EFAMA

European Fund and Asset Management Association

EFAMA COMMENTS ON IASB's REQUEST FOR INFORMATION

Post-implementation Review (PIR) of IFRS 9 – CLASSIFICATION AND MEASUREMENT

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INTRODUCTION AND GENERAL COMMENTS

Follow-up on the comments shared during the outreach phase

EFAMA is grateful for the opportunity to comment on the International Accounting Standards Board (IASB) Request for Information (RFI) on the Post-Implementation Review of IFRS 9.

During the outreach phase of this project, we shared some initial remarks with the IASB's team in charge of this PIR and explained that there is a revived interest in this topic especially in a context where at the EU level we see **the Commission has been pushing for long-term investment to the real economy.**

The key concerns of the industry concerning IFRS9 are the removal of recycling in particular for institutional investors, and the classification of investment entities and investment funds as debt instruments. When institutions (e.g. banks, pension plans, insurance companies) decide to invest in equities through an open-ended investment fund that interest becomes a debt instrument and needs to be accounted as a debt instrument irrespective of the economic substance of such investments.

Currently, **insurance companies are probably the main category of companies that are looking to implement IFRS9 with the new IFRS17 standard** – the European Insurance and Occupational Pensions Authority (EIOPA) is looking into an update of the regulatory capital requirements to make it easier for these companies to invest into equities by reducing their capital charge requirement. **The IFRS accounting of these positions is still challenging because**, even if the regulatory capital requirements are being eased **when they invest in equities they have to account through P&L, which results in volatility at certain times of the year**.

The same comments/challenges apply to certain funds when investing in equities as they have to account for them as a debt instrument and, if this type of instrument fails to pass the SPPI (Solely Payment of Principal and Interest) test they have to account for it at fair value.

This remains a significant challenge for the industry. Before IFRS9 was implemented institutional investors **were able to** buy into funds equities for long-term purposes**, present the fair value changes on the other statement of comprehensive income and were able to recycle it when sold.**

We understand there is a lot of research done on recycling (with pros and cons) and **EFAMA's position is that funds should be classified as equity (because that is the economic substance of these instruments) and we propose the recognition of the investment entity as a way to allow the classification.**

Secondly, we understand **the IASB should reconsider the reintroduction of recycling** because the **current approach deters investments in the real economy and makes it difficult for certain institutional investors (e.g. insurance companies) to invest in equity**.

EFAMA understands the aim of the PIR is to understand how these requirements are being applied in practice and get evidence on the effects of its application. **The IASB's team already took the opportunity to discuss concerns of EFAMA members with IFRS9 / volatility in P&L** – because these debt instruments (or other investments) are being classified/measured at fair value through P&L.

The IASB is focused on three questions: i) Is the standard achieving the objectives that IASB wanted to achieve when IFRS9 was issued? ii) Are the IFRS9 requirements capable of being applied consistently? Is the standard clear with enough application guidance, or do we see diversity in practice? iii) Are there any uninspected outcomes?

To clarify the debate we have explained the real problem for our industry is the unequal treatment of the investments. If you structure your equity investment through a fund or you hold it directly we see there is a different treatment from an accounting perspective.

This unequal accounting treatment of funds and equity holdings (direct/indirect investments) under **this standard leads institutional investors (that don't like to have volatility in P&L) to stop investing in funds (and this is detrimental for the asset management industry).**

The main impact is for the investor's reporting on their investments, especially some institutional investors e.g. insurance companies that have raised issues with the standard.

In a nutshell, the main concerns shared in the past by these investors were related to the **unintended consequences deriving from the aforementioned unequal treatment of funds and equity holdings under this standard that would lead them to stop investing in funds (which would be detrimental for the asset management industry).**

EFAMA takes the opportunity to reiterate the **main consequences:**

- **for the fund industry**, a significant **loss of assets under management**;
- **for the investors**, a **loss of investment expertise**, as they won't benefit from investment companies advice anymore if they do direct investments on their own
- **for the economy** a **reduction of long term investments** that are desperately needed and which are better made through the diversification and the hedging strategies of a fund than through direct holdings.

It is worth mentioning that most institutions already adopted these requirements but, Insurance Companies only have to adopt and apply the IFRS 9 requirements, as of January 2023. Hence, at this stage, we still do not have the full picture of the aforementioned impacts of the standard on the industry. **We can anticipate these challenges to get more topical throughout 2022.**

Below, especially in our reply to question 4 of the RFI, you will find a recap on EFAMA's key concerns and recommendations on IFRS 9.

