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FBF comments on the EFRAG Discussion paper: Equity instruments – Impairment and Recycling.

The French Banking Federation (FBF) is pleased to have the opportunity to comment on the EFRAG Discussion Paper (DP) regarding Equity Instruments – Impairment and Recycling.

We welcome the European Commission initiative to reconsider the effects of IFRS 9 on long term investors. We welcome, as well, the EFRAG DP to seek comments on whether equity instruments measured at fair value through OCI under IFRS 9 deserve an alternative accounting treatment and notably, to what extent recycling and impairment of these instruments could apply.

We are convinced that the issue of long-term investment is above all a matter of better account taken of the business model into the representation of the long-term investing activities.

We have consistently advocated for better reflecting, in the accounting standard, the way the entity recovers the cash flows generated by the equity instruments it holds on a long-term horizon as opposed to equity instruments held for trading purposes for which there is evidence of short-term profit-taking. We believe that the business model – why an entity holds an investment - should be the primary criterion when considering the performance model to apply. It should be more dominant in the standards than it is today.

We share most of EFRAG's views for a robust model for equity instruments held for long-term investors. We consider that the prohibition of recycling of disposal gains for equity instruments designated at FVOCI should be reconsidered but accompanied by an adequate impairment model. We also see no reason to prohibit equity instruments measured at FV OCI from impairment and recycling, while debt instruments held for the same long term purposes and measured at FV OCI benefit of this mechanism.

- Recycling should be reintroduced. A distinction should be made between realised gains and losses and unrealised gain and losses as they are of different nature. While the former are certain and should be recognised in the profit and loss account, the second are uncertain and are accumulated in the other comprehensive statement. These unrealised gains and losses should be recycled following the disposals of the equity instruments held in a long term, as part of the performance of these instruments alongside dividends which are included in the profit and loss. This is consistent with the revised Conceptual Framework for Financial Reporting that states that profit or loss is the primary performance indicator.

- Recycling should be complemented by impairment. Impairment losses should be accounted for when necessary and reverse through the profit and loss account when the impairment is no longer met. When the business model is to hold equity instruments for a long period, the concept of “value in use” should apply as a trigger to conduct the impairment tests but also as a reference value for the impairment amount. This would contribute to a relevant and reliable impairment model..

Finally, in our views, the outcome of the quantitative study of IFRS 9 effects on the long term equity investments carried out in a first phase should be interpreted very carefully as it should have included not only equity instruments but also equity instruments equivalents and as it has been performed for the years (2015 and 2016) before IFRS 9 becomes mandatory. It may be more appropriate to review the effects of IFRS 9 requirements after the new standard has been applied for the first two years.

We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,

Appendix – EFRAG’s questions to constituents.

Q1.1 What are your views on the arguments presented in paragraphs 2.3 – 2.10? Do you consider that the reintroduction of recycling would improve the depiction of the financial performance of long-term investors? Alternatively, do you consider that the existing requirements of IFRS 9 provide an adequate depiction? Please explain.

We share EFRAG’s arguments in favour of the reintroduction of recycling as it would enhance the representation of the financial performance of long-term investors.

Indeed, the performance of the equity instruments held in a long-term objective is the result, at the same time, of the dividends received, but also, of the gains and losses realized on disposals.

It is crucial to make a difference in the face of financial statements between realized and unrealized gains and losses. Both are of different nature. Realized gains or losses refer to gains or losses that are certain and that result from completed transactions. They should only be recognized in the profit and loss account. Unrealized gains or losses refer to gains or losses that are uncertain and that result from changes in the value of financial instruments that have not yet been settled. They are accumulated in the other comprehensive income. Recycling the unrealised gains and losses when these gains and losses become certain following the disposals of the equity instruments contribute to a better communication of the performance.

Accordingly, OCI should only include changes in the value of equity instruments not held for trading over the expected holding period of these instruments, otherwise including realised profit or loss in OCI would alter its nature. Moreover, it would create confusion for users when assessing the timing and the amounts of the cash flows generated by equity instruments.

This is consistent with the revised Conceptual Framework for Financial Reporting that states that profit or loss is the primary performance indicator and that, in principle, other comprehensive income can be used only in exceptional circumstances, i.e. income and expenses in other comprehensive income should be recycled where the relevance or faithful representation of the financial statements would be enhanced.

As regards to the existing IFRS 9 requirements, the prohibition of recycling gains and losses into the profit and loss account limits the relevance of the information of performance of the entity. Besides, it may have detrimental effects on long-term investments decisions.

Q2.1 What are your views on the arguments presented in paragraphs 2.11 – 2.17? Do you consider that, from a conceptual standpoint, recycling should be accompanied by some form of impairment model? Please explain.

From a conceptual perspective, we consistently support an impairment model for equity instruments held in a long term objective as a supplement to a mechanism of recycling. We believe it contributes to the best representation of the generated cash flows of such financial assets. Impairment losses should be recognised in profit and loss account when necessary and reversed when the impairment conditions are no longer met.

To meet users' expectation of a reliable information of the performance of equity instruments, there is a need for some caution to be exercised when making estimates of the occurrence and of the amount of the equity instruments' impairment and for taking into account adverse changes in the issuers' economic conditions. Thus, recognition of impairment in the profit and loss account in a timely manner is consistent with the notion of prudence.

