Financial Reporting and Long Term Investment

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1. Introduction

In the current economic environment, long-term investment is crucial to promote a sustainable growth and financial stability. Long-term investment is a key requirement to meet the EU 2020 strategy objectives.

Recently, the G20 leaders recognised that "long term financing for investment, including infrastructure, is a key contributor to economic growth and job creation in all countries". In this context, they agreed to launch a study on long-term financing, including the effects of regulatory reforms on the supply of long term financing. The European Commission will soon issue a Green paper on long-term investment, which will emphasize the need to finally balance prudential financial requirements and incentives to long term investment.

The European founding Members of the Long-Term Investors' Club (LTIC) – namely the European Investment Bank, Caisse des Dépôts, Cassa Depositi e Prestiti and KfW Bankengruppe –share the view that there is indeed a need to review the current regulatory and international accounting framework to take into account long-term investment specificities.

The business model of Long Term Investors (LTIs) is characterised by the provision of finance through lending and equity instruments, usually on a long-term basis, in order to support public policies. LTIs support structural policies (e.g. growth through investment) and also operate on a countercyclical basis. Their activity mix derives from the public policy agenda and not from profit objectives.

The purpose of this document is to present to EFRAG for further discussion, proposals for revisions of IFRS 9 Financial Instruments, aiming at a better representation of the LTI business model.

2. Impact of IFRS 9 on Long Term Investment

2.1 Classification and measurement of financial instruments

The classification of financial instruments according to IFRS 9 is based on the two criteria business model and Contractual Cash Flow Characteristics (CCC). Generally speaking, the business model is an appropriate condition to distinguish between amortised cost and fair value accounting. However as it is accompanied by a second criteria the line between the amortised cost and the fair value categories as it is drawn by IFRS 9 results in the recognition of certain instruments in the wrong category. Furthermore the different accounting treatment of hybrid financial liabilities and hybrid financial assets creates an accounting mismatch which does not contribute to a faithful representation of economic activities.

- **More prominence of the "business model" criterion**

As mentioned above, the business model of long term investors is characterised by the provision of finance through lending and equity instruments, usually on a long term basis.

Specifically, in relation to equity instrument, IFRS 9 allows entities to make an irrevocable election to recognise fair value changes through equity, without any recycling through profit and loss (P&L). But this option would be equivalent to denying the very concept of the income statement that is the best indicator of performance.

Therefore, in our view, the two options offered in IFRS 9 for the recognition of equities are equivalent to:

- In one case (fair value through profit and loss), denying the very concept of a long-term investor (which would be assimilated as trading from the user's perspective) resulting in undue volatility (see annex A),
- In the other case (fair value through other comprehensive income), denying the possibility for a long-term investor to measure its actual "performance" (assimilation of unrealised and realised results within equity).

In that perspective, we would suggest the retention of a mixed measurement model for the classification of financial instruments, including the following three categories, based on a business model classification criterion:

- Amortised cost category: financial instruments that the entity holds (or issues) for the purpose of collecting (settling) contractual cash-flows.
- Fair value through P&L category: actively traded financial instruments which are held for trading purpose by the entity
- A third category: financial instruments that are held as investments in a medium or long term perspective or that do not meet the definition of either the amortised cost category or the fair value through P&L category.

Financial instruments included in the last category would be measured at the lowest between the acquisition cost and value in use. Reversal of impairment through profit and loss should be allowed.

The concept of "value in use" is already defined by IAS 36 - §6: "value in use is the present value of the future cash flows expected to be derived from an asset"

In our opinion, this definition could be extended to financial assets when the business model applied is to hold these assets for a long period (a minimum commitment of 2 years of holding period for instance could be required).

The position described above is far from isolated. Most of the stakeholders involved in long term investments have expressed strong criticism on the proposed standard. See Annex A.

- Business model of a Liquidity portfolio

concerning a liquidity portfolio hold as a buffer for stress scenarios there is a debate whether it can be classified into the business model 'buy and hold'. Rationale: new regulatory rules may require frequent and/or significant sales of the instruments in such portfolios as a proof of liquidity. In this case an allocation to a 'buy and hold' business model appears not appropriate.