EFAMA'S RECOMMENDATIONS

- IFRS 9 should be amended to allow classification of certain investments in investment funds as Equity Instruments and applying the fair value in other comprehensive income ("FVOCI") (with recycling) treatment (by amending IFRS 9.5.7.5) to include the new asset category "Investment Entity" holdings as defined in IFRS 10.
- Alternatively, EFAMA would suggest the IASB introduce a 'look through' approach in IAS 32.11 for classifying holdings in "Investment Entities". This look-through approach would result in a debt classification for instruments passing the IFRS 9 SPPI test and an equity classification for anything else. Subsequent changes will also be required to IFRS 9 to recognise this revised approach.

List of EFAMA's comment papers on IFRS 9 previously shared with the relevant organisations (IASB, EFRAG, ESMA, European Commission (EC):

i. *"The IFRS 9 Phase 1 implementation will have a **negative impact on asset management industry**"* – a publication from May 2016 – EFAMA's comments are available here.

ii. **Impairment and Recycling:** EFRAG's Discussion Paper regarding the *"Impairment and Recycling of Equity Instruments"* – May 2018 – more info here. EFAMA's comments are available here.

iii. IASB's Discussion Paper regarding ***Financial Instruments with Characteristics of Equity*** *(FICE)* – December 2018 – more info here. EFAMA's comments are available here.[1]

iv. EFRAG's consultation on *"**Equity Instruments – Research on Measurement**"* – July 2019. EFAMA's comments are available here.

v. ESMA's Survey on *"collection of evidence on undue **short-term pressure from the financial sector on corporations**"* – July 2019. EFAMA's comments are available here.

vi. EC's consultation on the **renewed sustainable finance strategy** – July 2020. EFAMA's comments are available here.

EFAMA's reply to the questions for respondents

Besides the aforementioned general comments, EFAMA takes the opportunity to comment more in detail on the specific questions set out in the Request for Information.

Question 1 — Classification and measurement
Do the classification and measurement requirements in IFRS 9:

(a) enable an entity to align the measurement of financial assets with the cash flow characteristics of the assets and how the entity expects to manage them? Why or why not?

(b) result in an entity providing useful information to the users of the financial statements about the amount, timing and uncertainty of future cash flows? Why or why not?

Please provide information about the effects of the classification and measurement changes introduced by IFRS 9, including the ongoing costs and benefits in preparing, auditing, enforcing or using information about financial instruments. This question aims to help the Board understand respondents' overall views and experiences relating to the IFRS 9 classification and measurement requirements. Sections 2–8 seek more detailed information on the specific requirements.

No comments.

[1] When commenting on this initiative EFAMA insisted on the puttable exception. Paragraphs 16A to 16D of IAS 32 provide for an accounting treatment that is very relevant for the investment fund industry and should be retained unless the IASB is able to find another solution.

Question 2 — Business model for managing financial assets

(a) Is the business model assessment working as the Board intended? Why or why not?

Please explain whether requiring entities to classify and measure financial assets based on the business model assessment achieves the Board's objective of entities providing users of financial statements with useful information about how an entity manages its financial assets to generate cash flows.

(b) Can the business model assessment be applied consistently? Why or why not?

Please explain whether the distinction between the different business models in IFRS 9 is clear and whether the application guidance on the evidence an entity considers in determining the business model is sufficient. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) Are there any unexpected effects arising from the business model assessment? How significant are these effects?

Please explain the costs and benefits of the business model assessment, considering any financial reporting or operational effects for preparers of financial statements, users of financial statements, auditors or regulators. In responding to (a)–(c), please include information about reclassification of financial assets (see Spotlight 2).

No comments.

Question 3 — Contractual cash flow characteristics

(a) Is the cash flow characteristics assessment working as the Board intended? Why or why not?
Please explain whether requiring entities to classify and measure a financial asset considering the asset's cash flow characteristics achieves the Board's objective of entities providing users of financial statements with useful information about the amount, timing and uncertainty of future cash flows. If, in your view, useful information could be provided about a financial asset with cash flows that are not SPPI applying IFRS 9 (that is, an asset that is required to be measured at fair value through profit or loss applying IFRS 9) by applying a different measurement approach (that is, using amortised cost or fair value through OCI) please explain:

i. why the asset is required to be measured at fair value through profit or loss (that is, why, applying IFRS 9, the entity concludes that the asset has cash flows that are not SPPI).

ii. which measurement approach you think could provide useful information about the asset and why, including an explanation of how that approach would apply. For example, please explain how you would apply the amortised cost measurement requirements to the asset (in particular, if cash flows are subject to variability other than credit risk).

