European Investment Bank

Caisse des Dépôts

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EFRAG's Public Consultation

Is there a need for specific financial reporting for long-term investing activities business models?

Respond delivered by the working group of the Long term Investor Club (LTIC)

Stand: 25.06.2013

Version: 1.0

Status: final

Question 1: Would you describe your (or one of your) business model(s) as a long-term investing business model? Please explain. If so, what is its economic purpose?

In our view, "long-term financing" is the policy and/or liability driven intention and financial capability to hold assets financing long-term real investments. Long-term financing could therefore be considered as *the process of investing or lending implemented by a specific type of investor who (i) can count on sufficiently stable (especially long-dated) liabilities, and (ii) has the expectation of holding an asset for a long period of time with the purpose of achieving a fair, risk-weighted return.* Indeed, stable liabilities – whatever they are (public resources in the case of Sovereign Wealth Fund, public resources and/or private savings in the case of long-term financial institutions, private savings in the case of insurers or retirement funds) – are the prerequisite of Long Term Investment (LTI) and account for the characteristics of the Long Term (LT) investor.

Most of our institutions are state owned promotional banks. Our business model is based on specific laws, which set the objectives of our financing activities. Ultimate corporate objective, derived from our mandate, is mid- and long-term investments to sectors worthy of promotion.

In contrast, short-term financing is according to the law solely allowed as an exception and requires the permission of our governing bodies. Current balances of short-term receivables to Banks and Customers refer mainly to liquidity purposes.

Question 2: What are your long-term investing activities driven by (e.g. the need to back long-term liabilities)? What is the nature of your long-term commitments? How do you distinguish between assets held to back long-term liabilities and other assets? Are you also involved in trading activities? If so, to what extent and for what purpose?

Our long-term investing activities are driven by the financing of long-term assets in the real economy, like direct lending to corporates and large projects, as well as indirect lending to SMEs, mid-caps and smaller projects via financial intermediaries. Some of our institutions also hold a significant amount of equity investments (negligible for others) with a less material part consisting of guarantees and microfinance. Long-term liabilities are raised to finance the long-term assets, usually in the form of bond issues and for long tenors. In that respect, derivatives are used as part of the funding strategy in order to bring the characteristics of the funds raised, in terms of currencies and interest rates, into line with those loans granted and also to reduce funding costs. As part of our liquidity management, we maintain a treasury portfolio which represents a maximum of 10% of our total assets. Most assets are hold to maturity and are not traded.

As non trading book institutions we are not involved in trading activities and have no intention of short-term profit taking through trading. Derivatives are exclusively contracted for Hedging purposes.

Question 3: What are the different types of assets you invest in?

See above. Main assets are (i) long-term loans and advances to credit institutions and customers and (ii) listed equity, with the residual part represented by treasury assets, mainly held for liquidity purposes.

Question 4: How is your long-term investment strategy established and how do you report on it, for both transparency and stewardship perspectives? How do you ensure that your current or potential shareholders can make the link between how you report your investment long-term strategy and the information provided in your financial statements? Could such a link be improved? How?

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. We support structural policies (e.g. growth through investment, sustainable improvement of economic, social and ecological conditions) and also operate on a countercyclical basis. Our activity mix derives from the public policy agenda and not from profit objectives.

Currently, the information provided to shareholders in the statement of financial position and in the income statement does not appropriately reflect the long term nature of our activity because we are required to report volatility that will never materialise.

The Financial statement presented by LTIs should clearly reflect their ability to achieve their long term goals especially to generate a stable long term cash flow. If, for example, through asset liability management a long term positive margin is logged-in, short term fair value fluctuations are of no interest for the user of our financial statements.

As a consequence, preparers need to create separate documents to explain to shareholders how the long term strategy has been translated into the financial statements. Some of our member institutions currently report Profit and loss (P&L) in two different ways. To fulfil legal requirements, P&L is presented according to IFRS. However, to allow a view on the economic result, an additional non-GAAP P&L is presented which is adjusted by all valuation effects that will never materialise (e.g. valuation effects from economic hedging derivatives that do not qualify for hedge accounting under IAS 39, valuation effects that result from different measurement methods for the hedged item and the hedging instrument).

Over time this has led to too much and too complex information being provided to the shareholders. It would be useful to simplify the disclosures so that only key and relevant information is conveyed to the users.

Question 5: Do you believe the business model described above justifies a specific reporting treatment? If so, what should it be? Please explain how it brings relevant information to investors. Are there circumstances in which you would argue that fair value is not an appropriate measure? What other measurement attribute would you suggest and why (i.e. where a measurement basis in existing IFRS does not properly reflect the business model as described by you)? How should measurement uncertainty be dealt with in a "long-term investment activities" business model?

For a "long term investment activities" business model, we believe that fair value is not the appropriate measure as it creates transitional volatility of a short-term nature. This holds true for the assets held on a long term basis but also for long term liabilities for which the recognition of the change in the entity's own credit risk leads to counterintuitive outcome in the entity's own funds.

Please find below some accounting examples (considering the current development state of the IFRS 9) that do not reflect the business model and economics of a long-term investor appropriately (for additional issues in the context of IFRS 9 and LTI please also note our paper 'Financial Reporting and Long Term Investment' dated 18 March 2013, which is annexed).

