OECD round table on long-term investing—Singapore, 4 June 2014

Prepared opening remarks by Philippe Danjou, member of the IASB

Good morning, ladies and gentlemen.

It is often said that IFRS discourages long-term investment by relying excessively on fair value or other forms of current measurement. Because markets are volatile, fair value accounting leads to volatility in financial statements which undercuts the long-term horizon of investors, so the argument goes. I wonder how many papers and reports have been written on this topic in the past few years. Views tend to be very polarised and are often expressed by people who do not distinguish between different factors.

In response, it is important to bring a more nuanced approach to the debate. I have four points to make, and I will be happy to engage further with my fellow panelists and the audience on each of them.

- **First, I fully agree that long-term investors are very important for economic growth and for the stability of markets**.

  At the IASB, we are well aware that long-term investing is high on the political agenda of the G20, the OECD and the European Commission. The best sources of long-term finance for companies are the equity and long-term bond markets. They are very much dependent on high quality financial reporting, which reflects economic reality as closely as possible. And we are here to develop financial reporting standards that help investors make sound capital allocation decisions.

But is there really a conflict between the accuracy of information given to investors and incentives to hold and manage long-term investments? Are the information needs of long-term investors any different to those of those investing for a shorter term? Both need to be able to rely on high quality, robust financial information and both prize high levels of transparency. Does the pilot of a long-haul flight require different information to that of a short-haul pilot? Surely, even the long-haul pilot needs frequent waypoints to make sure he remains on track to reach the final destination. The same is true with investing. And fair value does not create volatility, it only reflects it: if any pressure is put on banks to liquidate capital-intensive positions in order to protect capital when markets fall, this is all a function of regulatory capital rules, not of accounting.

However, wisdom and a degree of prudence are necessary for management and investors when making use of fair value-based information. Disclosures are important to explain what that information means and how it has been determined. Our Standards require entities to provide such disclosures; investors and management should carefully assess the information about fair value measurements.

Delivering high quality, transparent and comparable financial information is our mission. It contributes to sound investment decisions, and it reduces the cost of capital for long-term investors.

Banks and insurance companies suffer from low market-to-book-value ratios, in comparison to other industries, and this is usually explained by a lack of transparency in their financial reports. To deal with the

inevitable short-term volatility of financial markets, long-term investors should have solid equity cushions. The unpleasant truth is that many financial institutions that have the ambition to be long-term investors are too leveraged to do so. Looking for instance at two of the major French banks, their equity stands at 4 per cent and 5 per cent of total assets (not weighted for risks). Our largest insurance company has a 7 per cent equity to total assets ratio.

We believe that our new Standards will greatly improve the potential of the banking and insurance industries to be long-term investors, by making it easier for them to tap the capital markets and obtain the degree of capitalisation that is necessary to withstand the short-term volatility that is inherent to equity investments.

- **Second, what evidence exists that certain types of accounting methods, such as the use of fair value accounting, have contributed to short-termism in financial markets?**

  Not much! The problems of short-termism are deep-rooted and are driven by many factors, such as weaknesses in corporate governance, badly-designed financial incentives for management and staff, lack of incentives for asset managers to support long-term investment strategies, insufficient shareholder engagement, and perhaps a lack of prudence in the distribution of dividends. Accounting is a descriptive function and therefore its relevance to the challenges of short-termism in capital markets is marginal at best. Long-term investors cannot ignore present economic conditions and their likely evolution, even if they decide that those conditions are not relevant to their immediate

strategy. "*Those who care about the long term should also know where they stand today*[1]"(this was said in a speech by Mr Hugo BASSI, Director of Capital and Companies, European Commission, DG Markt).

Distributing dividends is a management decision based on legal considerations of distributable profits, not an accounting rule. Our Standards provide all the necessary information for management to analyse the sources of underlying profits and whether or not it is prudent to withhold or distribute them. Similar considerations apply to the payment of bonuses.