It should be clarified that sales which are due to regulatory requirements should not prevent a classification as a 'buy and hold' business model.

- Contractual Cash Flow Characteristics (CCC) Test

We agree that accounting for financial instruments should consider significant cash flow risks that are not covered by impairment. However, given the current definition of the CCC criterion there are features of financial contracts that will result in the recognition at fair value even if there is no significant cash flow variability inherent in the instrument.

Linked Loans

There is a concern emerging among financial institutions about regulated financial assets. Indeed, there are jurisdictions with regulated pricing for specific financial instruments (such as 'Livret A deposits'). As such, an accounting mismatch would arise as the financial assets would be measured at FV-PL while the linked liabilities would be carried at amortised cost.

Such a concern also exists with regard to LTIs.

IFRS 9 requires interest to compensate the lender for the time value of money and credit risk. We understand this to mean the credit risk of the borrower, not the credit risk of the lender. Once the loan has been agreed to, the interest rate should be free of any other considerations that would change over the life of the loan.

There are classes of loans however for which this would not be the case, as for instance the loan interest rate readjusted subsequently to reflect funding parameters(e.g. loans where the interest rate is reset as a function of the refinancing costs). The exact behaviour of the interest rate is not solely dependent on market conditions (IBOR rate) and the borrower's creditworthiness, but also on the lender's creditworthiness.

Based on the examples above, we believe that IFRS 9 should not restrict the CCC test to the notions of "interest" and "principal". Instead, we favour a principle-based pronouncement on the characteristics that an instrument must have in order to be a possible candidate to be held for the collection of its contractual cash flows. This principle should be as wide as possible and focus on the notion of "contractual cash flows", given that the business model test (which should be the prominent one) will determine whether the instrument actually is held for either its cash flows or its value. However cashflow variability could be considered by referring to leverage and whether there is a significant risk not to recover the initial investment (beside the risk which is covered by the impairment provision).

Finally, we believe that the current long list of examples in IFRS 9 with regards to the instrument "characteristics test", induces a rule-based behaviour of attempting to pass the apparent bright line and will result in re-packaging exercises in order to comply with the rules. Accordingly, we believe that the examples developed by the IASB in appendix B of the Standard should be presented as illustrative examples instead of a binding regulation.

- Debt restructuring

In the case when a debt is restructured to prevent a loss event or to minimise losses in the case of a default the cash flow characteristics of the restructured instrument do often not meet the requirements to be accounted for at amortised cost. (e.g. because of a profit participation agreement). In our opinion there is a need for clarification in IFRS 9 regarding derecognition and as a result whether a new categorisation is required.

- Bifurcation of financial assets

The current IAS 39 provisions on hybrid financial instruments have been a successful approach to represent adequately determinable contractual cash flows which are managed on a cash flow basis (i.e. the host contract) and on the other hand to consider a possible variability of cash flows to be presented on a fair value basis (i.e. the embedded derivative). Such an approach better reflects the way in which these financial assets are managed by the entity for risk management purposes.

A usual long term funding of start-up enterprises in the context of our promotional business is for example a financing which includes a remuneration based on key performance figures of the borrower. Such a contractual feature, according to IFRS 9, does not qualify to be accounted for at amortised cost. However, as it is funded by liabilities accounted for at amortised cost there is an accounting mismatch between assets and liabilities.

Consequently, the opportunity for bifurcation of financial assets should be maintained under IFRS 9 in order to treat financial assets and financial liabilities consistently. Those amended requirements could replace the "characteristics test" test currently required by IFRS 9 for hybrid financial assets.

In that respect, we would also welcome a more principle based approach when determining the requirements for bifurcation of embedded derivatives. Indeed the current requirements are rule-based and difficult to apply in practice.

- Accounting for the own credit spread of financial liabilities

Generally speaking, we welcome the fact that, under IFRS 9, changes in own credit risk would not impact profit or loss for liabilities designated under the fair value option.

