EUROPEAN CENTRAL BANK
EUROSYSTEM

Vítor Constâncio
Vice-President

ECB-UNRESTRICTED

Mr Jean-Paul Gauzès
EFRAG Board President
EFRAG
35 Square de Meeûs
B-1050 Brussels
Belgium

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Contact person: J. Kirchhof
Ext.: 5634
E-mail: Jurgen.Kirchhof@ecb.europa.eu

EFRAG's Discussion Paper "Equity Instruments – Impairment and Recycling"

Dear Mr Gauzès,

In March 2018, EFRAG published a Discussion Paper entitled "Equity Instruments – Impairment and Recycling" (hereinafter "DP"). Comments were requested by 25 May 2018.

The ECB has a keen interest in high quality financial reporting standards that serve the public interest via a proper reflection of the economic substance of transactions and that do not compromise financial stability. High quality accounting standards are also a major prerequisite for effective prudential supervision. The accounting standard IFRS 9 is of particular importance as it governs the accounting treatment of financial instruments.

The ECB therefore welcomes the opportunity to comment on this DP.

In its letter of June 2015, the ECB assessed IFRS 9 and, based on the available evidence at the time, concluded that IFRS 9 could be conducive to the European Public Good. The ECB understands that some stakeholders are concerned about how the new accounting requirements for equity instruments measured at fair value through other comprehensive income (FVOCI) can impact long-term investment, and hence the European Commission called on EFRAG to investigate the potential effects of IFRS 9 for equity investments.[1]

[1] The available evidence seems to indicate that these concerns are concentrated in the insurance industry.

While the ECB generally has no clear preference from a conceptual perspective as to whether or not "recycling" should be reintroduced, we believe that the existence of a sound and operational impairment model is an indispensable prerequisite for reintroducing "recycling". Recycling without impairment in our view does not result in "prudent" accounting and may create adverse incentives for "earnings management". Hence, we do not support the idea of "disclosures" as a substitute for impairment, as presented in chapter 3 of the DP - disclosures cannot compensate for any adverse effects arising from inadequate recognition and measurement requirements. If it finally turned out that a suitable impairment model cannot be developed, the ECB would prefer that the existing requirements in IFRS 9 for equity instruments measured at FVOCI are kept.

As far as the impairment alternatives presented in chapter 4 are concerned, our preliminary view is that none of these alternatives are likely to improve financial reporting.

Finally, the ECB is concerned about the timing of this initiative as well as its interaction with other related initiatives. More specifically, re-opening discussions about fundamental aspects of IFRS 9 shortly after its effective date (1 January 2018) may create uncertainties among preparers and users of financial statements and may be too soon to reliably estimate the impact that the standard could have on long term investments.[2] Indeed, the evidence collected by EFRAG during the first phase of this project does not seem to allow a clear conclusion as to what extent the prohibition of "recycling" in IFRS 9 is likely to affect investment decisions. In regard to the interaction with other related initiatives, the ECB notes that the European Commission - in its "Action Plan" published in March 2018 – states its intention to ask EFRAG "*to explore potential alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments.*" By contrast, and in line with the related mandate, the DP maintains the basic premise that all equity instruments are measured at fair value. The ECB suggests that these initiatives are coordinated to ensure an effective and efficient use of resources.

If you have any questions regarding our comments, please feel free to contact us.

Yours sincerely,

Encl.

[2] In this context, we would like to refer to our recent comment letter to EFRAG on the amendments to IFRS 9 (8 November 2017): https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F1702031311307196%2FCL111%20-%20ECB%20-%20EFRAG%20DEA%20on%20IFRS9%20Amendments.pdf

Appendix

QUESTION 1 - RECYCLING GAINS OR LOSSES ON DISPOSAL

The Basis for Conclusions to IFRS 9 (paragraph BC5.25(b)) explains why IASB decided not to allow recycling when equity instruments are carried at FVOCI. EFRAG has previously argued that recycling enhances the relevance of the financial information provided to users of financial statements.

The DP (paragraphs 2.3 – 2.10) presents arguments as to why the recycling of cumulative gains or losses into profit or loss on disposal of equity instruments carried at FVOCI might improve the depiction of the financial performance of long-term investors.

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.

As a general remark, the ECB is concerned about the "timing" of the discussions about changing IFRS 9. More specifically, in view of the effective date of IFRS 9 (1 January 2018), challenging fundamental concepts of the standard has the potential to create uncertainty and may be too soon to reliably estimate the impact that the standard could have on long term investments. What is more, the available evidence does not necessarily seem to justify a call for reintroducing "recycling". In its letter to the European Commission (17 January 2018), EFRAG stated that "*respondents reported mixed views about the impact of the [new] requirements [of IFRS 9] on their asset allocation decisions.*"

The ECB considers both the arguments for and against reintroducing "recycling" as equally valid. From a conceptual perspective, it seems sensible that any gains or losses arising upon derecognition of assets or liabilities are presented in profit or loss. This treatment is consistent with the concept of "clean surplus accounting" according to which all changes in accounting equity other than transactions with owners are (ultimately) reflected in profit or loss. On the other hand, reflecting all the accumulated gains or losses in profit or losses only upon derecognition of the underlying equity instruments may not properly depict the investment performance over the entire holding period, in particular in case of a "long-term" equity investment (as the total accumulated gain or loss would be recognised in profit or loss in the period of disposal while the actual holding of the instrument may well have stretched over several years).

