect, as already stated in our comment letter on the draft endorsement advice of IFRS 9, we continue to hold the view that – lacking evidence to the contrary – "appropriate trade-off between reporting the underlying economic volatility of financial instruments and transparency of economic performance have been reached"[4]. Proper depiction of this volatility in the financial statements increases transparency of financial information and thus assists financial stability. Furthermore, as cited in the frequent asked questions related to the EU Directive on disclosure of non-financial information and diversity information[5], transparency leads to better performance. In this respect, we believe that the primary objective of endorsed accounting standards remains to promote transparency and better decision-making in financial markets and, therefore, they should be considered as neutral with respect to other public policy objectives. We believe that this approach is ultimately the most beneficial for the performance of capital markets, including their capacity to support long-term investments.

In addition, we are concerned with conducting the assessment of the impacts of IFRS 9 on *long-term investment* at this time, as this standard has successfully passed the endorsement process and has become mandatorily applicable only recently, from 1 January 2018. In this respect, we note that for insurance undertakings, which are typically regarded as long-term investors, the application date of IFRS 9 can be deferred up to 1 January 2021 and therefore valid evidence related to this industry will not be available until then. Consequently, we believe that casting doubt on the relevance of the information prepared in accordance with IFRS 9 at this point in time would introduce significant regulatory uncertainty amongst issuers and investors.

We rather believe that the focus of standard setters as well as enforcers should now be on the close monitoring of the first years of implementation of IFRS 9. The evidence from the *observed* impact should then be used as a basis to provide feedback, including proposals for changes, to the future IASB's post-implementation review of IFRS 9. In this respect, while we commend EFRAG's effort to prepare a report[6] (hereinafter the "EFRAG's Report") in which it collected and analysed data relating to the application of IAS 39 for equity instruments accounted for as Available For Sale (AFS), we highlight that these data do not pertain to the *actual* impact of the implementation of IFRS 9. We also note that the evidence presented in EFRAG's Report regarding the anticipated effects of the requirements in IFRS 9 for FVOCI investments is not conclusive on whether, and on the extent to which, IFRS 9 is expected to trigger a significant change in the asset allocation of the surveyed entities. More importantly, we highlight that the

[4] https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-esma-1056_-_esma_response_to_efrag_draft_endorsement_advice_on_ifrs_9_0.pdf

[5] http://europa.eu/rapid/press-release_MEMO-14-301_en.htm

[6] https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FEFRAG%2527s%2520letter%2520to%2520the%2520European%2520Commission%2520on%2520equity%2520instruments%2520%28assessment%2520phase%29.pdf

data are collected on samples that are not statistically representative[7] and therefore we question whether it could be used as a basis to challenge the suitability of IFRS 9 or to infer how IFRS 9 will impact long-term investment behaviour for the entire European market.

Recycling gains or losses on disposal (Question 1 of the DP)

As mentioned above, ESMA believes that the evidence collected by EFRAG does not provide an appropriate basis to conclude that recycling needs to be reintroduced to support long-term investments. ESMA has consistently supported the accounting treatment for equity securities introduced by IFRS 9 which, with the FVOCI option, provides a solution for holding equity investments held in a long-term perspective, while not exposing the income statement to short-term volatility.

We are also concerned that recycling may introduce in some cases, and especially for financial institutions, short-term accounting incentives to put in place opportunistic profit-taking disposal policies, thus sustaining earnings management practices, which would be contrary to the objective of encouraging long-term investments. In this respect, we note that the existing treatment under IFRS 9 for equity instruments accounted for at FVOCI is neutral with respect to any such accounting incentives.

This concern is supported by the fact that in EFRAG’s Report some of the surveyed entities, including insurance undertakings, financial institutions and non-financial entities, have indicated that their average equity holding period and their disposal policies are affected by factors that are not always consistent with what is expected to be a long-term investment strategy. For example, some entities mentioned factors such as: opportunities to make profits, changes in expected short-term performance as well as the stabilisation and steering of investment income. In our view, this is consistent with the fact that entities providing feedback for EFRAG’s report were not able to explain how they identify which equities are held for the long-term.

Furthermore, as we consider that impairment is a necessary precondition of recycling, the fact that, in our view, impairment or similar models discussed in the DP would provide information that is less comparable and relevant than the information prepared according to IFRS 9, leads us to conclude that a recycling solution is currently not viable. In addition, we believe that recycling would introduce an additional layer of complexity for investors, as also highlighted in EFRAG’s independent academic review[8].

For the reasons explained above, ESMA does not believe that there is evidence that the benefits associated with the information provided by recycling would outweigh its costs, and

[7] For example, in terms of size. See also page 6 of EFRAG’s report where it is stated that: “When using the data, it should be considered that the samples are not statistically representative, consistent with any other EFRAG public consultation.”
[8] EFRAG, Academic Literature Review - Interaction of IFRS 9 and Long-Term Investment Decisions, p. 6, available at: http://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FSiteAssets%2FAcademic%2520literature%2520review%2520on%2520IFRS%25209%2520and%2520long-term%2520investment%2520decisions.pdf

therefore we are currently not convinced that recycling should be permitted on equity instruments accounted for at FVOCI.

