TO BE VALIDATED

How can long term investment favour financial stability in the EU?

Long-term investment represents:

- An investment that aims to benefiting from the growth of the economies and free of markets volatility contingencies
- An investment requiring strong added value from the intermediary (which is responsible for managing it), notably in terms of understanding long-term economic trends (business sectors, etc.) and effectively managing the risks inherent in the investment horizon and timeframe
- An investment that is always for longer than five years, but may be for over 30
- An investment that is often based on equities

Rather than looking for the means to encourage long-term investment or savings, the Eurofi working group focused on identifying the obstacles that could hold it back.

Long term investment relies for a large part on intermediaries. Allowing long term investment to respond to the needs of both issuers and savers requires a particular attention on the role of intermediaries. In that respect it is essential to align the savers' long-term needs with the structure and conditions for savings. That requires the improvement of customer information and product distribution standards. It also requires an effective long term focus of the intermediaries (asset managers, pension or hedge funds, life insurers etc.). This supposes to create long term products and to incentivise accordingly investment managers. In parallel, specific education efforts intended to improve financial literacy of citizens in Europe have to be implemented by the member states.

Eurofi working group will be tackling later prudential legislation issues that could hinder long term investment. This interim document tackles so far the obstacles for long term investment stemming from accounting standards.

The impact of accounting standards on long-term investment stems from both the choice of marking assets to market and the various ways of reflecting this on the balance sheet and income statement required under these standards. The consequences for the economy as whole are significant. In turn the debate boils down to choosing the role of a company either only focused on creating short-term financial value added or providing long-term wealth to its shareholders, employees, clients and other stakeholders (issuers etc.).

Accounting standards materialising the marking assets to market is transmitting the volatility and illiquidity of the markets to long-term investors' accounting statements. Investments in equities and hedging techniques are particularly exposed to such drawbacks.

The changes to IAS 39, as presented in the IASB's working document published on July 14, prove to be negative or insufficient.

In general, there are many possible alternatives to replacing a mark-to-market valuation approach for assets. At this stage, one of them does not seem to have unanimous backing. At the same time it appears necessary to safeguard the accounts from relatively unreliable and unpredictable valuation approaches, particularly those applied to the risks characterising assets.

The move initiated by the possible valuation of basic loans assets at amortised cost need to be pursued by extending this valuation method to other asset classes but also by the simultaneous use of additional valuation methods (e.g. mark to market, discounted cash flows, market prices averages).

In parallel financial institutions, investing over the long term, need the specific features of their value contribution to be factored in to accounting standards. Indeed, they are suffering since only the trading business model is taken into account. Indeed the accounting treatment must not depend solely on the nature of the asset to be recorded, but rather strive for a balance between this criterion and the requirements resulting from the various forms of value added of financial institutions, including long-term investment.

This requires recognising that an asset sale is not necessarily a trading action, even if it takes place before an asset's maturity. In parallel in order to reduce accounting mismatches it is worthwhile to facilitate the access to hedging techniques whatever assets accounting options are and to align accounting options on the asset side with those required for the liabilities. Last accounting standards should avoid creating useless volatility of the P&L statement for long term investment activities. In other words different business models carried out by a single financial institution should be specifically recognised by accounting standards.

I. Investors and issuers are calling for long-term investment vehicles

As far as investment activities involve savers, financial intermediaries and issuers, the description of the need for long-term investment is manifold.

Certain issuers need to have investors who can accompany them over time. The parties in charge of economic activities with cycles that are long (motor industry, steel industry) or very long (airport or port infrastructures, nuclear power, etc.) are looking for investors who can notably participate in financing with a timeframe that is consistent with that for their investments, commit throughout the project development phase, effectively understand the nature of the operation's risk and adjust their financial support throughout the project. This type of need is particularly pressing, at a time when we are faced with numerous challenges, including the development and harnessing of renewable energies or the provision of urban and transport infrastructures; particularly since government borrowing points in many cases to growing use of private financing.

In this context long-term investments definition may cover a very wide range of economic needs - infrastructures, housing, transport, communications, new energies, etc. - and represent considerable financial sums. To contribute responding to such needs, some states have set up specific public institutions dedicated to long-term investment (e.g. Caisse des Dépôts des Consignations in France, KFW in Germany, Cassa Depositi e Prestiti in Italy etc…).

