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November 20, 2015

Roger Marshall and Francoise Flores
Acting President and Chair
European Financial Reporting Advisory Group
Square De Meeûs 35, 1000
1000 Ville de Bruxelles
Belgium

Re: EFRAG Draft Letter to European Commission on Adoption of IFRS 9

Dear Mr. Marshall and Ms. Flores,

The CFA Institute[1] appreciates the opportunity to comment on the European Financial Reporting Advisory Group (EFRAG) draft letter to European Commission on adoption of International Financial Reporting Standards Statement 9, *Financial Instruments* (IFRS 9) (herein referred to as 'EC letter').

CFA Institute is comprised of more than 130,000 investment professional members, including portfolio managers, investment analysts, and advisors, worldwide. CFA Institute seeks to promote fair and transparent global capital markets and to advocate for investor protections. An integral part of our efforts toward meeting those goals is ensuring that the quality of corporate financial reporting and disclosures provided to investors and other end users is of high quality.

OUR RESPONSE

In our response to EFRAG's draft endorsement advise on IFRS 9 (see excerpt in **Appendix**), we expressed our opposition to the deferral of IFRS 9, as we are not persuaded by the significance of the asserted concerns. Our opposition to the deferral beyond 2018 was for the following reasons:

- Significant uncertainty associated with the timing of completion of the insurance standard (IFRS 4, *Insurance Contracts*);
- Asset classification and measurement improvements are beneficial for investors on a stand-alone basis; and
- Need to consider investors ability to discriminate between economic versus accounting mismatches.

As an alternative to the deferral in the adoption of IFRS 9, we proposed the allowance of a one-time reclassification safe harbor once IFRS 4 is completed. As we understand, in response to the diversity of perspectives and strongly held opinions on this matter, EFRAG had some limited

[1] With offices in Charlottesville, New York, London, Brussels, Hong Kong, Mumbai, Beijing, CFA Institute is a global, not-for-profit professional association of more than 130,000 investment analysts, portfolio managers, investment advisors, and other investment professionals in 150 countries, of whom nearly 123,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 144 member societies in 69 countries and territories.

outreach to stakeholders including a few sell-side analysts in certain European countries. In addition, the IASB did extend its outreach to approximately 250 investors and is in the process of issuing an exposure draft that is due to be issued in December 2015 with a 60 day comment period.

A timely and effective implementation of IFRS 9 is a desired outcome by investors given the widespread use of financial instruments by financial institutions and across many other business models and due to the well-chronicled deficiencies of existing financial instruments accounting. Given investors' interest in the timely of adoption of IFRS 9 for all reporting entities, we are thankful for the opportunity to respond to EFRAG's preliminary view on IFRS 9 adoption for insurance companies as articulated in the November 2015 letter to the European Commission (EC letter).

In this response, we make three key points namely: a) EFRAG's articulation of its preliminary view is short on evidence; b) preliminary view does not adequately incorporate investor perspectives; and c) timing of European institutions decision-making should align with IASB due process for standard setting efficiency.

Articulation of Preliminary View Short on Evidence

A high level summary of the two possible alternative approaches ('deferral' versus 'overlay') as provided in the EC letter is simply not sufficient to facilitate a comparison and evaluation of the relative merits underpinning either of these alternatives being posited. While there may be legitimate claims of incremental net income volatility due to the reclassification to fair value through profit or loss (FVTPL) of items that are classified as either amortised cost or fair value through other comprehensive income (FVOCI) under IAS 39, there is hardly any empirical demonstration of the magnitude or pervasiveness of these asserted impacts and it is unclear whether the concerns mentioned in the EC letter can be generalized to the full universe of insurance companies and/or banks with bancassurance business models. Similarly, there hasn't been a transparent quantification of the anticipated incremental costs nor has there been a clear articulation of any anticipated operational complexities due to adopting IFRS 9 and IFRS 4 at different dates.

Evidence Related to Deferral Approach - The EC letter states the following

> "*EFRAG assesses, on a very preliminary basis, that the IFRS 4 amendments, if finalized on the basis of current IASB tentative decisions, would not allow EFRAG to lift reservations included in its endorsement advice of IFRS 9.*"

The main point of contention within the expressed preliminary view seems to revolve around IASB's tentative decision to apply the deferral approach at reporting entity level once it has been determined that insurance activities are predominant within a reporting entity's business model.

EFRAG seems to be arguing for the consideration of deferral at below reporting entity level even if this results in a situation of where a reporting entity will adopt IAS 39 for some transactions and IFRS 9 for other transactions. The arguments put forward seem to be around their being concerns for conglomerates with insurance activities not being eligible to defer the adoption of IFRS 9.