5.1 Classification and Measurement

Sales before Maturity (including sales that are imposed by a third party) in "Hold"portfolios

We agree to the new developments of ED/2012/4 regarding the sales before maturity in "Hold"-portfolios. However, liquidity portfolios hold as a buffer for stress scenarios are managed quite static at our institutions. But new regulatory rules may require routine and/or significant sales of the instruments in such portfolios to demonstrate the liquidity of these assets. Due to the fact that sales may be imposed by a third party the standard setter stresses that a "Hold"-portfolio is not the appropriate business model. It should be clarified that sales which are due to regulatory requirements should not prevent a classification as a '"Hold" business model. As long as liquidity can be demonstrated via Repo-Transactions this issue is of no relevance.

Own Credit Risk

Under IFRS 9, fair value changes attributable to own credit risk do not impact profit or loss for liabilities designated as measured as at fair value. We support this progress but the effects have to be recognized in OCI, which we believe creates artificial volatility in the entity's own funds leading to a counter-intuitive outcome. We propose to measure the "fair value" of liabilities designated under the fair value option using the own credit risk at inception ("frozen credit spread")because we believe this information would be more useful for the user rather than fluctuations that will never materialise.

Applying the "frozen credit spread approach" would not cause more complexity as the separation is already required under IAS 39 and under the current IFRS 9 proposals.

5.2 Impairment

The current IASB Exposure Draft with respect to Expected Credit Losses (refers to Phase 2: Impairment) proposes a three stages approach for all financial assets measured at amortised cost (AC) and measured as at fair value through other comprehensive income (FVOCI). We believe this is an acceptable and operational manageable approach to reflect the general pattern of the deterioration of the mentioned financial assets. The distinction between good and bad loans reflects the economics of lending in an appropriate way. For assets which are not impaired, the subsequent allocation to stage 1 or 2 is based on its change in the lifetime probability of default (PD) since initial recognition of the asset. Depending on this criterion the loss allowance shall be measured either based on the 1-year expected loss (stage 1) or based on the lifetime expected loss (stage 2). In our opinion the transfer criteria from stage 1 to stage 2 should be not solely driven by the change in lifetime PDs but should rather consider qualitative and other quantitative factors.

Another point of interest for a long-term investor is the fact that according to the current proposal the expected losses shall be analysed based on a point-in-time methodology. This means that only identifiable macro-economic as well as individual indicators have to be considered to quantify the expected losses. However, an allowance for macro-economic cycles (allowance for future economic downturns) is not permitted. 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. 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 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.

The measurement of the impairment allowance should be harmonised with internal risk management. Hence, the consideration of loss allowances for macro-economic downturns should be permitted as they may materialise in future. The anticipation of economic cycles would furthermore considerably reduce pro-cyclical P&L effects and therefore avoid the effect of a "self-fulfilling prophecy" in economic downturns.

5.3 Hedge Accounting

As stated above derivative financial instruments in the context of our business model are concluded exclusively for hedging purposes. Those are, to a large extent, interest rate derivatives and cross currency basis swaps which are contracted in the context of asset and liability management.

The aim of those hedging derivatives is to close the maturity gap between assets and liabilities. By closing the maturity gap a margin is logged-in which will be realised in earnings in future periods. Since the user of our financial statement is evaluating our ability to generate a stable return, volatility affecting P&L or the own funds, which will never impact our cash flow, is misleading.

Below we describe two examples where according to IFRS 9 fair value measurement of hedging transactions will affect P&L or the own funds without affecting future cash flows.

Hedging of a FX bond issue with a Cross Currency Swap

An entitiy issues a bond in foreign currency to refinance its loans. The bond pays a fixed coupon in foreign currency. Since the bond issue does not match the maturity and the currency of our loan portfolio, the coupon is swapped into a variable interest rate nominated in our functional currency. For swapping future payments between different currencies the market asks for a cross currency basis spread. This spread has to be considered when pricing our loans because it is part of our refinancing cost. However, it is logged-in when the derivative is concluded. Future variability of this spread will not impact future cash flows of the portfolio.

Hedging a Sub-Libor bond issue by a benchmark interest rate swap

For most highly-rated long-term investors the refinancing costs are below Libor but there is no derivatives market that allows to hedging this specific refinancing cost. Consequently, if we issue a bond which is priced with a negative spread against the market we hedge anyhow the market interest rate risk. As, generally, there is no floor contracted in these interest rate swaps, interest can turn into a negative rate when the Libor falls below our negative spread.

We believe that it would be appropriate to designate the Libor-risk even though the refinancing cost implies a negative component which arises independently from the benchmark interest rate risk. Otherwise, the fair valuation of the negative component of the refinancing cost would create an artificial P&L volatility that is of no interest for the user of the financial statement.

Question 6: If you are an investor in entities that are involved in long-term investment activities, what is the information that is the most relevant to you? How does IFRS financial reporting contribute to those needs today? Please explain.

With regard to long-term investments, the volatility is artificial in that transitory unrealised results will not normally materialise.

What is therefore needed is a practical approach that such volatility need not impact the income statement, it being understood that appropriate reporting will be put in place.

Rather than having artificial volatility pollute the results, without the impact being transparent, as it may be included in various items, a more comprehensive analytical presentation could be put in place to help the readers better understand and identify such investments. This can be done in the notes without having the income statement impacted.

For financial institutions such long term investments could entail a necessity to increase margins and capital buffers and would as such be detrimental to their willingness to participate in this economically crucial business area.

One needs to also possibly distinguish the information requirements of a debt investor from an equity investor. Whereas for the former the counterpart's capacity for timely reimbursement of capital and the payment of interest will be important, the latter will be more interested in maximising the overall return of the investment. As such the debt investor will seek to have information on the financial situation which is not marred by book losses/gains while the equity investor will also require information about the business model and the long term corporate strategy.