It is equally true that long-term investment decisions, and the assessment of their performance, are not based solely, or even mainly, on information of a financial nature. Investors use more and more non-financial information such as environmental and social responsibility. This is beyond the scope of our mission.

I have carefully read the "COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on Long-Term Financing of the European Economy[2]" published at the end of March, 2014. I did find very good ideas in it, but no conclusions about the role of fair value accounting with respect to long-term investing. To be specific, the two main action points noted in Chapter 7, which deals with accounting standards are the following:

[1] Speech at Chartered Accountants Hall, London, 9 April 2013
[2] http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014DC0168&from=EN

- *"In the framework of its endorsement of the revised IFRS 9, the Commission will consider whether the use of fair value in that standard is appropriate, in particular regarding long term investing business models.*
- *The Commission will invite the IASB to give due consideration to the effect of its decisions on the investment horizons of investors both in specific relevant projects and in its development of the Conceptual Framework, paying particular attention to the reintroduction of the concept of prudence".*

  I would like to note here that at a Board meeting two weeks ago, the IASB tentatively decided that the next due process document on its *Conceptual Framework*, an Exposure Draft, which is due to be published later this year, will include a proposal to reintroduce the concept of prudence and to reinstate stewardship as a key objective of financial reporting.

- **Third remark, the extent of fair value usage is much less than many believe. And where it applies, it does not always affect the profit and loss statement**.

  Outside of the financial services sector, the use of fair value is highly limited[3], and even within the banking sector, use of historic cost is far

[3] In industrial and commercial companies, the use of fair value accounting is limited to investment properties (an accounting option) and agricultural produce (IASB has recently modified IAS 41 *Agriculture* to revert to a cost approach for bearer biological assets). Derivatives are measured at fair value but hedge accounting neutralised the resulting volatility in the income statement); fair value is considered when writing down an asset in case of impairment, but the higher of fair value or value in use is retained. And fair values are recognised for assets and liabilities assumed in a business combination.

more widespread than the use of fair value[4]. Indeed, the issues in Europe with regard to the sovereign debt crisis, as well as with the sub-prime crisis, have related to the impairment of financial instruments that were mostly measured at cost.

Furthermore, long-term investors are only confronted by fair value accounting in a limited way. If they invest in fixed assets directly, amortised cost is the rule. If economic difficulties arise, impairment provisions are based on the higher of value in use or fair value. Value in use takes into account the re-estimated future cash flows over a long-term horizon. Equally, if they invest through corporate structures that they control or for which they have significant influence over the investee, fair value accounting does not come into play. If they finance through loans or acquisition of bonds on the primary market, amortised cost is the rule—provided the investor intends to hold the instrument and collect the cash flows, which seems inherent in the notion of long-term investment.

As part of our reforms following the financial crisis, we have taken steps to improve our accounting standards. Our new financial instruments accounting Standard, IFRS 9, confirms the use of a mixed measurement approach based on the business model followed by the entity with respect to its portfolios. It also has a more forward-looking credit risk impairment model.

[4] For instance, in the balance sheet at the end of 2013 of two large French banks Société Générale and BNP Paribas, the proportion of assets measured at fair value is 50%. But, when excluding derivatives and trading portfolios, the proportion falls somewhere between 20% and 25%. Those assets are mainly the portfolio of "available for sale" investments, mostly bonds. The situation of UK banks is similar.

With IFRS 13 *Fair Value Measurement*, we have also introduced substantial improvements to the application of fair value measurement, including requiring greater information to be provided about the assumptions made when applying fair value and the degree to which fair value measurements are based on observable market prices or on models[5].

In our revision to IAS 19 *Employee benefits* in 2011, we have decided that the changes in value of the net exposure of an entity to its defined benefits pension obligations, in response to market conditions, should be reported in Other Comprehensive Income (OCI). In contrast, the profit and loss statement will include only the service cost and the net interest on the net defined benefit asset or liability. We believe that this faithfully depicts the operating and financing expenses of an entity.