QUESTION 2 - CONCEPTUAL RELATIONSHIP BETWEEN RECYCLING AND IMPAIRMENT

The DP (paragraphs 2.11 – 2.17) discusses the relevance of an impairment model for equity instruments carried at FVOCI.

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.

The ECB agrees with the arguments presented in paragraphs 2.11 – 2.17. In our view, it is imperative that recycling is accompanied by a conceptually sound and robust impairment model. Recycling without impairment would in our view reduce transparency and may create adverse incentives for "earnings management" as divestment decisions might be driven by accounting implications rather than by (changes in) the underlying economics. For example, an investor (e.g. a bank or an insurer) may decide to maintain a loss-making equity instrument in spite of financial difficulties of the issuer of that instrument, only to avoid taking the accumulated losses to profit or loss. Conversely, the same reporting entity may decide to sell a particular equity instrument in a favourable market environment only to lift the entity's profitability.

QUESTION 3 - ENHANCING PRESENTATION AND DISCLOSURE REQUIREMENTS

The DP (Chapter 3) discusses whether and how presentation and disclosure requirements could provide better information on performance from a long-term investing perspective, including potential impairments of equity instruments. The DP presents arguments as to why enhanced presentation and disclosure requirements might not be an adequate substitute for improving the depiction of performance in profit or loss.

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 ECB generally agrees with EFRAG's analysis that it may be challenging to develop a fully satisfactory impairment model. However, the ECB agrees that disclosures complement but cannot replace an accounting solution based on recognition and measurement. As a consequence, in the event that – despite all reasonable efforts – it is not possible to develop a conceptually sound and operational impairment model for equity instruments measured at FVOCI, the ECB has a clear preference for keeping the existing requirements in IFRS 9 (i.e. no recycling of accumulated gains or losses arising from the derecognition of those equity instruments to profit or loss).

QUESTION 4 - TWO MODELS

The DP (paragraphs 4.4 – 4.22) describes two models for equity instruments carried at FVOCI:

- **a revaluation model in which all declines in fair value below the acquisition cost would be immediately recognised in profit or loss and changes in fair value above the acquisition cost would be recognised in OCI and recycled on disposal; and**
- **an impairment model similar to the model of IAS 39 for equity instruments classified as AFS, but with additional guidance to reduce subjectivity.**

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.

Ideally, in order to be considered "robust", any impairment model for equity instruments measured at FVOCI should meet all the technical endorsement criteria in the EU, i.e. relevance, reliability, comparability and understandability. In our view, the proposed models, i.e. the "revaluation model" and the "impairment model similar to IAS 39", do not seem to improve financial reporting as both models do not necessarily strike an adequate balance between relevance and comparability. For example, recognising all changes in fair value below the instrument's initial cost in profit or loss (as required under the "revaluation model") is quite "mechanistic" and is likely to increase comparability of accounting information. However, it does not differentiate between the respective sources of these fair value changes and may therefore not provide relevant information. Please also see our response to Question 5 below.

QUESTION 5 - QUANTITATIVE IMPAIRMENT TRIGGERS

The DP (paragraphs 4.12 – 4.22) discusses the inclusion of quantitative impairment triggers in its impairment model. Triggers reduce the extent of judgement in assessing whether a decline in fair value below cost represents objective evidence of an impairment, especially if set within the IFRS Standard. This enhances comparability (across entities and over time) but may reduce relevance.

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 ECB believes that prescribed impairment triggers would not necessarily improve financial reporting as impairment would become "rules-based". The general problem with rules-based approaches is that – while these approaches typically leave little room for misunderstanding – they tend to be rather rigid which may foster a so-called "box-ticking mentality" in the preparation of financial statements. Such a "mechanistic" approach would undoubtedly increase comparability but most likely fail to provide relevant information in several circumstances.

QUESTION 7 - OTHER CONSIDERATIONS

The DP discusses a number of other relevant considerations, including:

- **whether an IFRS Standard should introduce specific requirements for particular sub-sets of equity instruments and, if so, how these sub-sets should be defined (paragraphs 4.23 – 4.29). EFRAG has not developed this approach further;**

- **the use of rebuttable presumptions for recognising impairment losses instead of automatic triggers (paragraphs 5.11 – 5.13);**

- **the unit of account in applying the models (paragraphs 5.14 – 5.24); and**

- **other application issues (paragraphs 5.25 – 5.40).**

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 ECB believes it would be better not to create any sub-sets of equity instruments carried under the FVOCI election. We are afraid that any attempts to define "long-term equity investments" and to set them apart from any other equity investments would inevitably be "arbitrary". Moreover, this could create incentives for entities to manipulate their performance reporting ("earnings management").

QUESTION 8 - OTHER ASPECTS OF IFRS 9'S REQUIREMENTS ON HOLDINGS OF EQUITY INSTRUMENTS

The DP (paragraphs 1.15 – 1.16) explains that the scope of EFRAG's project is based on the specific questions in the EC's request for advice and that other aspects of IFRS 9's requirements on accounting for holdings of equity instruments have not been explored.

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.

On 8 March 2018, the European Commission published an "Action Plan" on sustainable finance, with three main objectives.[3] Among other things, the Commission states its intention to ask EFRAG *"to explore potential alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments."*[4] By contrast, and in line with the related mandate, this DP maintains the basic premise that all equity instruments are measured at fair value. The ECB suggests that all on-going initiatives relating to the accounting for equity instruments are coordinated to ensure an effective and efficient use of resources.

[3] The text of the Action Plan can be found here: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52018DC0097&from=EN

[4] Cf. Action Plan (2018), p. 10.