However, we do not support the new requirements i.e. to have the portion of fair value changes attributable to credit risk recognised in Other Comprehensive Income (OCI). We believe that in general the inclusion of the entity's own credit risk in the valuation of financial liabilities is inappropriate as it would create artificial volatility in the entity's own funds leading to a counter-intuitive outcome. Indeed, the prudential regulators themselves have expressed that "measurements subsequent to initial recognition that incorporate a change in an entity's own credit standing should be limited to situations in which this is clearly necessary to provide users with relevant information". Accordingly, we plead in favour of a proposal whereby the fair value of financial liabilities would only incorporate the level of own credit risk observed at inception (known as the "frozen credit spread" approach), thus avoiding undue volatility of own funds. The "frozen credit spread" approach has been discussed in the 2009 IASB staff paper "Credit Risk in Liability Measurement". The most frequent objection made against this method is that it might be difficult to apply, in the sense that there is not a unique and simple way to separate the effects on fair value of credit spreads from those of risk-free interest rates. While it is a matter of fact that isolating the effect of credit risk from the effect of other factors is not straightforward, this calculation is already required under several circumstances under both IAS 39 and IFRS 9. The clearest example is the requirement, under IFRS 9, that the portion of fair value changes attributable to credit risk is recognised in Other Comprehesive Income, separately from fair value changes attributable to other factors: in order to comply with the IFRS 9 proposal, an entity which measures a liability at fair value will be required in any case to isolate the effect of credit risk from other factors that affect fair value. Moreover, a very similar type of "attribution" exercise is already required under IAS 39. For example, when an entity estabilishes a fair value hedge relationship among a fixed rate loan subject to credit risk and an interest rate swap, it is required to measure the portion of the fair value changes in the loan which are "attributable" to the hedged risk (interest rate risk) and not to credit risk. We deem therefore that the application of the "frozen credit spread approach" would imply no greather complexity than is already required under IAS 39 or that would be required under the current IFRS 9 proposals.

2.2 Impairment

We agree with the aim of the current IASB proposal to switch from the IAS 39 incurred loss model to an expected loss model. We also think that the general approach to classify the assets into 3 buckets based on the probability of default (PD) and its change since initial recognition is a feasible approach to differentiate assets according to their credit quality. However, the measurement requirements as they are defined in the Exposure Draft do not suit the business model of LTIs.

The expected loss, according to the current proposal, should be analysed based on a point-in-time methodology. This means that only identifiable macro-economic as well as individual indicators are to be considered to quantify the expected losses. However, an allowance for macro-economic cycles is not allowed. In our opinion this will considerably increase the volatility of impairment allowances especially in the case of long term assets that are exposed to macro-economic fluctuations.

Thus, it is usual market practice of long term investors to make assumptions about the economic cycle when pricing long term assets and managing the risks of those assets (through-the-cycle rating). If the allowance for future economic downturns is not considered in accounting there will be an inconsistency between accounting and internal risk management that will cause volatility in the income statement (P&L). The reader of the financial statement will not be able to correctly evaluate the capacity of the entity to effectively manage its risks.

A good capacity of risk management to predicting future losses should be rewarded by a low P&L volatility caused by credit losses. Hence, it should be allowed to build an impairment allowance for macro-economic downturns which can be used when they materialise if this is part of the internal risk management strategy. The anticipation of economic cycles furthermore avoids the effect of a “self-fulfilling prophecy” and procyclicality in economic downturns.

2.3 Hedge Accounting

The aim of hedging in the context of long term investment is to reduce the variability of future cash flows. This is generally implemented through derivative instruments which have to be accounted for at fair value. However, it is not appropriate to recognise successive fair value variations in P&L or in OCI because these are fair value changes that will never get realised. In contrast, to give a clear view on the ability of the long term investor to achieve its investment objectives it is much more appropriate to present the cost of hedging synchronously with the cash flows to be realised.

The Review Draft on general hedge accounting proposes some relaxations concerning the qualification criteria for micro hedge relationships. However, from the point of view of a long term investor there are still some requirements that do not allow to presenting its hedging activities appropriately (for a summary on the effects resulting from the requirements in the RD see Appendix B):

- Accounting for Basis Spreads

Any risk component that impacts the value of the hedged financial instrument should qualify to be designated as hedged risk. We consider any hedging costs incurred in arm's-length hedging transactions to be a value driver of the hedged item and hence to qualify as designated hedged risk. This includes the variability of the cross-currency basis spread as well as the variability of the tenor spread to be considered in normal hedge transactions. In this context we reject any attempt of the IASB to exclude specific risk

components from hedge accounting as proposed in IFRS 9 (RD) B.6.5.5. and confirmed by the tentative decision made in January 2013.

