efama

European Fund and Asset Management Association

THE IFRS 9 PHASE 1 IMPLEMENTATION WILL HAVE A NEGATIVE IMPACT ON ASSET MANAGEMENT INDUSTRY

This memo covers investments in collective investment vehicles (CIV) in contractual, trust, or corporate form (simply referred as funds) from corporate and institutional investors acting on their own account (e.g. banks, life insurers, industry companies, etc.) and the accounting treatment of such investments under the upcoming IRFS 9 rules.

While IFRS 9 contains many positive evolutions, many of our members have been warned by their client investors that IFRS 9 would change their attitude towards investing in funds. Effectively, IFRS 9 would breach the overarching principle that the regulation should not create any distortion between direct holdings or investments through a fund vehicle.

IFRS 9, as it stands today, would disadvantage fund investors by not allowing them with any option with regards to the accounting methodology used. This comparative disadvantage for investment funds adversely affects the economic efficiency and should be avoided. **Therefore, EFAMA urgently presses authorities to clarify the situation of funds under IFRS 9 before endorsing this new norm.**

Context: current accounting regime for investments in funds

According to the current accounting standard IAS 39, companies have several options to classify their financial assets. Four categories of financial instruments exist concerning financial assets: Loans and Receivables (L&R), available for sale (AFS), held to maturity (HTM) or at fair value through profit or loss (either designated as such at initial recognition or held for trading ("FVTPL"). The assets classification determines the measurement models that are applicable to each investment.

Funds can be classified into the following categories:

- FVTPL: Investments in funds will be measured at fair value through profit and loss accounts (FVPNL) which is not preferred, especially by long term investors, because volatility investment portfolio value is reflected by a volatility of the net results posted by the company.
- Available for Sale: Investments in funds will be measured at Fair Value through Other Comprehensive Income (FVOCI) which allows fair value changes to be recorded in other

comprehensive income unless the asset is impaired. IAS 39 requires a financial instrument to be impaired only if there is a significant and prolonged decline in the fair value of the asset. At the time of sale the effective result is recycled in the profit and loss account.

- L&R and HTM categories are not permissible for investments in funds as do not have fixed or determinable payments and fixed maturity.

Mutual fund investors' investment strategies are often long-term rather than short term profit taking and thus in practice, **funds' investors often use the "Available for Sale" category in order to benefit from the FVOCI with recycling in P/L when sold** as this better corresponds with their long term investment strategy. For long term investors, their business model foresees the possibility to regularly include capital gains or losses in their result. The current low interest rate environment underlines the practical relevance of this approach.

About IFRS 9

IFRS 9 will be implemented on 01/01/2018. For insurance companies the initial application of IFRS 9 is expected to be delayed as they would only be required to implement IFRS 9 together with the new insurance standard. However, some European insurance companies may want to early adopt IFRS 9 accounting rules as soon as it will be endorsed by EU.

Following IFRS 9 implementation, methods of asset classification will be changed: Loans and Receivables (L&R), available for sale (AFS), held to maturity (HTM) and held for trading (HTF) categories will be discontinued. Loans and bonds will be either considered at amortised cost (hold and collect) or FVOCI with recycling in P/L (hold and collect and sell) provided they meet the SPPI (Solely Payment of Principal and Interest) test. FVOCI without recycling possibility will be the methodology for equities that are not held in a trading portfolio. All other assets are considered under a FVPTL approach, which is accessible on option for all assets.

Under the IRFS 9 norm, the FVTPL becomes the unique methodology for funds. The FVOCI is theoretically available for funds only if the investor opts for this treatment and the instrument is an equity instrument in accordance with IAS 32. Furthermore the recycling of the capital gain or loss in the P/L account when realized is no longer authorized for equities, irrespective of the investment horizon or objectives. FVOCI with recycling is not available for funds because they do not meet the SPPI test.

Why such a problem?

In practice, investments in funds will not be eligible anymore to FVOCI measurement method, because they may not pass the SPPI test:

- Fund shares are not considered as equity instruments under IFRS 9 if the instruments include a contractual obligation. BC 5.21, a comment under IFRS 9, considers that the FVOCI option is only available for equity instruments that comply with the definition of equity instruments in accordance with IAS 32.11. Whilst puttable instruments may be presented as equity for accounting purposes, if they meet all the criteria in IAS 32.16A and 16B, they do not meet the definition of equity under IAS 32.11. Therefore, an entity cannot apply the FVOCI option for equity instruments, and the puttable shares should be measured at FVPNL. The same applies for funds with an obligation to deliver a pro rata share of the net assets on liquidation.

- as debt instruments, puttable shares do not fill the SPPI criteria (which would allow FVOCI with recycling in P/L);

- Under the upcoming accounting norm, investors are left with no alternative than to account their investments in funds in FVPNL, which is not preferred because volatility investment portfolio value is reflected by a volatility of the net results posted by the company.

On the other hand, direct investment in bonds and equity (i.e. the underlying securities of their traditional funds' investments) will be eligible to FVOCI measurement method if the OCI-option is elected for equity instruments or if the business model hold to collect and sale for bonds applies.

This situation creates a competitive disadvantage for investment funds when FVOCI is of importance to the investor: investors will liquidate their positions in funds and do direct investments, in order to avoid introducing an undue volatility in their profits figures. The main consequences would be:

- 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.

The second difficulty results from the impossibility for funds to be at par with direct investment when considering recycling in P/L when investors dispose of their units or shares of funds. This is an authorized option for loans and receivables held with a view to hold and collect and sell. It is not authorized for funds which are, by nature, not able to pass the SPPI test.

What would be the solution?

1. Basically, the first issue mainly comes from the inability to classify certain fund shares as Equity Instruments. An exemption for fund shares, unit trusts and similar entities would solve the issue in the long term for the asset management industry.

   The standard could be amended as follows:

   > *IFRS 9.5.7.5: At initial recognition, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument within the scope of this standard,* ***an investment entity as defined under IFRS 10 (e.g. collective investment vehicles (CIV) in contractual, trust, or corporate form)*** *that is neither […]*

2. In order for funds not to be at a loss when compared to direct investment, profits or losses realised on funds units or shares should be allowed to recycle in P/L when accounted for at FVOCI. This is allowed for loans and bonds and we consider that the suggestion made by EFRAG (B.1.6 §41, p. 26) in its endorsement advice to introduce an option for a look through approach for funds would re-establish a level playing field. We believe that it should be optional in order to apply only in those cases where the administrative burden that it implies would be acceptable and to those clients that wish to do so.

3. As for the recycling possibility for equities when FVOCI is available, the point is made by EFRAG in its endorsement advise when discussing the shortcomings of proposed IFRS 9 for long term investors in B.1.6 page 25 §§ 39 and 40. Our members are very apprehensive of the immediate impact of the prospect of IFRS 9 being endorsed as it stands without a carve out for long term investors: amounts in billions are poised to be withdrawn from funds. EFRAG noted (§ 61 p. 70) that this creates a divergence with US GAAP and adds in its assessment of the impact on investors (§§ 84 to 88 pp. 74/75) that it would dramatically impact the business model of long term investors. EFAMA shares this analysis and suggests that a carve out for long term investors be introduced.

***

Brussels, 12 May 2016