(See Section 7 for more questions about applying the effective interest method.)

(b) Can the cash flow characteristics assessment be applied consistently? Why or why not?
Please explain whether the requirements are clear and comprehensive enough to enable the assessment to be applied in a consistent manner to all financial assets within the scope of IFRS 9 (including financial assets with new product features such as sustainability-linked features). If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

(c) Are there any unexpected effects arising from the cash flow characteristics assessment? How significant are these effects?
Please explain the costs and benefits of the contractual cash flow assessment, considering any financial reporting effects or operational effects for preparers of financial statements, users of financial statements, auditors or regulators.

In responding to (a)–(c), please include information about financial instruments with sustainability-linked features (see Spotlight 3.1) and contractually linked instruments (see Spotlight 3.2).

No comments.

Question 4 — Equity instruments and other comprehensive income

(a) Is the option to present fair value changes on investments in equity instruments in OCI working as the Board intended? Why or why not?

Please explain whether the information about investments in equity instruments prepared applying IFRS 9 is useful to users of financial statements (considering both (i) equity instruments measured at fair value through profit and loss; and (ii) equity instruments to which the OCI presentation option has been applied).

For equity instruments to which the OCI presentation option has been applied, please explain whether information about those investments is useful considering the types of investments for which the Board intended the option to apply, the prohibition from recycling gains and **losses on disposal and the disclosures required by IFRS 7.**

(b) For what equity instruments do entities elect to present fair value changes in OCI?

Please explain the characteristics of these equity instruments, an entity's reason for choosing to use the option for those instruments, and what proportion of the entity's equity investment portfolio comprises those instruments.

(c) Are there any unexpected effects arising from the option to present fair value changes on investments in equity instruments in OCI? How significant are these effects?

Please explain whether the requirements introduced by IFRS 9 had any effects on entities' investment decisions. If yes, why, how and to what extent? Please provide any available evidence supporting your response which will enable the Board to understand the context and significance of the effects.

In responding to (a)–(c), please include information about recycling of gains and losses (see Spotlight 4).

[EFAMA comments on question 4]

Please refer to EFAMA's recommendations in the introductory section.

Unequal treatment of direct and indirect investments

Under IFRS9, investors investing in investment funds must recognize changes in fair value in profit and loss as they arrive ("FVPL") concerning investments in redeemable preferred shares and puttable instruments, that give the holder the right to give the instrument back to the issuer.[2]

The standard provides the entity holding equity instruments with the possibility to make an irrevocable election at initial recognition to present changes in fair value in other comprehensive income **("FVOCI election")**, but **this option does not exist for a holding in an open-ended investment fund units even if the respective investment fund is mainly invested in equity.[3]**

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[2] The definition of "puttable instruments" includes mutual fund units which leads to a significant impact of IFRS 9 for EFAMA's members.

[3] The FVOCI election is not available to mutual fund units that are mainly open ended funds with puttable features, even if the respective investment fund is mainly invested in equities, as these instruments are classified as debt instruments based on the definition in IAS 32.11.

This **unequal treatment of direct and indirect investments should be fixed to avoid unintended consequences for institutional investors** (e.g. higher administrative costs, loss of diversification and hedging of assets, higher management costs, less professional management of portfolio investments).

Accounting neutrality in respect to investment funds (investment entities)

Economically, there is no difference between direct investments in equity and indirect investments via equity funds. For example, most countries within the OECD have a tax system that should, in principle, treat direct investments and investments through a Collective Investment Vehicle (CIV) equally, to maintain *"the economic efficiency and other advantages CIVs provide".*[4]

Furthermore, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS), which brings together over 125 countries and jurisdictions to collaborate on the implementation of the BEPS Package, already agreed that *"[t]he need to preserve the tax neutrality in respect of investment funds is a widely recognised principle that underpins the design of the international tax rules"* [5]. **The** same **need to preserve neutrality between direct and indirect investments should** also **underpin the design of international accounting standards**.

To level/keep the neutrality on the accounting treatment of direct and indirect investments, **funds (as indirect investments in equity) should benefit from FVOCI under IFRS 9.** We also re-emphasise the importance of considering the re-introduction of the recycling option for FVOCI gains and losses arising from the disposal of equity instruments not held for trading, as per the recent technical advice issued to the European Commission by EFRAG.

