



In the present note the Eurofi Working Group focuses on identifying the factors that could act as impediments to high and stable levels of long-term investment and the savings flows that finance such investment. A future paper will then build on this analysis to consider measures that might

be used to encourage long-term investment and savings. In its future activities the Working Group will also address issues relating to those elements of prudential legislation and regulation that could act as impediments to long-term investment.

Long-term investment represents:

- An investment that aims to achieve a high long-term risk-adjusted rate of return. Such an investment is often related to the introduction of new technologies or products, and with associated long-term increases in productivity and GDP. Thus, the short-term volatility of these investments is of limited relevance.
- Such investments typically require active professional investment analysis and management by an intermediary, such as an asset manager, securities firm, pension or hedge fund, insurance company, etc. Such institutions add value by researching long-term economic trends (business sectors, etc.) and effectively managing the risks inherent in an open-ended investment horizon and timeframe.
- Typically, such investments tend to be for periods of more than five years, and may be open-ended
- Such investments typically involve either equity participation or buy-and-hold strategies in long-term debt instruments.

Since long-term investment relies heavily on intermediaries in order to respond to the needs of both issuers and savers, particular attention must be given to the role and incentives of these intermediaries – a standard principal/agent problem. In that respect, it is essential to align the savers' long-term needs with the structure and conditions for savings. This will require considerable further improvement in the information provided to customers and in product distribution standards. It also necessitates an effective long-term focus of the intermediaries (asset managers, pension or hedge funds, life insurers etc.). This means creating long-term products that are attractive to final investors and to the investment managers who are their agents. In parallel, specific education efforts intended to improve financial literacy of citizens in Europe have to be implemented by the member states.

This interim document addresses the following topics:

- The need for long-term investment vehicles that satisfy both investors and issuers
- The long-term investment process
- Long-term investment issues
- Aligning saving vehicles with the needs of long-term investors
- Accounting issues for long-term investors

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

I. The need for long-term investment vehicles that satisfy both investors and issuers

Since investment activities involve savers, financial intermediaries and issuers, the description of the need for long-term investment is manifest.

Certain issuers need to be able to attract investors that intend to buy the financial instruments they issue in order to hold them for the long term. For example, corporations that undertake 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 participate in financing with a timeframe that is consistent with that for their physical investments, commit funds throughout the project development phase, effectively understand the nature of the operation's risk and adjust their financial support as needed throughout the duration of the capital investment project. This type of need is particularly pressing at a time when the global economy is 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, the definition of long-term investments may cover a very wide range of economic needs - infrastructures, housing, transport, communications, new energies, etc. - and represent considerable financial sums. To respond 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 needed to finance at least five key areas: retirement funds, real estate acquisition (a "fourth pillar" for households), wealth transmission, reducing dependency and access to education.

To stimulate these activities the instruments in which savings are held need to deliver attractive risk-adjusted returns over the long term and thereby help investors to achieve their financial goals, while also assuring their long-term financial security. In particular, certain financial needs require investment vehicles that are linked over time with the development of the economy and wages. This is notably the case for pension funds. They need to invest over the long term in real assets such as equities or property instruments, in order to replicate the trend of wages that, as for equities, is linked to global economic performance¹.

As regards long-term investments, investors are also sometimes looking for opportunities for diversification, particularly in terms of their horizon. These investors often turn to dedicated infrastructure financing funds. Research by CEPRES² highlights the importance of the amount of capital raised in this way, put at 67 billion dollars for 2007.

In sum, in responding to the needs of both issuers and savers, long-term savings exert a significant impact on the allocation of capital in the economy.

ALM of European Pension Funds January 2009 - EDHEC Risk and Asset Management Research Centre Publication"

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.

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II. The long-term investment process: a key role for financial intermediaries in delivering 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
<p>Who: Consumers, employees, individuals, etc.</p> <p>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.</p>	<p>Who: •Pension funds •Funds, hedge funds, etc. •Life insurance •Banks •Sovereign funds •Para-public structures •Etc.</p> <p>Regulatory frameworks: UCITS Directive, IORP, CRD, Solvency II IAS 39, 19, 17, etc.</p> <p>Management tools: Simple or sophisticated: asset and liabilities management, risk hedging financial instruments (rate, Forex, counterparty, etc.), etc. Leverage effect or not Etc.</p>	<p>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</p> <p>Investment vehicles Bonds Equities Etc.</p>

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

III. Long-term investment issues

In this context the Eurofi Working Group has highlighted, in particular, the difficulty of defining long-term investment issues as a whole.