Relationship between recycling and impairment and disclosure as substitute of impairment (Questions 2-3 of the DP)

While currently we do not support a recycling solution, we believe that an impairment requirement shall represent an integral part and a prerequisite of any such solution. Therefore, we particularly support the arguments in EFRAG's DP that an impairment model enhances the relevance of profit or loss for stewardship purposes and that it provides information that is relevant for the assessment of future cash flow prospects.

In a scenario in which recycling is reintroduced, we strongly disagree that a disclosure approach could provide an appropriate alternative to an impairment model. We believe that, if the rationale underlying the need for a recycling solution is linked to the fact that the statement of profit or loss is the primary source of information on an issuer's performance, the same argument shall apply to the recognition of incurred losses on equity instruments in the statement of profit or loss.

We also note that a recycling solution that is not accompanied by impairment would result in a situation that might promote risk-taking and short-term opportunistic strategies to a larger extent than during the financial crisis, as issuers will have an incentive to delay the recognition of losses on equity instruments even if already incurred, thus reducing the usefulness of OCI.

Alternative impairment models for equity instruments (Questions 4-6 of the DP)

We believe that a robust impairment model for equity instruments would need to provide timely, reliable and consistent information on incurred losses relating to equity instruments. ESMA has consistently highlighted the inadequacy of the IAS 39 impairment model with regards to the AFS equity securities as, with its set of indicators, it has led to widely different practices, as highlighted in ESMA's report *Review of Accounting Practices: Comparability of IFRS Financial Statements of Financial Institutions in Europe*[9] and recalled also in the DP.

Therefore, we are not supportive of an approach that tries to revise the IAS 39 impairment model with changes aiming at setting predetermined impairment triggers and thresholds. Particularly, we note that while predetermined triggers and thresholds may conceptually help providing a consistent and comparable basis for the recognition of losses, they would imply that the IASB shall make an arbitrary choice as to when a "significant or prolonged" decline in fair value is deemed to have become a proxy that an impairment on equities has occurred. Besides, we firmly believe that, as discussed in the DP, this choice should not be delegated to issuers as the outcome would result in the same degree of diversity in practice that is observed with respect to the impairment approach in IAS 39.

[9] https://www.esma.europa.eu/sites/default/files/library/2015/11/2013-1664_report_on_comparability_of_ifrs_financial_statements_of_financial_institutions_in_europe.pdf

For the above reasons, we believe that the revaluation model proposed in the DP would seem slightly more capable of achieving the objectives of timely and comparable recognition of declines in fair value below its acquisition cost which can be regarded as a proxy of impairment. However, we note that this solution would not provide necessarily relevant information as it might not be able to distinguish between adverse declines in fair value that are due to a deterioration in an issuer's economic position from other declines in fair value and recognise impairment losses accordingly. Therefore, in our view, should recycling be reintroduced the revaluation model would be, among the solutions provided by EFRAG, the preferred alternative if accompanied by additional disclosures enabling the user to understand the nature of the impairment that has occurred. We provide some suggestions of additional disclosures in the remainder of this letter.

Other considerations (Questions 7-8 of the DP)

We believe that in order to prevent the risk that entities may use the recycling option for short-term opportunistic profit taking strategies, in principle this option should be made available only to the population of equity instruments to which an issuer publicly commits to put in place long-term investing strategies that should be clearly defined by the standard.

However, we acknowledge that in practice creating a sub-category of equities reflecting the objective of a long-term investment strategy is highly difficult and, in the past, the IASB tried to define the sub-portfolio of strategic investments, but concluded that such definition would be impracticable. In our view, this is consistent with the fact that entities providing feedback to EFRAG's Report were not able to explain how they identify which equities are held for the long-term. If the subcategory is not properly defined, it may result in structuring opportunities or in limitations that may not ultimately reflect the objective of a long-term investment strategy, for example when issuers put in place a genuine portfolio rebalancing or asset-liability management policy. Consequently, if recycling would be re-introduced, ESMA believes that an impairment model should apply to all equity instruments carried under the FVOCI election.

ESMA is also of the view that the unit of account for measurement of financial instruments is the individual instrument and that a portfolio exception should not be introduced for equity instruments. However, ESMA agrees that different cost formulas are available and can be used to account for different tranches of identical instruments. In this respect, it would be necessary to firstly identify and appropriately define and limit which equities are *genuinely* held with a long-term strategy.

Finally, ESMA believes that if recycling is reintroduced a comprehensive presentation and disclosure package would need to be developed. This would require, as a minimum:

- qualitative disclosure on the nature of the long-term strategy and its attainment;
- Separate presentation of gains stemming from the long-term investments (if a separate subcategory was identified);
- separate presentation of the (i) amounts recycled from the OCI; and (ii) impairment losses at the face of the income statement; and

- a reconciliation table for the movement in the OCI, separately disclosing amounts related to (i) reversal of impairment, (ii) reclassification to the P&L; (iii) market movement other than reversal of impairment.

Please do not hesitate to contact me or Roxana Damianov, Acting Head of the Corporate Affairs Department and also observer to EFRAG's Board, should you wish to discuss any of the issues raised in this letter.

Yours sincerely,

Steven Maijoor