With its tentative decision the IASB has acknowledged that the FX basis spread can be considered as cost of hedging. We welcome this step. However the proposed accounting consequences do not yet reflect the management approach to include any cost of hedging in pricing a financial instrument. We do not understand why a pricing component should be excluded from the designable risk components. Furthermore we criticise the decision to account for the FX Basis Spread volatility through OCI because it increases complexity considerably without producing any relevant information for the user of a financial statement.

Generally speaking, the business model of long term investors aims at generating a stable long term cash flow. Through the use of hedging derivatives these cash flows are stabilised. The hedging of cash flow risks implies additional costs which may vary over time. In our opinion, a fair valuation of these hedging costs is not useful for the readers of our financial statement because it does not impact the future cash flow of the investment. Hence, it does not help in evaluating the potential of the long term investor to achieve the objectives of its investments.

- Sub-Libor issue

The market practice to managing interest rate risks in the balance sheet is to hedge a benchmark risk (e.g. Libor-risk). The current Review Draft does not allow designating the benchmark risk if it is above the total cash flows of the hedged item (IFRS 9 (RD) B6.3.21). For most highly-rated long-term investors the refinancing cost are below Libor but there is no derivatives market that allows to hedging their specific refinancing cost. We believe that it is adequate to designate the Libor-risk even though the refinancing costs imply a negative component which arises independently from the benchmark interest rate risk. Otherwise, the fair valuation of the negative component of refinancing costs would create an artificial P&L volatility that is of no interest for the user of the financial statement.

- Macro Hedging

Beside the micro hedge relationships a macro hedge approach to manage balance sheet gaps is generally applied (asset-liability management) by long term investors. Until today there are very few indications about how restrictive the new macro hedge requirements will be. To be able to implement a consistent hedging strategy it is of upmost importance to get the new macro hedge accounting requirements as soon as possible and to issue the macro hedging approach synchronously with the rest of IFRS 9.

In order to allow an appropriate presentation of the macro hedging transactions some features should be considered by the future macro hedge approach:

- The aim of hedge accounting should **not** be to reflect an economic risk management result (e.g. result from open positions of the loan book accounted for at amortised cost) but to reduce volatility in P&L caused by hedging derivatives. In other words: When hedging transactions evidently reduce the balance sheet risk it would be counter-intuitive if, caused by restrictive accounting rules, hedging would increase P&L volatility.
- The unit of account should be defined as an open portfolio with daily transactions

- The qualifying hedged risks should include all the value drivers of the hedged instruments. This includes any hedging costs that are apparent in the hedging derivative (e.g. the tenor spread) and that do indirectly influence the value of the hedged item
- The approach should allow a measurement method which leads to an unbiased result (elimination of P&L volatility attributable to the hedging derivatives in case of an effective hedge relationship)

Annexes:

A Categorisation of equity instruments

One of our institutions tried to simulate what the consequences of IFRS 9 would have been on its net income if recognition of unrealised gains/losses in P&L had been applied on its available-for-sale portfolio (period 2006 to 2010)

The results of this simulation are mentioned in the table below:

	Net income under IFRS 9 (Billions euros)	Net income actually published (IAS 39) (Billions euros)	Volatility Under IFRS 9	Volatility Under IAS 39	Increase in volatilty
2006	+6.7	+3.7			
2007	+1	+2.5	5.7	1.2	x 4.7
2008	-9.2	-1.5	10.2	4	x 2.5
2009	+4.9	+2	14.1	3.5	x 4
2010	+5.4	+2.1	0.5	0.1	x 5

The differences between the calculated net income under IFRS 9 and the published net income under IAS 39 are linked to the unrealized gains and losses on equity instruments classified as available-for-sale.