Conversely, insurance companies with a bancassurance business model not being able to apply IFRS 9 for any of their banking book activities in 2018.

However, there is no practical illustration of the impacts and relative merits of an alternative of deferral occurring at below reporting entity level and especially if/how these would impact on consistent application of accounting principles and comparability in the reporting of transactions within and across reporting entities. It is not clear to investors what will be the reporting outcomes if two different standards (IAS 39 and IFRS 9) are applied at the same time across a portfolio of financial instruments, as seems likely to be the case if deferral occurs at below reporting entity level. In addition, there will be a question of to what extent will there be transparency for investors on situations of where similar financial instruments within the same reporting entity will end up have differing accounting treatments depending on whether they are deemed to be related to either insurance or banking activities? In other words, there could be a situation of swapping one type of complexity for another without presenting adequate evidence for investors to fully judge the implications of the alternative being considered.

Furthermore, in EFRAG's seemingly preferred approach (deferral at below reporting entity level), where reporting entities will have to apply IFRS 9 for some financial instruments, there is a need to demonstrate the difference between the incremental implementation costs related to IFRS 9 being applied for some financial instruments versus the costs for it being applied to all financial instruments. In other words, in this instance, EFRAG seems comfortable with a different version of a two stage IFRS 9 implementation for insurance entities with banking activities (i.e. IFRS 9 for non-insurance activities financial instruments in 2018, IFRS 9 for all financial instruments in 2021). However, it is not apparent for investors why the incremental implementation costs concerns for a two stage implementation are less pronounced for this alternative approach. In general, there is need to fully clarify the effects of any alternative that requires the concurrent application of IAS 39 and IFRS 9 across a portfolio of financial instruments within the same reporting entity. This clarification is especially necessary because IAS 39 and IFRS 9 requirements encompass and have differing treatment of financial instruments classification, financial asset impairments and hedge accounting.

Evidence Related to Overlay Approach- The preliminary view presents a rather high level critique of the 'overlay' approach, which as we understand it will require insurance companies to adopt IFRS 9 in 2018 and would have alleviated[2] the expressed concerns about incremental net income volatility. Unfortunately, the critique mainly revolves around an anecdotal articulation of concerns on insurance companies' implementation costs. EFRAG also asserts that it has heard that IAS 39 and IFRS 9 would have to be run in parallel for the assets to which the overlay approach is applied.

Overall, the preliminary view set forth in the EC letter seems to be putting forward an alternative 'deferral' approach, yet it fails to facilitate investors' ability to provide incremental feedback on this matter - in a manner that is based on any updated illustrative evidence of incremental costs and/or the alleged incremental volatility that insurers are assumed to be likely to face if IFRS 9 is adopted by all companies in 2018. In general, there is a need for a transparent demonstration and

[2] Within the overlay approach, any incremental IFRS 9 related volatility could be reflected in the Other Comprehensive Income (OCI) statement.

communication of any evidence that is available to EFRAG regarding incremental volatility, implementation costs and operational concerns. Such communication can be accomplished within the boundaries of respecting company specific confidentiality. Otherwise, it is puzzling how the EC and its related decision bodies would be able to come to a fully informed decision on this particular matter. This evidence related to the impacts of adopting IFRS 9 in 2018 is also required by all key stakeholders including investors to facilitate feedback.

Preliminary View Does Not Adequately Incorporate Investor Perspectives

Beyond the undemonstrated incremental volatility and implementation costs that are at the heart of EFRAG concerns (as evident from the questions posed in the EC letter), the letter crucially omits to mention or rather it does not convey if/how EFRAG's preliminary views have been informed by the user feedback gleaned from both its own and the IASB's outreach to a full spectrum of investors during the last few months. In addition, the questions posed mainly relate to implementation costs and there are no questions on the decision-usefulness of the preliminary view from a user standpoint.

In our July 2015 letter (see excerpt in **Appendix**), we put forward investor-oriented arguments against the deferral of IFRS 9 and highlighted the need to consider investor's ability to discriminate between accounting and economic volatility. Similarly, the IASB staff paper outlining the results of outreach to 250 users reveals that accounting volatility for insurance companies is not a concern for many investors. The staff paper also outlines user perspectives when asked to give their relative preferences for the deferral and overlay approaches. The articulated user preferences (e.g. on the overlay approach and reporting entity for deferral approach) are not aligned with EFRAG's preferred approach expressed in the preliminary view. Hence, it is not clear how much weight EFRAG gave to the overall investor feedback.