So, while fair value measurement is not perfect, allow me to paraphrase Churchill and to quote the economist Nicolas Véron, from the BRUEGEL Institute[6], "it is the worst form of measurement, apart from all of the others that have been tried".

- **Last, accounting standards are often a collateral victim of criticisms addressed at prudential regulations**, such as the Solvency II and Basel

[5] Where market prices are not observable, sensitivity analyses must be provided.

[6] "Fair value accounting is the wrong scapegoat for this crisis" BRUEGEL publications 29 May 2008.
This policy contribution by Nicolas Véron argues that in times of market disruption, no accounting standards could lead to consensual outcomes, and that fair value remains better than proposed alternatives. Rather than reducing its scope, policymakers should focus on capital requirements standards (Basel II), where the negative effects of pro-cyclicality are concentrated.
http://www.bruegel.org/publications/publication-detail/publication/19-fair-value-accounting-is-the-wrong-scapegoat-for-this-crisis/

requirements. In most of what I read in the past five years, the critics did not properly analyse the respective effects of the prudential and accounting requirements. I am not competent to assess the merits of the prudential regulations, but I am convinced that, together with tax incentives, or lack thereof, they have a much bigger impact on long-term investors than financial reporting.

So, to summarise my views—

- I do not believe long-term and short-term investors have different information needs
- I am not convinced that the use of fair value accounting has contributed in a material way to short-termism in markets, while the use of fair value is much less prevalent than many believe.
- Fair value accounting, where it is a relevant measure, enables transparent and timely reporting of the “bad news”, which is essential for sound investment decisions.
- In our plans to replace the Standards on financial instruments and insurance contracts, we do not intend to increase the use of fair value accounting.
- We want to better align the accounting rules with the business models of the banking industry, to make them more understandable, and we will make the financial reporting by insurance companies more transparent. I will provide more details about these two projects in our discussion later on today.

Detailed comments on new accounting Standards IFRS 4 *Insurance Contracts* and IFRS 9 *Financial Instruments*

A/IASB's plans to address volatility in a revised Standard for insurance contracts[7]

- **The Board does not intend to require that insurance liabilities are measured at any form of fair value or market value**. This idea was abandoned very early in our deliberations. Rather, we intend to propose that liabilities arising from insurance contracts are measured using a "building blocks approach" with four levels:
  - The first level is a best estimate of future cash outflows (claims and benefits) that will arise out of the insured risk, net of future inflows from the premiums to be received.
  - This will be discounted to present value (which is NOT FAIR VALUE) to reflect the time value of money. The selection of the appropriate discount rate has been subject to intense discussions with the industry and is still being debated by the IASB[8]. The basic idea is that discount rates should reflect the characteristics of the cash flows of the insurance contract, and should be consistent with market data, taking into account, where appropriate, the dependence of the liability to the return on underlying items.
  - The third level is the addition of a risk margin to reflect the cost of the uncertainty in the timing and amount of the future cash flow. You may call it "accounting prudence" if you wish.

[7] Exposure Draft *Insurance Contracts* (June 2013); comment period ended 25 October 2013. The Standard is expected to replace the current IFRS 4 which, when it was published in 2002, enabled existing practices to be maintained and was intended as a stopgap measure pending a more fundamental reassessment of the accounting for insurance contracts.

[8] One of the main criticisms of current accounting in many jurisdictions is that the interest rate used to discount an insurance contract is set at contract inception and is not updated unless there is evidence of loss. We propose that an insurance contract would be discounted using a current rate at the end of every reporting period. However, the effects of using a current value measure for the balance sheet would be separated into two elements for presentation in the statement of comprehensive income:

. The first element, which would be presented in profit or loss, represents the rate applied to discount the insurance contract liability at the date that a contract is initially recognised (the original rate).

. The second element would be presented in OCI. It represents the difference between the effects of discounting the insurance contract using a current rate in the balance sheet and the effects of discounting the insurance contract using the original rate in profit or loss.