The Group's first objective is to clarify the specific features linked to long-term savings, as well as the difficulties of aligning the long-term needs represented by pensions, etc., with the structure and conditions for savings.

This requires, in parallel, finding out the difficulties of delivering to 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 has 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.

Thus, up to this point 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 structure and conditions of savings instruments with the long-term needs of savers³: learning lessons on fund management

Educational improvements

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

Access to financial knowledge should be diffused more widely in the population, particularly to the less affluent. Helping the consumer understand the product and building investor confidence are fundamental. The financial services industry must markedly increase its efforts in this area. Simultaneously, the financial services industry needs to set itself high standards in respect of product transparency,

clarity of information and good client service.

Improvements in information standards

The effective implementation of the Key Investor Document (KID) for UCITS – due to replace the simplified prospectus – is a key element for 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.

Another major challenge for the investment 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 requires the industry to:

- Improve its governance
- Bring further transparency to investment products

Evolving toward a 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,

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

as mentioned above. Looking at net sales of cross-border funds in Europe, the yearly redemption rate has increased from 76% in 2004 to 101% in 2007. Ultimately, this volatility causes higher transactions 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 that adversely affects long-term savings flows can be a lack of training amongst asset managers' sales teams: resources should be spent on ensuring continuous upgrading of these 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 the 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 savings. 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 needs 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.

The industry should focus on crafting products that are fit for purpose. The global financial 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. In particular, 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. 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.

The next section addresses the obstacles stemming from accounting standards. The Eurofi working group will tackle prudential legislation issues at a later date.

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 for financial instruments is focused primarily on the relevance and the strengths and weaknesses of the various approaches for valuing financial assets and financial liabilities: measurement at their current value, as indicated by the markets (fair value), or at amortised cost⁴.

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 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 (see below), accounting standards may or may not reflect changes in the market value of financial instruments on the balance sheet (totally or partially) or on the income statement; these repercussions are either irreversible (impairments) or reversible.

For most⁵ equity financial asset categories, the current accounting standard, IAS 39, implies a measurement at market value with adjustment through profit and loss (income statement) or through equity (balance sheet). For equity instruments classified as Available-for-Sale, impairment losses cannot be reversed.

IAS 39: main principles currently in force (see table on next page)

Under these conditions changes in the market value of assets and liabilities - even when their impact owing to market volatility, temporary market illiquidity etc. are directly reflected on the balance sheet as the accounts are closed, and may be misleading concerning:

- The value of the business' holdings (value if it was liquidated)
- The 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 valuation changes differentiate from one balance sheet item to the next, thus creating mismatches in an accounting sense⁶.
- Since balance sheet items are often valued in the same way whether or not they have been sold, it is not easy⁷ 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 on the assessment of:

- The quality of the company's management, depending on whether fair value adjustments are immediately reflected on the income statement or not
- The quality of the firm's risk management, e.g. depending on whether

⁴ Other valuations methods based either on moving averages, or on the likely future value of financial instruments (discounted cash flow, etc.) are also proposed to complement market valuation and amortised cost.

⁵ Some equity investment can be measured at cost (so-called "cost exemption" under IAS 39)

⁶ It is possible to apply the Fair Value Option under IAS 39 to mitigate an accounting mismatch

⁷ On the basis of all the information provided by the income statement, the balance sheet and the disclosures notes it is possible to distinguish the realized gains/losses from the unrealized gains/losses