For the European public, long-term savings are expected to help ensuring financial needs in at least the five key areas of retirement financing, real estate acquisition (a fourth pillar for households), wealth transmission, reducing dependency and access to education.
In this case long-term savings are expected to deliver high returns over the long term and thereby help investors to achieve their financial goals but assuring their long-term financial security. In particular certain financial needs require investment vehicles that follow the development of the economy and wages. This is notably the case for pension funds. Indeed, they need to invest over the long term, in real assets such as equities or property instruments, in order to replicate the trend for wages that, as for equities, is linked to global economic performance[1].

With long-term investments, investors are also some times looking for opportunities for diversification, particularly in terms of their horizon. These investors notably turn to dedicated

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[1] *"Insofar as wages or company profits represent payment for production factors within the economy, and they are a stable part of value added, all it takes is for their values to be stable and move within a range over the long term for there to also be a stable relationship between wages and equity prices. Indeed, wages and equities are effectively co-integrated, in other words they show a high level of dependence over the long term".* "Impact of Regulations on the ALM of European Pension Funds January 2009 - EDHEC Risk and Asset Management Research Centre Publication"

infrastructure financing funds. Research by CEPRES[2] highlights the importance of the mass of capital raised, put at 67 billion dollars for 2007.

Due to the importance the needs in both issuers and savers sides long-term savings have a significant impact on the allocation of capital in the economy.

II. Long-term investment process: a key role for financial intermediaries to deliver expected high-value added

Financial intermediaries linking savers and issuers play a key role in the long term financing process.

Long-term investment process

Investisseurs « primaires »	Intermediaries	Emetteurs
Who: Consumers, employees, individuals, etc. **Objectives:** •Have retirement savings that do not lose their purchasing power, in order to effectively ensure future supplementary income •Safeguarding the purchasing power of a financial portfolio to be passed on •Contributing to and benefiting from innovation and dynamic economic development •Having diversified savings vehicles that dovetail effectively with one another: long horizon, business sectors with long cycles, etc.	**Who:** •Pension funds •Funds, hedge funds, etc. •Life insurance •Banks •Sovereign funds •Para-public structures •Etc. **Regulatory frameworks:** UCITS Directive, IORP, CRD, Solvency II IAS 39, 19, 17, etc. **Management tools:** Simple or sophisticated: asset and liabilities management, risk hedging financial instruments (rate, Forex, counterparty, etc.), etc. Leverage effect or not Etc.	**Who:** Structures carrying economic activities with long cycles: steel industry, motor industry, etc. Structures carrying economic activities with very long cycles: energy, transport infrastructure, etc. Issuers looking for stable investors **Investment vehicles** Bonds Equities Etc.

The approaches and more specifically the types of players linked to long-term investments are highly diverse. When analysing long-term investment, it is therefore essential to start off from the actual nature of the goals pursued by the "primary" investors - in most cases savers and employees - and the added value they expect their intermediaries to deliver.

In this respect, it is clear that long-term investment represents:

- An investment benefiting from the growth of the economies and free of markets volatility contingencies
- An investment benefiting from strong added value from the intermediary (which is responsible for managing it), notably in terms of understanding long-term economic trends (business sectors, etc.) and effectively managing the risks inherent in the investment horizon and timeframe

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2 Buchner, A., C. Kaserer and D. Schmidt (2008), “Infrastructure private equity: markets, funds, investment behaviour and outlook”, Center of Private Equity Research (CEPRES), Munich.

- An investment that is always for longer than five years, but may be for over 30
- An investment that is often based on equities

III. Long-term investment issues

In this context the Eurofi working group highlighted in particular the difficulty of describe long-term investment issues as a whole.

They demand first to clarify the specific features linked to long-term savings as well as the difficulties for aligning the long-term needs represented by pensions, etc., with the structure and conditions for savings.

They require in parallel finding out the difficulties for actually delivering to the savers the specific value added they require from their long-term investments.