*Q3.1 What are your views on the arguments and analysis presented in Chapter 3 of the DP?
Q3.2 Are there other improvements in presentation and disclosure that you would support?*

The revised Conceptual Framework for Financial Reporting reaffirms the importance of the income statement as the main information source of the financial performance. Income and expenses should be included in the profit and loss account including recycled OCI items when such items are realised in cash or equivalent and when recognition of such transactions contribute to a faithful information.

In accordance with EFRAG, we believe that additional disclosures would not provide sufficient appropriate information compared to the information provided in the financial statements composed of the statement of position and the profit and loss account in order to adequately picture the performance of the equity instruments and the way they are managed.

In addition, the effect of additional too granular information would be negative as being disproportionate to the current need. It will lead to burdensome reporting for preparers and readers going against the current objectives of disclosure effectiveness, notably given the size of portfolios.

*Q4.1 What should be, in your view, the general objective and main features of a robust model for equity instruments (relevance, reliability, comparability...)?
Q4.2 Which, if either, of the two models do you prefer? Please explain.
Q4.3 Do you have suggestions for a model other than those presented in the DP? If so, please describe it and explain why it would meet characteristics such as relevance, reliability and comparability.*

Equity investments can be managed on a long-term basis, with the possibility to be sold when the opportunities arise. They are managed on a portfolio basis as well as on a line by line basis,

So, a robust model for equity instruments held in a long term horizon should take into account management objectives. It should not introduce short term volatility in the performance of the business model. Therefore, measurement at fair value through equity with unrealised gains and losses recycled through income on disposal would be more relevant for such instruments. The recycling should be complemented with impairment losses being taken where necessary and reversed as soon as the impairment is no longer justified. We also see no reason to prohibit equity instruments measured at FV OCI from impairment and recycling, while debt instruments hold for the same long term purposes and measured at FV OCI benefit of this mechanism.

The aim of a robust impairment model is to provide a relevant and accurate information. Besides, we do not believe that impairment requirements would add complexity. The EFRAG has identified two main impairment models that could accompany measurement at FVOCI with recycling. We consider that the improvements proposed to IAS 39 model (additional guidance and disclosures on methodology) shall not be retained without an impairment reversal mechanism. Concerning the re-evaluation model, as it is driven by comparability objective rather than relevance, it would lead to volatility in profit and loss account as a result of changes in fair value without consideration for adverse changes in the economic situations of the issuers.

Another option could be considered. We would suggest retaining the concept of “value in use” to conduct the impairment tests but also as a reference value for the impairment amount to be recognised in the profit or loss account. The concept is already applied in IFRS standards – i.e. defined by IAS 36 - and commonly understood by preparers and users. In our opinion, the concept of “value in use” could be extended to financial assets when the business model applied is to hold these assets for a long period

The value-in-use measure is an entity specific measure determined in accordance with “ future cash flows that the entity expects to derive from the assets” (IAS 36.6) . It takes into account internal and external factors and notably, the intended holding horizon of the assets. Any decline in value of the equity instruments would be accounted for at a minimum between their original costs and the value in use. Reversal of the impairment would either be automatic for any subsequent increase in value or follow a symmetrical approach to the impairment model taking into account external and internal indicators that the impairment loss no longer exists or has decreased.

*Q5.1 Do you support the inclusion of quantitative impairment triggers in an impairment model? If so, should an IFRS Standard specify the triggers, or should management determine them?
Q5.2 If you do not support quantitative impairment triggers, how would you ensure comparability across entities and over time?*

We do not support the inclusion of quantitative thresholds within an impairment model. Although some quantitative impairment triggers seem to facilitate comparability across entities, it would be, on the long term, at the expense of a faithful representation of entities’ own business models and investment portfolios.

Please also refer to question 4.

*Q6.1 How should subsequent recoveries in fair values be accounted for? Please explain.
Q6.2 If subsequent recoveries in fair values are recognised in profit or loss, which of the approaches in paragraphs 5.2 – 5.10 do you support and why?*

Subsequent recoveries in fair value.

Different views can be assessed.

Subsequent recoveries could be account for automatically for any subsequent increase in value of the equity instrument. Or subsequent recoveries could follow a symmetrical approach to the impairment model taking into account external and internal indicators that the impairment loss no longer exists or has decreased.

Unit of account. Individual investment or portfolio.

Equity investments held on a long-term basis can be managed on a portfolio basis as well as on a line by line basis. In our views, a long term investment model should apply to both approaches,

*Q7.1 Do you consider that the same model should apply to all equity instruments carried under the FVOCI election? If not, why not and how would you objectively identify different portfolios?
Q7.2 Do you have comments on these other considerations?
Q7.3 Are there other aspects that EFRAG should consider?*

The first and main driver to apply a measurement model to equity instruments should be the purpose of the investment, - the business model -, whether the management intention is to hold these instruments for short term profit taking or whether the management intention is to hold them on a longer term horizon with no intention of selling in the near future. Furthermore, the same long-term business model treatment should not be limited to direct equity holdings, but it should also apply to indirect equity holdings (such as funds). Indeed, excluding instruments equivalent to equity instruments – currently classified as debts in accordance of IAS 32 – would not appropriately reflect the long term investment business model as such instruments are part of a diversification business model. So, this issue may be further discussed in connection with the FICE project..

Q8.1 Are there other aspects of IFRS 9's requirements on accounting for holdings of equity instruments, in addition to those considered in the DP, which in your view are relevant to the depiction of the financial performance of long-term investors? Please explain.

The representation of long term investments' financial performance should be further assessed in the light of other IASB's projects such as FICE and Primary Financial Statement projects.