EFRAG's draft comment letter to this request for information is available here – and **EFAMA members concerns were also acknowledged with EFRAG considering the IASB should review the non-recycling treatment of equity instruments within IFRS9.**

For EFAMA, the accounting option (to use FVOCI with recycling) would provide a far more accurate picture of the overall activities carried out by investors intending to hold equity funds on a long-term basis. Solid impairment provisions on potential losses should be introduced (as an efficient means to avoiding the potential risk of "earnings management").

Any different accounting treatment for equity instruments held in a long-term investment business model should also be made available for equity-type instruments (puttable instruments from the holders' perspective such as units in investment funds) and debt instruments with equity-like features (e.g. profit linked notes) that fail the SPPI (Solely Payment of Principal and Interest) test.

Question 5 — Financial liabilities and own credit

(a) Are the requirements for presenting the effects of own credit in OCI working as the Board intended? Why or why not?

Please explain whether the requirements, including the related disclosure requirements, achieved the Board's objective, in particular, whether the requirements capture the appropriate population of financial liabilities.

[4] OECD 2010 CIV report *"The granting of treaty benefits with respect to the income of collective vehicles",* 23 April 2010, Section I, para. 1

[5] OECD (2020), *"Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS, OECD/G20 Base Erosion and Profit Shifting Project"*, OECD Publishing, Paris – section 2.3, para. 76

(b) Are there any other matters relating to financial liabilities that you think the Board should consider as part of this post-implementation review (apart from modifications, which are discussed in Section 6)?

Please explain the matter and why it relates to the assessments the Board makes in a post-implementation review.

No comments.

Question 6 — Modifications to contractual cash flows

(a) ***Are the requirements for modifications to contractual cash flows working as the Board intended? Why or why not?***
Please explain what changes you consider to be modifications of a financial asset for the purpose of applying paragraph 5.4.3 of IFRS 9 and as a modification of a financial liability for the purpose of applying paragraph 3.3.2 of IFRS 9. Does the application of those paragraphs, and the disclosure requirements related to modifications, result in useful information for users of financial statements?

(b) ***Can the requirements for modifications to contractual cash flows be applied consistently? Why or why not?***
Please explain whether the requirements enable entities to assess in a consistent manner whether a financial asset or a financial liability is modified and whether a modification results in derecognition. Have the requirements been applied differently to financial assets and financial liabilities? If diversity in practice exists, please explain how pervasive the diversity is and its effects on entities' financial statements.

No comments.

Question 7 — Amortised cost and the effective interest method

(a) Is the effective interest method working as the Board intended? Why or why not?

Please explain whether applying the requirements results in useful information for users of financial statements about the amount, timing and uncertainty of future cash flows of the financial instruments that are measured applying the effective interest method.

(b) Can the effective interest method be applied consistently? Why or why not?

Please explain the types of changes in contractual cash flows for which entities apply paragraph B5.4.5 of IFRS 9 or paragraph B5.4.6 of IFRS 9 (the 'catch-up adjustment') and whether there is diversity in practice in determining when those paragraphs apply. Please also explain the line item in profit or loss in which the catch-up adjustments are presented and how significant these adjustments typically are. If diversity in practice exists, please explain how pervasive the diversity is and its effect on entities' financial statements.

In responding to questions (a)–(b), please include information about interest rates subject to conditions and estimating future cash flows (see Spotlight 7).

No comments.

Question 8 —Transition

(a) ***Did the transition requirements work as the Board intended? Why or why not?***
Please explain whether the combination of the relief from restating comparative information and the requirement for transition disclosures achieved an appropriate balance between reducing costs for preparers of financial statements and providing useful information to users of financial statements. Please also explain whether, and for what requirements, the Board could have provided additional transition reliefs without significantly reducing the usefulness of information for users of financial statements.

(b) ***Were there any unexpected effects of, or challenges with, applying the transition requirements? Why or why not?***
Please explain any unexpected effects or challenges preparers of financial statements faced applying the classification and measurement requirements retrospectively. How were those challenges overcome?

No comments.

Question 9 — Other matters

(a) ***Are there any further matters that you think the Board should examine as part of the post-implementation review of the classification and measurement requirements in IFRS 9? If yes, what are those matters and why should they be examined?***
Please explain why those matters should be considered in the context of the purpose of the post-implementation review, and the pervasiveness of any matter raised. Please provide examples and supporting evidence when relevant.

(b) ***Considering the Board's approach to developing IFRS 9 in general, do you have any views on lessons learned that could provide helpful input to the Board's future standard-setting projects?***

No comments.

About EFAMA:

EFAMA is the voice of the European investment management industry, which manages over EUR 27 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

More information is available at www.efama.org.

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