

# POSITION PAPER



## **ESBG's reflections on EFRAG's Discussion paper on equity instruments – impairment and recycling**

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**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 see merits in the arguments provided by EFRAG in paragraphs 2.5 and 2.7 and would support the reintroduction of recycling for all the different classes of equity instruments under the FVOCI election. In our opinion, recycling realised gains and losses on equity investments to profit and loss would, at least temporarily, enhance the relevance of the reported financial performance of long-term investors and provide more useful information for stewardship purposes.

We refer to a temporarily improvement because at present we believe that users of financial statements analyse and assess the performance of an entity mainly based on the profit and loss statement, instead of considering both the profit and loss statement as well as other comprehensive income. Until a comprehensive analysis of both statements are considered and widespread among users of financial statements, we understand that recycling will provide more useful information.

In addition, the reintroduction of recycling would increase the consistency in accounting for equity investments measured at FV-OCI with that of other investments accounted for at amortised cost and/or FV-OCI.

Banks may hold equity instruments that are classified at FV through OCI under IFRS 9 for the four following reasons:

- a) non-controlling interests in unconsolidated entities providing operational or IT services to Group entities (Economic Interest Group)
- b) non-controlling interests in unconsolidated entities held for strategic reasons (building of partnership, promote cross-selling activities,...)
- c) investment in private equity with capital gains expected on a medium to long term horizon
- d) investment in equity instruments of customers additionally to loans in order to finance the development or long-term projects of our customers

The a) and b) investments are not expected to be sold and the prohibition of recycling under IFRS 9 is less at stake for banks. We would, however, be ready to accept a recycling with the corresponding impairment on these investments given the stakes of described below in c) and d).

The c) and d) investments are expected to be sold at a medium to long term horizon. Therefore, recycling in P&L is required to properly reflect the performance of this business. We are afraid that the absence on recycling would discourage investment in those equity instruments that are essentials for the development of our markets.

Furthermore the introduction of a recycling model for equity instruments measured at FVOCI should be discussed between EFRAG and IASB, but the final decision should be at IASB level only

**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.**

We concur with EFRAG's analysis in paragraphs 2.12-2.16 and believe that a measurement model for equities involving recycling should also be subject to impairment.



The need for the impairment model should be only based on the fact that although not having a superior hierarchy, one should consider prudence in accounting as an overarching principle.

One of the merits we see in having an appropriate impairment model is that it would provide relevant information to users of financial statements regarding whether a decline in fair value is more or less likely to reverse in the future.

**Q3.1 What are your views on the arguments and analysis presented in Chapter 3 of the DP?**

ESBG members do not consider that flaws in recognition requirements can be rectified by set of disclosures as also evidenced by the EFRAG's analysis in Chapter 3.

**Q3.2 Are there other improvements in presentation and disclosure that you would support?**

No

**Q4.1 What should be, in your view, the general objective and main features of a robust model for equity instruments (relevance, reliability, comparability...)?**

If an impairment model were to accompany the recycling requirement, our view is that the critical feature of an accounting model for equity instruments should be relevance of the information: a robust impairment model should lead to relevant information being provided to users of an entity's financial statements. Comparability and reliability are important characteristics but if there is a conflict, some of their aspects could be sacrificed in favour of relevance. For example, relevance of the impairment model for equity investments should take precedence over the fact that the impairment triggers may not always be reliably identifiable and different triggers applied across entities may not lead to fully comparable information.

**Q4.2 Which, if either, of the two models do you prefer? Please explain.**

We have sympathy for the alternative of an impairment model similar to IAS 39 for financial instruments classified as AFS (available for sale).