Last, rather than looking for the means to encourage long-term investment or savings, the Eurofi working group focused on identifying the obstacles that could hold it back. In fact, the working group's aim would be to identify what could represent “appropriate treatment” for this type of investment and not to seek a preferred treatment.

The Eurofi working group has focused for the time being on customer literacy (education) as well as on the quality of the information provided and distribution practices (consumers protection legislation). Indeed they strongly influence the long term focus and an appropriate behaviour of individuals. The legal framework - solvency legislations - and accounting standards also play a key role to set an appropriate treatment for long term investment.

IV. Aligning the savers' long-term needs with the structure and conditions for savings[3]: learning lessons on fund management

> Educational improvements

Individuals are increasingly responsible for managing their financial savings and the risks they incur, and at the same time are faced with increasingly complex choices for their savings. The level of investment education at the societal level is therefore of fundamental importance.

Access to financial knowledge, should be given to a wider number of citizens, including the less affluent. Making the consumer understand the product and building investor confidence are fundamental, and the industry can't do enough.

But at the same time the financial services industry needs to set itself high standards in respect of product transparency, clarity of information and good client service.

> Information standards improvements

The effective implementation of the Key Investor Document (KID) for UCITS – due to replace the simplified prospectus – is a key element to ensuring that the best information standards are implemented in the interests of long-term investors. More specifically, the KID should help investors to determine what is most suitable given their investment horizon, and allow them to better distinguish between the products.

[3] See « Building Long-Term Savings in Europe The Case for UCITS » January 2009

Another major challenge for the fund industry in terms of product information is to improve fund classifications and provide more coherence within the various classifications used by regulators, the industry and performance measurement agencies.

> Advice and distribution: aligning stakeholders' interests

It is essential that the fund industry constantly put investors' interests and protection at the forefront. In that regard, the industry is dependent on the quality and independence of advice given to the end investor at the point of sale by distributors.

Ensuring quality advice and fair treatment of customers is crucial if the industry is to meet its fiduciary obligations. This encompasses for the industry to:

- Improving its governance
- Bringing further transparency on investment products

> Evolving toward greater long–term focus

Volatility of fund flows, reflected in the growing gap between gross and net sales of UCITS funds, has increased over the last few years as mentioned above. Looking at net sales for cross-border funds in Europe, the yearly redemption rate has increased from 76% in 2004 to 101% in 2007. Ultimately this volatility results in higher transaction costs to be borne by the funds and their long-term shareholders. It also generates volatility in the financial markets, as funds need to adjust their size.

This volatility in flows is a direct consequence of an increase in churning notably due to the high level of intermediation in retail sales and short-term performance league tables.

Another factor affecting flows can be a lack of training amongst asset managers' sales teams: resources should be spent on ensuring continuous upgrading of those teams, especially when product creativity and sophistication is as high as it has been in the last couple of years.

The fund industry must address this issue of short-termism that is driven by the fact that although asset managers manage long-term assets, they tend to be evaluated on short-term results.

Sometimes, however, short-term behaviour can also result from the end investor's own investment decisions. The decisions taken are often not in their own best economic interests and may be the result of a lack of financial knowledge.

> Long-term products

Such volatility highlights the need for a greater focus on long-term performance, and this is all the more important in the context of retirement. For investors, the development of regular savings plans can encourage a long-term focus in investing and stickier savings. Both distributors' and asset managers' sales teams should become the biggest advocate of such products.

> Ensuring product suitability: the right product for the right investor

Beyond the need described above, the fund industry should be careful about how it promotes products. The fact that the industry has lately relied to a large extent on "new stories to sell" tends to favour the proliferation and increasing sophistication of products, and ultimately of a high level of churning.

So, the industry should focus on crafting products which are fit for purpose. The liquidity crisis has served to highlight potential excesses in terms of marketing strategies, and the potential lack of a match between products and investors' needs, especially when the degree of sophistication of underlying assets is high: the cost of liquidity appeared too high in certain

cases. Overall it is important that products do not make any 'implicit promises' to investors and that fund names and classifications are not misleading. And at a distribution level, the packaging should be appropriate to the product.
For these reasons, some sort of labelling for long-term savings would be useful.