- The fourth and last level is what we call “CSM” or contractual service margin, which is in effect a deferral of profit recognition. The idea is that on Day 1, when a company takes on a contract, the profit on the life of the contract (estimated by comparing the premiums to be received with the cash outflows) should not be recognised immediately; instead, it should be reported in profit and loss over the coverage period according to a pattern that depicts how the insurance service is provided.

This approach also does not attempt to model an exit price, ie the amount that a third party would be willing to pay to take on the insured risk. It is trying to depict as accurately as possible a fulfilment value and is to a large extent entity specific: the cash outflows and the risk margin will be determined according to the entity’s own data and will take into account the degree of diversification of its portfolios.

B/How did we address the volatility created by the changes in discount rates that are needed to keep the measurement current at each balance sheet date?

- We propose, by way of an accounting policy election, that the effect of remeasuring the liability using the new discount rate is accumulated in OCI, and it will stay there, because it will normally end up reversing to zero at the end of the period of coverage.
- We also propose that the profit margin that has been deferred on Day 1, and which is included in the liability, is used as a shock absorber when the estimated cash flows (the first building block) are re-estimated; only when there is no residual (CSM) margin will the variations hit the reported profit or loss.

C/We will also address the asset/liability management to avoid a mismatch in measurement. If liabilities are measured on a current basis with the most significant variations, which are the effect of changes in DR, being reported in OCI, the same should be possible on the assets side. Hence, we will allow financial assets are classified in the Fair Value through OCI category, provided that their cash flows meet the “solely capital and interests” test. If the asset/liability management strategy is efficient, both the assets and

liabilities should react in a correlated way to changes in market conditions and profit and loss should reflect only the economic mismatch.

The IASB is still debating the different possible solutions for contracts which provide for an amount based on the performance of a specific pool of assets, which is the so-called "mirroring approach"; that is, to eliminate mismatch by measuring and presenting cash flows in the same way as the underlying items, and also solutions for participating contracts outside the scope of mirroring.

The IASB has decided to postpone to 1 January 2018 the effective date of the new Standard IFRS 9 *Financial Instruments*, with the objective of aligning it with the effective date of the new Standard on insurance contracts. This will help to avoid a temporary accounting mismatch.

D/We do not intend to force insurance companies to mark to market their assets held with a long term view, except for their investments in equity instruments for which we do not believe that there is a realistic alternative measurement basis. Loans and other debt instruments (even if they are marketable securities) that have simple cash flows and are held within a business model that consists of "holding the asset to collect the contractual cash flows" will be measured at amortised cost, and a new impairment model will better reflect the assessment of deteriorations in credit risk. We will eliminate the "tainting rule" that has created trouble for the insurance industry. For investments in real estate properties, fair value measurement will remain an option. For investments in debt instruments that the investor holds as a liquidity reserve (the "hold to collect or sell" business model), they will be classified in the "fair value through OCI" category. They will be measured at fair value on the balance sheet, and the profit and loss statement will record the interest income and impairment losses, if there are any. The other variations due to market volatility will be recognized in OCI, and "recycled" to profit and loss only when the instrument is sold.

Finally, for investments in equity securities held for a purpose other than trading, we have decided that the entity can elect to classify them in the "fair value through OCI" category. This will combine a faithful measurement on the balance sheet with a "protection" of the

profit and loss against market volatility that may not properly depict the performance for the current financial period. But we are aware that the question of “recycling” gains and losses upon realisation is a matter of concern for some entities.

E/The IASB’s plans to address volatility affecting the banking business in the revised Standard for financial instruments

For financial assets, amortised cost is still the applicable accounting model for those which are issued, or acquired, in order to recover the capital and contractual interest though cash receipts over time. The “conventional” bank assets (eg loans and other receivables) and the bond investment portfolios held to maturity, which together represent the majority of the balance sheet of a bank, are still classified and stated at historical cost, provided the institution intends to keep them.