Timing of European Institution Decision-making Should Align with IASB Due Process for Standard Setting Efficiency

There seems to be a particular urgency for stakeholders to come to conclusions regarding the timing of insurance companies' adoption of IFRS 9 prior to the issuance of an IASB exposure draft (ED). This urgency is exemplified by the extremely short two week comment period allowed for the EC letter. As we understand, the EC letter expressing EFRAG's preliminary view has been issued to align with the timeframes of different EC financial reporting decision-making bodies (e.g. Accounting Regulatory Committee (ARC)). Nevertheless, the observed urgency is puzzling given that there are other implementation issues within IFRS 9 that are being addressed by the impairment transition resource group (TRG) and the resolution of these issues does not necessitate any pressures to alter the adoption date.

We are also not aware of any similar push by authorities in other IFRS jurisdictions for the IASB to expedite it's clarification of IFRS 9 adoption date on behalf of the insurance companies' domiciled within their countries or regions. Nor are we aware, of insurance company adoption date being a factor in determining the overall suitability of adopting IFRS 9 in other jurisdictions. Thus, it remains unclear what is the distinctive nature of European insurance companies that necessitates the overall angst on IFRS 9 adoption date within Europe.

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Finally, it is challenging for stakeholders and especially for investors to effectively allocate resources to reviewing and responding to these important proposals, if the main standard-setter and the organizations that are involved in the endorsement process reach out to investors at different junctures on the same issues and with varied levels of information of the proposed models being put forward. We expect that the IASB ED and underlying due process should allow for a transparent and inclusive sourcing and incorporation of stakeholder perspectives. Hence, we encourage EFRAG to update its views, come to conclusions after the issuance of an exposure draft and obtaining broad-based stakeholder views. We also encourage European financial reporting decision-making bodies (e.g. ARC) to align their timing to the IASB due process.

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Thank you again for the opportunity to comment on the assessment paper. If you or your staff have questions or seek further elaboration of our views, please contact either Vincent Papa, PhD, CFA, by phone at +44.207.330.9521, or by e-mail at vincent.papa@cfainstitute.org.

Sincerely,

/s/ Vincent Papa

Vincent Papa, CFA
Director, Financial Reporting Policy
Standards & Financial Markets Integrity Division
CFA Institute

cc: Sandra Peters, CPA, CFA; Head Financial Reporting Policy
cc: Corporate Disclosure Policy Council
cc: Hans Hoogervorst, Chairman International Accounting Standards Board
cc: Erik Nooteboom, DG Markt, Head of Unit Accounting and Auditing

APPENDIX

In our July 2015 comment letter on EFRAG's IFRS 9 draft endorsement advice we responded to the then expressed perceived benefits of a deferral including:

- Alleviating the expected incremental volatility for insurers that apply the cost model for their liabilities;
- Incremental costs of a staggered implementation of IFRS 9 and IFRS 4- *Insurance Contracts*; and
- Purported user difficulties in assessing the performance of insurance companies and concerns about the increase in non-GAAP measures.

We expressed our concerns and disagreement with the perceived benefits as shown below.

Significant Uncertainty Associated with the Timing of Completion of IFRS 4

As we understand a key motivation for the proposed deferral is the view that IFRS 9 and IFRS 4 should be adopted at the same date by insurance companies. Stakeholders, including users of financial statements, look forward to the overall update of IFRS standards including the adoption of IFRS 9 and completion of IFRS 4. However, we are not supportive of the proposed alignment in the adoption dates of these two standards for the following reasons:

- *Uncertainty on the timing of completion of IFRS 4*: Our opposition to the deferral is in large part influenced by the significant uncertainty associated with the completion of IFRS 4-, which has been under deliberation for 10+ years. To inextricably link, the completion of IFRS 9 to IFRS 4 will not only set a bad precedent, it will also contribute to a potentially highly inefficient standard-setting process and introduce a risk of needing to re-open IFRS 9 due to the emergence of insurance sector specific concerns.

- *Staggered rollout costs are not exceptional to the insurance industry:* All industries are faced with the reality of the need for a staggered roll-out of multiple accounting standards (IFRS 10, IFRS 15, IFRS 9) and the situation of adopting IFRS 9 and IFRS 4 at different dates should not be viewed as exceptional and unusual for the insurance industry.