Next chapter tackles the obstacles stemming from accounting standards. Eurofi working group will be tackling later prudential legislation issues.

V. Accounting issue for long-term investors: stakes and outlook

1. The impact of accounting standards on long-term investment stems from both the choice of marking assets to market and the various ways of reflecting this on the balance sheet and income statement required under these standards

The debate over accounting standards is focused primarily on the relevance and the strengths and weaknesses of the various approaches for valuing assets and liabilities: measurement at their immediate value, as indicated by the markets (fair value), based on moving averages, at their historical acquisition cost, based on their probable future value (discounted cash flow, etc.).

The consequences of one or another approach for the economy as whole are significant. In turn the debate boils down to choosing the role of a company either only focused on creating short-term financial value added or providing long-term wealth to its shareholders, employees, clients and other stakeholders (issuers etc.).

However, the impact of accounting standards is not linked solely to the conditions for valuing the various balance sheet items they require.

Currently, depending on the activities (trading, portfolio management, hedging of certain risks linked to an asset or liability, etc.), the nature and characteristics of the assets they involve (equities, fixed-income products, derivatives, etc., the contractual nature of the revenues they provide, any leverage effects included in the asset's engineering, the possibility for determining the asset's value, etc.), the accounting standards also set the conditions for determining their value, as well as the impact of changes in their value on the balance sheet and income statement.

In concrete terms, depending on the cases, accounting standards built solely around "management intentions" reflect changes in the value of assets and liabilities on the markets on just the balance sheet and (totally or partially) the income statement... and these repercussions are either irreversible (impairments) or reversible.

Accounting categories	Accounting features
Trading assets Includes derivative products	**Asset valuation:** mark-to-market **Change in valuation:** P&L (additional impairment rules are not necessary) **Dividends and realised capital gains or losses** (after selling the assets): P&L
Assets available for sale (AFS)	**Asset valuation:** mark-to-market **Change in valuation** through the balance sheet (increase or decrease in equity) **Dividends and realised capital gains or losses** (after selling equity assets): through the balance sheet (increase or decrease in equity) **Impairment:** depreciation through P&L; if

	the value recovers, its reversal cannot go through P&L but through equity
Assets held to maturity (HTM) Investors also have the possibility to value assets at cost (held to maturity category), but are therefore subject to the tainting rule (all the asset portfolio would be transformed into a trading portfolio if any of its assets are sold before maturity) Equities are excluded from this category	**Asset valuation**: acquisition cost; **Change in valuation:** none **Dividends, interests and realised capital gains or losses** (after selling the assets): P&L **Impairment:** depreciation through P&L; if the value recovers, it can be reversed through P&L but only to a certain extent **Tainting rule:** all the asset portfolio would be transformed into a trading portfolio if any of its assets are sold before maturity
Hedging (fair value hedge)	**Asset (derivative) valuation:** mark-to-market **Change in valuation:** BS - direct impact on the value of the asset hedged and in P&L **Restriction:** the current version of IAS39 allows for portfolio hedging only for interest rate risk (macro hedging), and for fair value hedging of homogeneous groups of items (homogeneity means having roughly proportional sensitivity).

Under these conditions, changes in the market value of assets and liabilities are first of all reflected on the balance sheet as the accounts are closed, concerning the measurement of the:

- Value of the business' holdings (value if it was liquidated when the financial statements are released)
- Value of equity (appreciation or depreciation of assets resulting in a contra entry with an increase or reduction in equity capital), notably with consequences on its capacity for borrowing as far as debt/equity is one of the key ratios to assess one business' borrowing capacity (hence the pro-cyclical effects assigned to the fair value), etc.

It is also important to note that:

- These valuations change in line with changes in the volatility and illiquidity of the markets, differentiating from one balance sheet item to the next.
- Since balance sheet items are often valued in the same way whether or not they have been sold off, it is not easy to determine whether their value is theoretical (as long as an asset has not been sold, its value remains theoretical) or effective.

It is also important to note that accounting standards may impact the appreciation of:

- The quality of the company's management, depending on whether market value adjustments are immediately reflected on the income statement or not
- The quality of its risk management, e.g. depending on whether changes in the value of hedging products may or may not be booked directly against the value of the assets they cover.