ESBG members oppose the revaluation model alternative. It would bring permanent bias in accounting for equity instruments when all negative changes in fair value below the purchase price are automatically recognised in profit or loss. Such a bias goes well beyond the notion of prudence. This model could not be considered as involving an impairment model it would just be an overly simplified measurement algorithm. Moreover, its consistency with the business model of holding the assets would be very questionable and we do not believe that preparers would have incentives to choose this model. Since equity investment at FV through OCI are usually long term investments which are not managed on mark-to-market basis, a revaluation model (in which all declines in fair value below the purchase acquisition cost would be immediately recognised in profit or loss and changes in fair value above the acquisition cost would be recognised in OCI) does not seem relevant, especially for equity instruments which are unquoted and when the fair value is difficult to estimate. Currently when the default IFRS 9 measurement method for equity investments recognises the fair value changes in profit or loss why would an entity choose to have just the negative movements in profit or loss?

We admit that IAS 16 knows the revaluation model alternative with similar accounting mechanics. However, for property, plant and equipment this is the only alternative of fair value measurement offered by the standard. Without having a practical experience with the revaluation model, we consider



that the potential for negative fair value changes impacting profit or loss is much lower for the IAS 16 revaluation model than for equity investments. This is because the volatility of the prices of tangible assets is generally lower and revaluation is required only when the fair value materially differs from its carrying amount (which may result in infrequent revaluations e.g. in three or five years frequency as stated in paragraph 34 of IAS 16). Furthermore, for assets other than land, the negative changes in fair value are absorbed over the assets' life through regular depreciation accounting entries.

**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**

No

**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?**

The definition of impairment triggers should remain on a business model-based approach and with complete disclosures (transparency policy).

Every company should define their own triggers – qualitative and quantitative (e.g. fair value test or value in use test, where equity instruments would be impaired only when the value in use falls below the original costs). Comparability and reliability are important characteristics but if there is a conflict some of their aspects could be sacrificed in favour of relevance. The comparability may be ensured through disclosures.

We support the introduction of impairment triggering events to be determined by each entity but do not agree that quantitative thresholds should be specifically defined in the standard. In this regard:

- Entities should define in their accounting policies how they assess that there is objective evidence and impairment, including a description of qualitative events (which we would expect to be similar to current IAS 39 principles) and the methodology that they follow to set quantitative thresholds used to assess whether there is an impairment in an equity.

For example, an entity could describe how they consider the volatility of a quoted equity to set the quantitative thresholds but also could describe the methodology used to estimate an expected internal rate of return (IIR) and how is monitored over time for some type of equities (such as unquoted start-up projects) to assess its impairment.

- At initial recognition and at each reporting date (considering the materiality of the equity), entities would make a transparent disclose in the annual report of the quantitative thresholds set and used and include a statement on whether they have been reached or not.

- Quantitative triggers should be monitored and reviewed periodically (i.e. on an annual basis) if needed, providing supporting evidence in case a review is made.

- Entities should disclose the rationale behind not impairing an instrument when the triggers are met (rebuttable presumption).

**Q6.1 How should subsequent recoveries in fair values be accounted for? Please explain.**

ESBG considers that subsequent recoveries in fair value of impaired assets should be reversed through profit or loss if the impairment triggers are no longer met. The only asset type in IFRS for which impairment reversals are prohibited is goodwill. However, unlike goodwill, equity investments are



measured at fair value and there is a clear basis for determining the value and reversing the impairment once the impairment triggers no longer apply.

**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?**

As explained in our answer to Q6.1 any recoveries in fair value must be recognised in profit or loss.

We would support the reversal of impairment through profit or loss if the impairment triggers are no longer met. Regarding the approaches discussed in the discussion paper this would correspond to the “Limited reversal” approach.

**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?**

Yes, FVOCI measurement should apply to all equity instruments which are not held for trading (nor contingent consideration in a business combination), considering also the difficulties in developing a proper description to limit the scope in this sense.

If this alternative is not acceptable and the FVOCI measurement stays optional we suggest that no specific criteria determining what kind of equity instruments can qualify under this option are defined. We consider that for non-trading equity investments it would be difficult to find the criteria distinguishing different kinds of investments in equity instruments that could deserve different measurement method (as also confirmed in paragraph BC5.25(c) of IFRS 9).