Structured or complex financial assets, which generate cash flows that do not depend only on capital and contractual interest representing the time value of money and credit risk, are stated at fair value, with changes in fair value reported in profit or loss. Indeed, a comparison with future cash flows, which is necessary to determine the possible impairment allowances, cannot be based on capital and interest, because the cash flows are significantly changed by the derivative instruments embedded in the contracts.

For assets held for trading purposes, and those that are managed on the basis of changes in fair value, changes in value are reported in the profit and loss account because this is consistent with the business model.

The IASB has decided, in its pending amendments to IFRS 9, to create a third accounting classification to be called “fair value through OCI” in order to reflect the interaction between the reporting of financial instruments held by insurance companies and the measurement proposed for their insurance liabilities. For the banks and the insurance companies as well, this classification would include the bond portfolios held either to collect

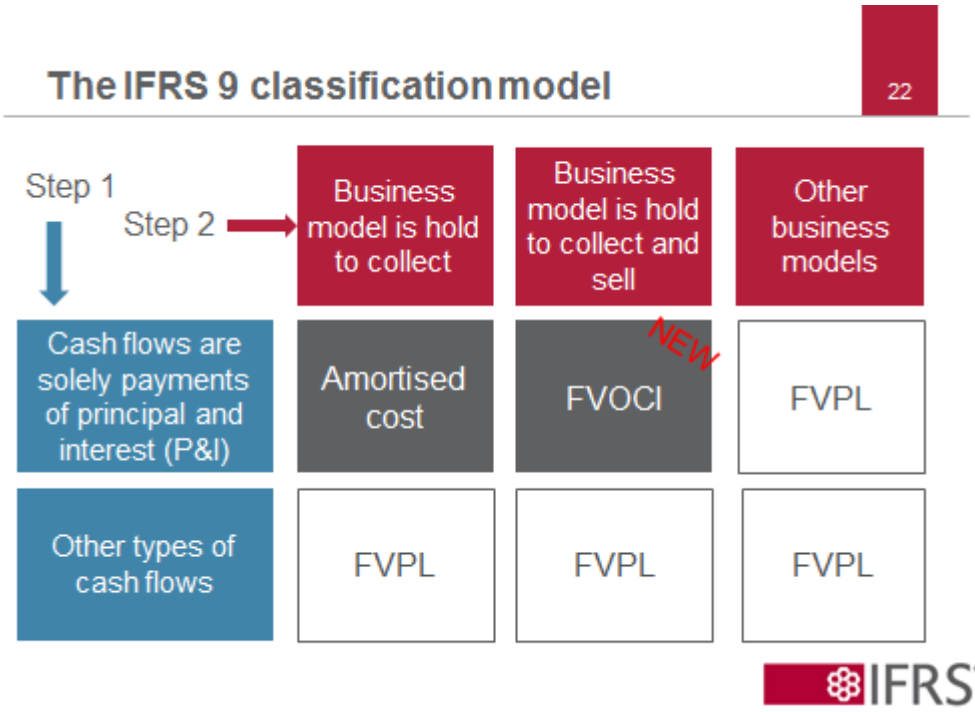
the cash flows or as “liquidity reserves”. The proposed classification of financial assets is therefore truly a matter of **reflecting the business model of an entity, while providing two types of useful information**: the fair value of instruments in the balance sheet, and the contractual interest income and loan loss provisions in the income statement.

Similarly, the accounting choice available to reflect the changes in the fair value of equity securities either in Profit or Loss or in OCI provides an opportunity to align the reporting with the way those investments are managed.

A summary of the IFRS 9 classification model is provided in the attached Exhibit.

The IASB has also recently published amended rules on hedge accounting that will allow entities to better reflect the accounting for derivative instruments, in a way that is aligned with their risk mitigation strategies.

Exhibit


The IFRS 9 classification model
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Step 1
Step 2
Business model is hold to collect
Business model is hold to collect and sell
Other business models
Cash flows are solely payments of principal and interest (P&I)
Amortised cost
NEW
FVOCI
FVPL
Other types of cash flows
FVPL
FVPL
FVPL
IFRS