KBC responses to "EFRAG research project on equity instruments"

REQUEST FOR FEEDBACK – QUESTIONNAIRE

EQUITY INSTRUMENTS – RESEARCH ON MEASUREMENT

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.

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

General information about the respondent

1) Name of the individual/ organisation

KBC Group

2) Country of operation

Belgium

3) Job title

Belgian bank-insurance group

4) E-mail address

toon.clercx@kbc.be

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

(X) Yes

( ) No

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

A long-term investment business model is a model in which the company acquires assets in order to generate a stream of revenues on the long run. The assets are not primarily held for selling in the short period of time. For some insurance products (pension savings) , there is a legal

requirement to hold a min level of investments is specific equity types. These investments are typically held for a very long period

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

(X) Yes

( ) No

8) How do you define sustainable activities?

KBC Group has a various set of policies around sustainability which are publicly disclosed and which are also embedded in our offer of investment funds (referring to the so called 'SRI' or socially responsible investments criterium). Nevertheless, we would not like to elaborate further on the definition of sustainable activities in this context, because of the following 2 reasons:

1) We believe this is something which has to be defined outside the accounting framework, even outside the regulatory framework. If governments want to promote sustainable investments, we believe that non-disturbing measurements could be taken via f.e. subsidies or tax benefits, but not by incorporation in accounting rules, nor in the regulatory framework.

2) We believe that something which would be classified as sustainable today might not longer be perceived as sustainable tomorrow. For example, coal versus nuclear energy 30y ago versus wind energy now, etc.

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 longterm investment business model, which characteristics would you require to identify a *long-term investment business model*?

[X] The characteristics/ business model of the investor

[ ] The expected holding period

[ ] The actual holding period

[ ] The long-term nature of the liabilities that fund the assets

[ ] Other

If you have indicated "Other" please provide details

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?
(X) Yes

( ) No

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

KBC believes that a different accounting model is needed for equity instruments which are held on the long(er) term, because neither the FVOCI option, nor the presumed FVPL classification properly portrays the relevant performance on shares that are acquired for a long-term horizon perspective. The FVPL classification gives too much volatility which disturbs the performance during the holding period; the FVOCI option eliminates the realisation through P&L upon disposal of the equity instrument.

An additional reason why an additional measurement model is required mainly for the insurance business is the matching with the insurance liabilities that they cover. Typically, investments in equities cover the very long tail of the insurance liabilities and the full return on the equity investments is part of the financial return used for the profit sharing to be distributed to the policy holder and thus included in the IFRS17 fulfilment cash flows. Not taking into account the overall financial return on equities (incl. realised gains and losses) would create mismatches in profit recognition.

KBC supports the **re-introduction of recycling**, which could solve the above dilemma of choosing between FVOCI and FVPL. The re-introduction of recycling would entail that essentially the measurement of IAS 39 for equity instruments would be reapplied, but where targeted improvements to the impairment model could be made to improve the divergence observed in practise. The reintroduction of recycling is necessary for equities measured at FVOCI since it would significantly improve the presentation of the financial performance of insurance companies. Just as dividends, gains and losses realised on disposal of equity instruments measured at FVOCI are an integral part of the company performances and should be shown in the results. As such, there is no conceptual reason to make a distinction between these different sources of profits and losses. In addition, there might be a risk that equity markets may include the dividend policy in their pricing models and put additional pressure on companies to maximize dividend distribution. In addition there might be an impact on the pricing of high dividend yield equities versus growth equities. Financing start-up and young companies will also suffer competitive disadvantage as they would be unable to distribute dividends typically in the early years of the company.

Reporting consistently all the components of the performance of equity instruments in profit and loss will provide complete and appropriate information to users about the performance of the

related investments. This will also ensure consistency with the accounting treatment of debt instruments accounted for at FVOCI for which interests payments as well as gains and losses upon realization are recognised in profit and loss

In case the re-introduction of recycling would not be acceptable by the IASB, we believe a third measurement basis could be a suitable alternative. This measurement basis is also discussed by EFRAG in chapter 2.12 and following and is called the **average fair value model**. The measurement basis here is FVPL, but with only changes of average fair value being recorded in the P&L and the difference between the average and closing price being recorded in OCI.

The application of the average fair value model could be applied for equity instruments for which there is a long-term horizon investment perspective. We believe that the **business model assessment** as existing for debt instruments in IFRS 9 could be extended to equity instruments and could stipulate if the equity instruments qualifies for this long-term horizon criterium or not. Often the long-term profile of the liabilities are the driver of the investment horizon of the assets. This can be clearly documented in the business model assessment.

The advantages of this model is that there is no discussion on recycling of gains and losses on disposal of equity instruments through P&L (since they are already measured at FVPL) plus shocks in the stock prices will have much less volatility on the P&L as only the average movement will impact the P&L. Moreover, there is full transparency as the equity instrument remains at fair value on the balance sheet and any unrealized result is disclosed in OCI.

We also see similarities with other accounting standards such as **IAS21 Foreign Exchanges**, which allows entities to measure the revenues in foreign currency to be converted using average FX rates. The difference between the average FX rates and the closing rate will be booked as translation difference in OCI. The proposed average fair value method is therefore not completely new in the IFRS literature. Next to that, there is also a similar principle in the 'cost view' of IFRS17.

The key operational challenge will be to extend the financial reporting with a third classification option for equity instruments, whereby the business model assessment will also need to be extended to equity instruments. Also a calculation should be embedded at each period end to recalculate the average fair value movement, which cannot be deducted from markets. This will require some technical processing and documentation, but we expect this to be manageable.

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?