Accounting categories	Accounting features
Trading assets (and Fair Value Option FVO) Includes derivative products	Asset valuation: fair value (mark to market value or, if not available, a mark to model value) Change in valuation: P&L whatever realized or not capital gains or losses (as a consequence additional impairment rules are not necessary) Dividends, interests and realised capital gains or losses: P&L
Equity Assets available for sale (AFS)	Asset valuation: fair value Change in valuation through the balance sheet (increase or decrease in equity i.e. OCI) except impairment losses Dividend, Interests: P&L Realised capital gains or losses (after selling equity assets): through P&L including recycling of changes in valuation previously recorded through OCI Impairment: through P&L; reversal of impairment losses on AFS equity instruments not allowed
Assets held to maturity (HTM) If the management intention is to hold the assets until their maturity, the assets can be classified into the category "held to maturity". This category implies to value assets at cost, but they 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: amortised cost; Change in valuation: none except impairment losses Dividend, Interests: P&L Realised capital gains or losses (after selling the assets): P&L Impairment: through P&L; if the value recovers, it can be reversed through P&L but only to a certain extent Tainting rule: reclassification of the whole portfolio to AFS category if more than an insignificant amount of its assets is sold or reclassified before their maturity.
Hedging (fair value hedge)	Asset (hedging instrument & hedged item) valuation: fair value Change in valuation (hedging instrument & hedged item): P&L Restrictions: 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). HTM assets cannot be hedged against interest rate risk and prepayment risk
cash flows hedge & net investments hedge	Asset (hedging instrument & hedged item) valuation and change in valuation: effective hedge through OCI (BS equity statement), ineffective hedge P&L

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 transmits the volatility and illiquidity of the markets to long-term investors' accounting statements. However, unlike institutions that base their decisions on a short time horizon, this information is not relevant for players who can (or must) carry assets over the long term and are not subject to major liquidity constraints on account of the nature of their liability.

The current evolution of accounting standards may be leading some long-term investors to adopt behaviours that are more akin to those of short-term investors, and at least, financial statements of long-term investors redraw short-term behaviours while the intention of management is long term, 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. This same volatility may also undermine a company's profit and loss, **which no longer makes it possible to rate 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 underestimated⁸**, 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)⁹.

• **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 debt instruments.

⁸ Unless long-term equity investments is classified as AFS assets; in this case changes in FV are recognized in OCI i.e. with no impact on P&L

⁹ <http://aon.mediaroom.com/file.php/356/Aon+200+november.pdf>

- **Certain balance sheet items are particularly ill suited to a fair-value accounting treatment**

- This is more particularly the case of assets valuations which involve the credit risk of the institution holding them (Own Credit Risk)¹⁰
- There may not effectively be any market in this type of asset (insurance liabilities, etc.)
- It also related to insurance liabilities 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. 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 in order to avoid creating an artificial and damaging volatility differential¹¹; this possibility must be available even when other accounting options prove to be better suited to reflecting the activity on other activity portfolios.
- Assets corresponding to liabilities that are subject to 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 (interest rate swaps, currency swaps, etc.) should be able to fully offset the value of the asset or liability they cover in order to be a perfect hedge, in line with sound risk management by the entity; this possibility must also be open to aggregate 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 very significant. 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, 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-sector basis. However, the majority of users of accounting statements still appear 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 well-recognized alternatives to a mark-to-market valuation approach for assets that may be of particular relevance to long-term savers' and investors' assessments of financial performance. At this stage, however, no single valuation method seems to have unanimous backing.** The use of moving averages is being put forward by some advocates as a way of reducing the volatility of values offered by the market; for its part, valuation at acquisition cost makes it possible to free the accounts from volatility as well as a decline in valuations due to market illiquidity. This approach may be 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.

3. Proposed changes to IAS 39 regarding classification and measurement

- On July 14 the International Accounting Standards Board (IASB) published an exposure draft proposing changes to the "classification and measurement" elements of IAS 39. This exposure draft continues to make use of the "mixed valuation model" of accounting for the valuation of financial instruments. Specifically, it is proposed that two replace the four existing categories: amortized cost (with impairment) and fair-value through profit and loss. But many commentators would take the view that this exposure draws the line between fair value and amortised cost in an inappropriate place. Regarding, in particular, the reporting of equity securities, the proposed standards might not accurately reflect the business strategy of a long-term investor.