**Q7.2 Do you have comments on these other considerations?**

Regarding hedge accounting considerations, if the current FVOCI measurement method without impairment and recycling was replaced by the alternative with impairment and recycling the special requirements in specific parts of paragraph 6.5.8 of IFRS 9 (applicable to the measurement without impairment and recycling requiring revaluation of both sides of the hedging relationship through OCI) would become redundant. The considerations in paragraphs 5.28 to 5.33 of the discussion paper would not be relevant, in our view.

The standard fair value hedge accounting mechanism could be applied as it was under IAS 39. It means that the hedging instrument would be measured at fair value through profit or loss as well as the hedged equity investment (in respect the fair value changes attributable to the hedged risk). This would be also relevant for impaired equity investments. However, in the paragraph below we also suggest one modification to the calculation of the impairment loss.

We do not believe that the impairment triggers should be determined net of the hedging effect as discussed in paragraph 5.32 of the discussion paper. The IFRS 9 impairment model considers financial instruments as subject to significant increases in credit risk (Stage 2) or as credit-impaired (Stage 3) without taking into account the collateral or other credit enhancements. From this perspective, impairment triggers should not be impacted by the fact that the asset is hedged. However, as hedging effects are similar to collateral or other credit enhancements (which in the IFRS 9 impairment model affect the measurement of the impairment loss) we consider that the impairment loss for equity instruments should be determined after taking the hedge accounting effects into account. The effects of the impairment loss reduction due to the hedge accounting should be subject to disclosures.



To illustrate the approach we would use, let us consider an example of an equity investment acquired for 100 currency units (CU) which starts to be hedged when its fair value is 90 CU. Subsequently the fair value reaches 78 CU and also impairment is identified. The hedged loss on the equity instrument is 12 CU. The gain on the hedging instrument side is 11 CU. The total loss on the equity investment of 22 CU (reclassified from OCI to profit or loss) would be split into 10 CU as impairment loss (= fair value loss 22 – hedged loss 12) and 12 CU hedging loss. The hedging result would consist of hedging instrument gain 11 CU and hedged item loss 12 and the offsetting effect would bring an ineffectiveness loss of 1 CU. If in the case of equity instruments in foreign currency only their FX risk or fair value changes in foreign currency (e.g. in USD) were hedged, the impairment loss would be adjusted for fair value changes attributable to the hedged risk portion.

Regarding the issue of unit of account – individual investment or portfolio discussed in paragraphs 5.14 – 5.19 of the discussion paper, we do not see merits in the alternative of the unit of account for measurement and impairment recognition being at the level of portfolio of investments. Each investment in equity instruments generates cash flows which are largely independent from other assets. As a result, equity investments should generally be measured and the impairment should be assessed at an individual instrument level.

However, we agree that in particular cases (e.g. insurance companies) a portfolio approach may be relevant.

### **Q7.3 Are there other aspects that EFRAG should consider?**

Regarding transitional provisions ESBG considers that the new requirements should be applied retrospectively. However, if the measurement of non-trading equity investments at FVOCI was optional it would be vital that upon the transition, entities are provided with a choice of which non-trading equity investments would be measured at fair value through profit or loss and which through OCI.

### **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.**

We would like to raise concerns about the treatment of investments through an investment vehicle (e.g. an investment fund or limited partnership). Under IFRS 9 these instruments do not pass the solely payments of principal and interest test and they also do not qualify as 'equity instruments' and therefore the FVOCI election would not be available. As a consequence, these assets are carried at FVPL, creating income statement volatility and accounting mismatches when these back liabilities that are not accounted for at fair value through profit and loss



### **About ESBG (European Savings and Retail Banking Group)**

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 1,000 banks, which together employ 780,000 people driven to innovate at 56,000 outlets. ESBG members have total assets of €6.2 trillion, provide €500 billion in SME loans,



and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking.



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