2. Difficulties for long-term investors under current accounting rules

> Marking assets to market is transmitting the volatility and illiquidity of the markets to long-term investors' accounting statements. However, unlike institutions operating over the short term, this information is not relevant for players who can (and must) carry assets over the long term and are not subject to major liquidity constraints on account of the nature of their liability. Indeed, it is for this very reason that these players usually achieve better returns on assets and are much less prone to credit losses.

The current evolution of accounting standards is now leading long-term investors to adopt the behaviours of short-term investors, with all the harm that implies notably for their stakeholders. Indeed, this volatility is reflected in continual increases and decreases in both the apparent value of the holdings of such investors and that of their equity capital. This same volatility is also undermining the company's profit and loss, **which is no longer making it possible to rate the management performance.** This volatility is even disrupting the assessment of the continuity and predictability of this performance. Moreover, due to the irreversible nature of some impairments booked on the income statement, the **quality of the long-term investor's management is systematically underestimated**, even when in the end it knows that it will be able to honour its commitments due to the proven turnaround in the value of the assets held.

The Aon200 index provides an interesting illustration of the scale of the volatility brought about by fair value on pension funds' accounts. Quarter by quarter, this index tracks the net balance of assets and liabilities of the UK's top 200 private sector pension funds measured at fair value. Between March 2005 and June 2009, this chart shows a balance climbing from an 80 billion pound shortfall to a 40 billion surplus. Even from one quarter to the next, this balance can change radically from an apparent 25 billion shortfall to an apparent 25 billion surplus (cf. December to March 2007).[4]

> **Investments in equities are particularly exposed to such drawbacks**. Indeed, since:

- Such assets do not have any maturity, the revenues they offer (dividends) are in most cases not contractual,
- Their valuation is more delicate (uncertain future payout policy, impact of changes in the issuer's solvency on changes in the value of its securities),
- Such assets are realised through their sale on the market and not any redemption on a contractual basis...

Equities are not entitled to the HTM treatment, which is only available for bonds.

> Certain balance sheet items are particularly ill-suited to a mark-to-market valuation

- This is more particularly the case of assets which involve a credit risk linked to the relationship between the institution and its counterparties (Own Credit Risk) insofar as each financial institution analyses and manages these credit risks based on its own know-how
- There is not effectively any market on this type of asset (insurance liabilities, etc.)
- And these instruments, when they are traded, are handled in blocks and not individually, and the trading does not concern the credit risk inherent in the institution selling them.

> Accounting standards must **make it possible to factor in the diversity of financial intermediaries' activities, and more specifically**:

- When assets are held against marked-to-market liabilities, such as units of account, they should also be eligible to be recognised at their market value if we want to avoid

[4] http://aon.mediaroom.com/file.php/356/Aon+200+november.pdf

creating an artificial and damaging volatility differential; this possibility must be available even when other accounting options prove to be better suited to reflecting the activity on other activity portfolios.

- The assets corresponding to the liabilities including frequent or daily customer-redemptions, must also be accounted at market value
- In a Fair Value Option (FVO) relationship, the value of the hedging instruments (rate, currency swaps, etc.) must be able to perfectly offset the value of the asset or liability they cover in line with the safe and sound risk management policy of the entity; this possibility must also be open to portfolios and not exclusively applicable asset line by asset line. For a preparer with a policy of absolute risk avoidance, the consequential volatility of the use of the FVO on the Net Profit of the Year can be horrendous. For an underlying profit moving from 100 CU to 120 CU, the profit showed on the P&L statement as a consequence of the fair value accounting of derivatives can easily go from -500 CU to + 500 CU, thus resulting in a total absence of "true and fair" financial reporting.
- Similarly it should be possible to adequately reflect the management of financial instruments hedging cash-flows together with the related portfolio of assets accounted under HTM (i.e. report no volatility in the Income Statement when the asset and the hedging instrument cash flows are perfectly matched),
- For the assets held on a long term perspective in particular under the AFS option, dividend incomes should be recognised in P&L as far as the ongoing costs incurred by holding them are passed in P&L.
- The reversal of prior impairments (through P&L) under strict and explicit conditions is particularly necessary for assets held on the long term whatever their accounting option (AFS or HTM)

> **Accounting reporting tools / standards do not seem to be able to offset the impact of the volatility produced on the accounting statements**. Standard valuation rules, whatever the company, offer the benefit of avoiding the use of subjective valuations and enable information to be aggregated on a trans-sectoral basis. However, the majority of users of accounting statements still seem to be sensitive to the unrefined information resulting from a direct reading of the accounting statements (net income, amount of equity capital, etc.).