- **MAIN ELEMENTS OF THE IASB'S PROJECT CONCERNING SECURITIES:**

For equity instruments (equities)

The general principle is to systematically fair value (spot prices if listed), with value adjustments recognised through profit and loss. However, the exposure draft also offers an option for recording such instruments at their fair value (spot prices if listed), with value adjustments impacting equity statement, without any subsequent recycling through profit and loss even at the time of their sale. Under this option the possible dividends would also be recognised only through the equity statement.

This option could only be selected at the outset (date on which the security is acquired) and would be irrevocable.

In view of these provisions, impairment is no longer an issue, since value adjustments are recognised either directly through profit and loss (under the Fair value through P&L category), or directly and definitively through equity (under the Fair value through OCI category).

¹⁰ A fair value measurement of a liability (an entity's own debt) assumes that the entity's own credit risk is incorporated in the measurement of the liability. This means that the chance that the entity will fail to perform as required (i.e. the risk that the entity will not fulfil its obligation, referred to as the "non-performance risk") is taken into account in the measurement of the liability. The fair value rule in the measurement of an entity's li-

ability results in an entity reporting a gain from a decline in the credit quality of its liabilities (i.e. from a deterioration of its creditworthiness). This gain or loss (in the case of improving credit quality) is counterintuitive

¹¹ It is possible to apply the Fair Value Option under IAS 39 to mitigate an accounting mismatch

For debt instruments (including bonds):

The IASB proposal is to value them at their amortised cost only if they are "basic" debt-instruments (i.e. without any leverage effect notably linked to certain embedded derivatives) for which the management intention is to match and guaranty contractual flows.

Other instruments would be measured at fair value through profit and loss.

Reclassifications from one category to another would not be possible¹².

- The comment period for this exposure draft extended until the 14 of September. Initial indications are that many observers believe that the criteria proposed by the IASB for accounting financial instruments at amortized cost with impairment are too narrow and, more generally, that other accounting methods may fit more appropriately users with long-term time horizons.

Generally speaking:

- Many observers consider IASB proposals inappropriate for long-term investors because the accounts will continue to reflect market volatility into long-term investors' accounting statements.
- The proposed option for recording financial instruments at their fair value with value adjustments impacting equity statement, excludes the possibility to "recycling" dividends through profit and loss: this is not appropriate for long-term investors
- IASB proposals deny the possibility to explicitly and directly¹² report long-term investors' actual "performance", due to the assimilation of unrealised and realised earnings within equity

More specifically,

- The removal of "Available-for-sale" (AFS) equity investments accounting is considered by some stakeholder to represent a regression.
- It is also difficult to take a position on classification and measurement when the rules for impairment and hedge accounting are not yet known;
- The conditions imposed by the IASB to be eligible for the amortised cost category are widely regarded as 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 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:
 - An expansion of macro 'hedge accounting' to the different categories of risks, e.g. interest rate, forex, inflation and equity of the hedge accounting option allowing macro hedging
 - The adequate provisions to reflect hedging financial instruments together with the related portfolio of assets accounted at amortised cost in order to avoid any accounting mismatch

Since long-term investment can play an essential counter-cyclical role in markets, it appears essential to adapt accounting rules to their specificities.

4. First lessons learned

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

Currently, such institutions are adversely affected because 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 in 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 making it clear where they would be appropriate and why they would be helpful though many of them have been dismissed by standard setters
 - Defining the alternative valuation methods (common or proprietary models Etc.) and their conditions for implementation which must be used immediately as soon as markets are illiquid
 - Encouraging an on going comparison and review of various valuation methods to be used in particular in reporting financial instruments held at fair value

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 specific to long-term investment business models,.

This will probably make it necessary to set up specific accounting options that

- Recognise that an asset sale is not necessarily a 'trading action', even if the transaction takes place before an asset's maturity (which requires a radical revision of the tainting rule that is removed in exposure draft; in this draft some sales are also allowed among assets classified in the amortised cost category)
- Review the practical application of the FVO to ensure that 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

¹² N.B. In addition to the provisions outlined above, the project presents several "alternative" approaches, under which some of the securities valued at amortised cost (as well as equity instruments measured at fair value through equity) would be recorded at fair value through profit and loss.

¹³ The annual report composed of the income statement, the balance sheet and the notes allows the users to distinguish realized gains/losses from unrealized gains/losses

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