As a matter of interest, you will find below extracts of the answers sent to the IASB by different national and international bodies on the issue of categorisation of equity instruments:

French accounting standard setter (ANC)

The proposal of this national standard setter is to “Create a third category (for which an appropriate measurement attribute should be determined): financial instruments that are held as investments in a medium or long term perspective or that do not meet the definition of either the amortised cost category or of the fair value through P&L category.

As this last category would not be measured at fair value through P&L, it implies that an impairment model, which should take into account investors’ holding horizons, should be determined. Moreover, it should require recognition in profit or loss of impairment on debt instruments relating to credit risk and should allow for reversal (for all instruments) in case of a change in the circumstances leading to impairment”

French Banking Federation:

The point of view of this Federation is that “The business model should be the primary criteria”.

“When the business model leads to hold the position until maturity or for a long period, cost is the best measurement attribute to reflect the cash flows the firm can collect in the foreseeable future”

"Equity instruments held for long period, strategic investments for example, must also be recorded at cost, with impairment if...dramatic changes in the markets parameters lead to believe that the intrinsic value of the security is lower than its cost".

Even if EFRAG and the European Banking Federation didn't argue clearly in favour of recognition at cost for all the financial instruments held on medium and long term, they didn't support the proposals of IFRS 9, as we can see in the extracts below:

European Banking Federation

The European banking Federation:

- "do not support the concept of fair value through Other Comprehensive Income (OCI) with no recycling in income for certain equity investments"
- "believe that there are circumstances where the Available For Sale (AFS) category could provide the most useful information about certain equity investments, although we acknowledge that further consideration should be given to when and how to measure impairment and that impairment should be reversed if there are indications that the causes of the impairment no longer exist".
- "firmly believe that the "business model" should be the primary criteria for the classification and measurement of a financial instrument"

B Volatility resulting from IFRS 9 Hedge Accounting requirements

The following illustrative examples demonstrate that the effects resulting from the restrictive requirements in the Review Draft are severe. The chosen scenarios represent realistic market fluctuations.

Valuation feature	IFRS 9 Review Draft requirements and tentative decision of IASB	Resulting balance sheet and income statement volatility (example of a typical LTI balance sheet)
Changes in FX Basis Spread.	According to the tentative decision as of January 2013 FX Basis Spread volatility cannot be designated as a hedge risk. Accordingly the FX Basis Spread volatility affects unilaterally the fair value of the hedging instrument. As the FX Basis Spread is considered as 'cost of hedging' the volatility can be reported in OCI in spite of P&L.	Volume of FX Refinancing activities: approx. 100 bn, average term of hedging relationship approx. 3 years **Scenario of a 10 bp shift of the FX Basis Spread:** **Effect in OCI: 280 m.**
Sub-Libor issue	According to the Review Draft it is not allowed to designate the benchmark interest rate risk if the effective interest rate of the hedged item is lower than the benchmark rate. The refinancing rate of LTIs is generally lower than the benchmark risk (e.g. Libor). Thus, there will be a remaining P&L volatility resulting from the valuation of the negative Spread between the hedged interest rate and the refinancing rate.	Volume of Refinancing activities: approx. 400 bn, average term approx. 6 years; average Spread: -15 bp **Scenario of a 100 bp shift of the discount curve:** **Effect in P&L: 100 m**
Own credit spread	Changes of the own credit spread affects the fair value of liabilities designated as at fair value through profit or loss. According to IFRS 9 the resulting volatility should be reported in OCI.	Volume of issues securities designate FVTPL: 36 bn, average term appro years **Scenario of a 10 bp shift of the own credit spread:** **Effect in OCI: 180 m.**
Tenor Spread	In the context of a multi-curve valuation model (e.g. discount curve: OIS, fixing curve: 3-M Libor) there is a volatility arising from the variability of the tenor spread (spread between OIS and 3-M Libor). The current market practice to reflect this effect in hedge accounting is through adjusting the hedge ratio. This method cannot be applied under IFRS 9 because of the restrictions around the sub-Libor issue (the hedge ratio cannot exceed 100%).	Volume of Refinancing activities: approx. 400 bn, average term approx. 6 years **Scenario of a 1 bp shift of tenor spread:** **Effect in P&L: 200 m.**