> At the same time it appears necessary to **safeguard the accounts from relatively unreliable and unpredictable valuation approaches**, particularly those applied to the risks characterising assets: more specifically, this concerns leverage effect products, complex instruments, securitisation tranches, mezzanine debt, private equity, etc. From this point of view, **no alternative to the market value** (even in the case of valuations based on unobservable inputs so called "level 3" valuations) **has been put forward**.

> In general, **there are many possible alternatives to replacing a mark-to-market valuation approach for assets. At this stage, one of them does not seem to have unanimous backing.** The use of moving averages is being put forward in order to reduce the volatility of values offered by the market; for its part, the valuation at acquisition cost makes it possible to free ourselves from volatility as well as the decline in valuations due to market illiquidity. This approach seems relevant for fixed-income products held to maturity, whose yields are contractual as long as their credit risk remains limited. The discounted cash flow method is also mentioned, combined with a systematic comparison with market prices and testing the sensitivity of the resulting valuation to variations in the underlying economic assumptions. More specifically, this method makes it possible to look for a valuation of assets at maturity for the liabilities for which they are set up. It also reduces exposure to market illiquidity and volatility.

> The changes to IAS 39, as presented in the IASB's working document published on July 14, prove to be negative or insufficient.

More specifically,

- The disappearance of the treatments reserved for AFS assets possible up until then for certain assets, are considered to represent regressions.
- It is also difficult to take position on classification and measurement when rules for impairment and hedge accounting are not yet known;
- The conditions imposed by the IASB to be eligible to the amortised cost category are too stringent. Taking into account the main characteristic of various business models some flexibility in the criteria for eligibility is required.
  In particular it would be appropriate to enlarge to "debt instruments without significant leverage" this option which access is currently restricted to assets complying with the "basic loan feature criterion".

> To match Long-Term Investors needs the IASB Exposure Draft should also include in its scope

- Thee opening to the different categories of risks e.g. rate, forex, inflation and equity of the hedge accounting option allowing macro hedging
- The relaxing of the requirements to be fulfilled to access the possibility to account hedging instruments together with the related assets under HTM

3. First lessons learned

Financial institutions investing over the long term need the specific features of their value contribution to be factored in to accounting standards.

Indeed, they are suffering since only the trading business model is available (the alternative categories such as HTM and AFS are not mentioned as ideal accounting rules).

More specifically, this assumes that:

1. The various shortcomings with marking assets to market for instance will be rapidly reduced by
   - Preventing the mark-to-market valuation from being rolled out across the board
   - Looking into the use of average market values or other valuation techniques in order to reduce market volatility impacts
   - Defining the alternative valuation methods (and their conditions for implementation) that must be implemented immediately as soon as markets are illiquid
   - Encouraging an on going comparison and review of various valuation methods

2. The accounting treatment must not depend solely on the nature of the asset to be recorded, but rather strive for a balance between this criterion and the requirements resulting from the various forms of value added of financial institutions, including long-term investment; this will probably make it necessary to
   - Recognise that an asset sale is not necessarily a trading action, even if it takes place before an asset's maturity (which requires a radical revision of the tainting rule)
   - Review the practical application of the FVO (and in particular the valuation methods applied to items designated at fair value) to ensure it meets its objective i.e. reducing accounting mismatches and more generally the review should aim to facilitate the access to hedging techniques whatever assets accounting options are, notably for portfolios of assets held at amortised cost
   - Allow the coexistence of different business models among the various activities carried out by a single financial institution, authorising it to the concomitant implementation of a greater diversity of options for accountants to draw up their accounts".