KBC would support a measurement at FVOCI with reclassification to profit and loss upon disposal of the valuation gains or losses previously recognized through OCI. An impairment model would hereby be a requisite. The IAS 39 impairment model would be a good starting point whereby the

terms 'significant and prolonged' could be defined in a more strict manner to address the issue of a wide variety in application.

However KBC believes that also alternative measurements have to be considered in an attempt to improve the IFRS 9 standard in any ways, hereby referring to the previously mentioned average fair value method.

Question 5

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

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

[X] Yes

[ ] No

14. Please explain your answer

We believe the discussion is limited to equity instruments

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 measure 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.

[X] Yes

[ ] No

16. Please explain your answer

KBC does not invest only directly in equities instruments; we also invest in equities indirectly, for example through investment funds. It is important not to create competitive disadvantage because

the same assets are hold through different mechanisms. Therefore, to provide relevant information for the performance of long-term investors, we believe that the accounting treatment of equity-like instruments such as UCITS should also be eligible to the FVOCI category under IFRS 9, or to the FVPL average fair value which is here further for discussion. It also reflects the fact that the investor is fully exposed the equity risk ; e.g. the underlying investments of EFT funds is equity risk and therefore the accounting treatment should be identical to equities.

In the Belgian market, there is a typical type of UCITS called ‘BEVEK’/’SICAV’ which is a fund with variable capital which increases or decreases its capital based on investors stepping in or out of the funds. The funds generally invests in equity instruments, but because of the puttable feature, the investor would need to classify its investment in this UCITS as a debt instrument at FVPL, since it fails the SPPI-test. This creates a competitive disadvantage of the funds compared to directly investing in shares.

We believe that classifying puttable instruments as debt from the perspective of the issuer depicts also a misleading view because the **put option has no intrinsic value** as the put option is merely there to provide liquidity to the investor. The put will be exercised at the pro rata amount of the NAV of the equity funds, which would generally be **the same price** as the market price for the pro rata amount of shares in the funds (which are mostly tradable on the market). If we would classify these instruments as debt instruments purely because of the puttable feature, this would not represent the economic substance as the investor is fully exposed to equity risk at any time. It has no protection against a decrease in share price unlike a true put option.

Furthermore, a lot of those UCITS appear to have put options which are **not genuine** (unlike the BEVEK/SICAV). Instruments such as ETFs may perhaps be puttable according to the prospectus, but they are never putted directly to the issuer in reality. Accounting for those funds as debt instruments would also not properly depict the economic substance of those instruments.

Question 7

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

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

[ ] The nature of the assets invested in

[ ] Mutual funds

[ ] Other

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

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.

0 ____75%____ 100

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.

We have not identified other characteristics.

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.

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.

(X) Yes

( ) No

If yes, please explain why.

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

________The sustainable nature of the investee's operation

___X____The definite useful life of the investee's operation

________The investor's inability to dispose of the shares

23. Which accounting treatments do you support?

( ) Historical cost

(X) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

( ) Existing requirements are appropriate

(X) 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.

The Belgian banking industry would support the **average Fair Value** as an alternative accounting treatment, next to FVPL (Held-for-trading) and the FVOCI option already foreseen in IFRS9. Hereby the instruments are measured at FVPL, but only with average changes in equity prices in P&L, the rest in OCI.

In order to be eligible for this third accounting treatment, the **business model assessment** from IFRS 9 for debt instruments should be extended to equity instruments as well. If the equity instrument qualifies for the 'hold-to-collect & sell' business model, it could be eligible for FVPL average fair value measurement.

The average fair value should **reward investors that keep the equities for a longer term**, therefore we believe that the average FV is calculated as the **difference between the acquisition price and the price at each reporting date.** The average FV becomes in that sense a cumulative average fair value, with all yearly stock prices as reference points to be taken into account for the average price movement calculation. This mechanism benefits long-term investors more than short-term investors because a stock market crash in year 10 of a holding period will have less effect than a stock market crash in year 1 of a holding period. This is because the crash in year 10 will be compensated by (higher) stock prices in the previous years. This model makes that a fair amount of volatility goes into P&L in the short run; on the long run, most volatility will go into OCI. This accounting principle would fit to the long-term horizon perspective of the 'hold to collect & sell' business model which also allows some selling of instruments (with recycling through P&L)

In order not to make the accounting model too complex, we suggest to **calculate only one average fair value per accounting year**. Calculating quarterly/monthly/daily averages would be too complex, because there would be too much reference points after a certain period of time. In order to produce monthly or quarterly P&L figures, the average P&L entry of the previous month will be reversed and recalculated to the next month (f.e. the January FV adjustment being the

average between 1/1/x1 and 31/1/x1 will be reversed and replaced by the average between 1/1/x1 and 28/2/x1. The closing price on 31/1/x1 will in that case have no relative weight in this average fair value calculation.

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.

(X) Yes

( ) No

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.

(X) Yes

( ) No

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.

(X) Yes

( ) No

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.

(X) Yes

( ) No

If yes, please explain why.

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

___ X __The investor's assessment of the long-term nature of its investment

________The listed feature of the fund

________The investor's ability to redeem or sell

35. Which accounting treatments do you support?

( ) Historical cost

(X) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

( ) Existing requirements are appropriate

( ) 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 explanation on illustrative example A

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.

(X) Yes

( ) No

If yes, please explain why.

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

___ X ___The investor's assessment of the long-term nature of its investment

________The unlisted feature of the fund

________The investor's ability to redeem or sell

38. Which accounting treatments do you support?

( ) Historical cost

(X) Average fair value

( ) Adjusted cost

( ) Adjusted fair value

( ) Allocation-based approaches

( ) Existing requirements are appropriate

( ) 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 explanation on illustrative example A