Asset Measurement Improvements are Beneficial for Investors on a Stand-alone Basis

Further to the benefits of a deferral of IFRS 9 for insurance companies, the EFRAG assessment document also outlines several drawbacks associated with any such deferral. As users of financial statements, we give more weight to the following drawbacks that were also recognized by the EFRAG assessment document in the articulation of motivation for a deferral of IFRS 9:

- *Delaying the provision of improved financial instruments information*: Stakeholders anticipate that, when compared to current standards, IFRS 9 will result in a more timely reflection of changes in the value of assets - and this will result in an improvement in the existing financial reporting of assets. There are analytical benefits associated with the enhanced reporting of: a) individual income statement line items (i.e. asset re-measurements) and b) insurance company balance sheet assets. For example, the importance of balance sheet valuation as a valuation input for insurance companies can be inferred from a Columbia University research paper-*Relative Valuation of Insurance Companies,* which shows that relative valuation models (i.e. valuation based on multiples such as Price to Book ratios (P/B)) have higher predictive power when fair value re-measurements of financial assets are reflected on the balance sheet. The study shows that when the book value, which is the denominator of P/B, includes accumulated unrealized other comprehensive gains or losses (i.e. AOCI), it results in higher valuation predictive power, than where the investors strip out AOCI from the book value of equity whilst valuing insurance companies. In other words, the evidence shows that a balance sheet which fully reflects updated economic re-measurements of assets is more relevant for valuation purposes than one that does not.

- *Reduction in comparability across banks and insurance companies:* Cross-industry comparability is important for investors who typically hold cross-industry portfolios. The deferral of IFRS 9 will undermine the desirable cross-industry comparability that is expected from a common adoption date for all companies.

Need to Consider Investors Ability to Discriminate between Economic versus Accounting Mismatches

The principal argument put forward in favor of the deferral of IFRS 9, largely revolves around expected incremental volatility of net income due to accounting related asset/liability mismatches and the associated perceived difficulties investors will experience in judging the performance of insurance companies. It is presumed that this may then lead to the proliferation of non-GAAP measures. We are not persuaded by these concerns for the following reasons:

- *No demonstration of widespread and significant incremental earnings volatility*: A mismatch in the recognition and measurement of asset and liabilities already exists under the current reporting requirements. There is no widely available empirical evidence substantiating that projected incremental volatility will result from IFRS 9 requirements. Besides, investors already understand that there are differences between the economic asset-liability mismatches under the insurance business model and that these economic mismatches are different from the accounting mismatches reflected under the current reporting requirements. Investors will still be able to discriminate economic versus accounting mismatches under any updates to the accounting standards.

- *Limits to the ability of accounting to fully reflect economic asset/liability management*: The emphasis on reflecting asset/liability management (ALM) in a financial reporting context

seems misplaced because accounting information cannot reflect the full spectrum of economic ALM mismatches across the insurance company product and liability profile. In addition, there is yet to be established a robust conceptual basis of inextricably linking the measurement of assets and liabilities. That said, the emphasis on minimizing asset/liability accounting mismatches by the insurance industry is understandable and seems to have been accommodated by IFRS 9 requirements that include a fair value through OCI (FVOCI) classification category. We consider that having FVOCI as a classification category under IFRS 9 is as far as the financial instruments accounting standards should go.

- *Investors are sophisticated enough to identify economically relevant income statement line items:* In our opinion, EFRAG's assessment paper overstates the concerns about net income volatility- when such volatility is in fact driven by the inclusion of economically relevant individual line items. The arguments put forward do not seem to give adequate weight to the ability of investors to breakdown the components of the net income sub-total and to determine the individual income statement line items that they consider to be core performance line items and predictive of future cash flows. Besides, we are not aware of any analogous empirical evidence[3] that supports the notion that differing measurement attributes for assets and liabilities held in an ALM context, lowers the predictive value of reported earnings.

Non-GAAP measures growth are not driven by investor concerns on accounting mismatches: The inference made within the articulated benefits for deferral, is that reporting of relevant line items within the income statement can be a root cause for the proliferation of non-GAAP measures. This inference is highly debatable. There is no evidence that non-GAAP measures are investor demand driven whenever reported but rather these measures tend to represent how management wants their performance to be viewed by investors and there are many cases where these measures are actually presented in a biased fashion and with a distortion of a business model's economic reality. We do not disagree that there is need for standard setters to define performance within the conceptual framework and to consider how performance is represented within the financial statements under the financial statement presentation project. However, we anticipate that even such clarity and enhanced financial statement presentation is unlikely to eliminate the reporting of non-GAAP measures. Hence, delaying improved reporting of individual income statement line item due to concerns about non-GAAP measures is likely to be a *red-herring* argument.

[3] We recognize that robust empirical evidence related to IFRS 9 can only be obtained after its adoption. But analogous evidence is the type that would show that earnings quality (i.e. predictive quality) diminishes whenever fair value recognition through profit and loss for assets and not liabilities occurs and that such differential measurement basis for the assets and liabilities is occurring in the context of an asset/liability managed business model. We are not aware of any such evidence.