Paris, 29 June 2015

Contribution of the « Task Force ILT de la Place de Paris » [1] on its draft endorsement advice on IFRS 9 Financial Instruments

Noting that since 2007, following the economic and financial crisis, the level of investment in the European Union (EU) fell by 15% and that the forecasts do not appear to announce significant rebound in the next 5 years even though our economies are in an urgent need of long investment, the European Commission launched in November 2014 "an investment plan for Europe" which aims to raise EUR 315 billion in additional investment[2] by 2017. Due to the public finance management constraints the implementation of this plan requires the mobilization of at least EUR 252 billion of private funds.

This lack of investment that constrains economic recovery, job creation, long-term growth and competitiveness, adds to the uncertainty of the economic situation so that high levels of public debt in some European countries limit the margins of maneuver. Nevertheless there are significant savings volumes (only for France, household saving is estimated at EUR 12,000 billion) while many viable investment projects do not find funding.

The large stock of savings of European households is tied in large part to the fact that they have changed their saving behavior following the crisis of 2008 in the direction of a greater caution: precautionary savings are up, a willingness to invest in more secure investments, and a growing distrust in the pension plans. However these savings are *de facto* long-term savings that households prefer to direct towards liquid investments preventing these savings to be directly affected to long-term investments.

Therefore the challenge is to channel a significant part of household savings towards long-term investments, which can be done only by the interposition of intermediation balances, including bank or insurance.

This intermediation may include a share of transformation since a short and liquid resource in theory actually represents a long and sustainable resource since the savings behavior makes it a stable resource. Prudential regulation should set up precautionary limits to this transformation based on a realistic observation of risks involved, but we must ensure that the various applicable standards, notably accounting standards, do not prevent the provision of this service which is both a benefit convenience for households and a vital contribution to the overall economy.

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[1] *The « Task Force on Long Term Investment » leaded by Gérard de La Martinière gathers representatives of Paris Financial Center : Association Française des Investisseurs pour la croissance (AFIC), Association Française des Investisseurs Institutionnels (AF2i), Association Française des Entreprises Privées (AFEP), Association Française de Gestion Financière (AFG), Groupe Caisse des Dépôts, EUROFI, Fédération Bancaire Française (FBF), Fédération Française des Sociétés d'Assurance (FFSA), Fédération Nationale des Travaux Publics (FNTP), Groupement des entreprises mutuelles d'assurance (GEMA), Mouvement des Entreprises de France (MEDEF), Paris Europlace.*

[2] *EUR 240 bn in strategic infrastructure of European interest and EUR 75 bn in the risk financing of SME-Mid-Market Companies.*

Entities with long term liabilities are characterized by the permanence of their resources determined by the nature of their contractual commitments, tax losses or observable and predictable statistical reality. So they are structurally less exposed to liquidity risks, as well as those resulting from the volatility of the financial markets. They have both the capacity and the fiduciary duty to lean against their liabilities an asset management of long-term. Their business model is radically different from that of other economic actors which fund themselves in the short term (*i.e. the Fund managers*).

The IFRS 9 standard on the accounting treatment of financial instruments theoretically focuses on the business model - but in the restrictive sense of the intention of management – in order to classify financial instruments. In reality it fails to take into account the specificities of the economic model of the long-term investor - especially regarding the treatment of the long term share ownership : thus, the investor has the choice between the use of fair value through profit and loss (implying a strong volatility of it, which has no economic sense in a long-term approach) or through equity (which then prohibits recycling in profit and loss thus precludes and the prevents any measurement of the actual performance of the long-term investment). Neither of the two economic models used is relevant to the long term investors.

EFRAG has also taken this fact into account in its « *Draft Endorsement Advice* »[3] :

"It has been brought to the attention of EFRAG that other long-term investors, in certain European jurisdictions may face undesirable effects of measuring equity investments at fair value through profit or loss. <u>These entities argue that they invest in equity investments with a long-term horizon and the fair value movements recognised in profit or loss on period-by-period basis does not reflect the economic reality of their business since any gains or losses on their equity investments will only be realised at expiry of their investment horizon</u>. For these long-term investors, EFRAG believes that the option to recognise fair value changes in other comprehensive income is not a preferred solution. While it would remove the fluctuations resulting from unrealised gains or losses from profit or loss and recognise it in other comprehensive income, the prohibition on reclassification of accumulated gains or losses from other comprehensive income to profit or loss is regarded as distorting the performance of these entities given that these equity investments are held primarily for capital appreciation in the long run. EFRAG also believes that, as a consequence, this may lead to non-GAAP measures being developed by such entities to provide relevant information about their performance by removing the fluctuations caused by unrealised gains or losses from profit or loss. <u>EFRAG</u> thinks it is unlikely that these entities would change their investment strategy as a result of the implementation of IFRS 9, but <u>will gather further information on this during the consultation period of the draft endorsement advice</u>."

From this point of view the current revision of the "*IASB's Conceptual Framework for Financial Reporting*" is interesting because it proposes to reintroduce explicit reference to the concept of "prudence" but also to the principle of "going concern" that involve renewed and objective analysis of the activity of long-term investors in order to identify appropriate solutions to transcribe the reality of their economic performance without introducing any methodological bias which may discourage long-term investment. So the principle of prudence should lead to exclude consideration in the results of unrealized gains that may evaporate immediately after the closing of accounts; as well, the principle of "going concern" should exclude any approach of the value in a purely "net asset value" view, as is that of the market value.

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[3] *4 may 2015, Appendix 3 « Assessing whether IFRS9 is conducive to the European public good », paragraph 83, page 67 « Impact on investor » Equity investments at fair value and long term investments »*

Finally, the question of the business model needs to be carefully considered as this is the nature of the activity and its organization which should determine the accounting and not the reverse. Furthermore the usefulness of accounting information is measured by the way it is able to translate the economic reality, which implies that accounting standards should seek to match this reality to better represent it : the market value is certainly a good approach to a bank trading room; but it is not automatically a good approach for a life insurer that carries contracts from 12 to 15 years. The adaptation of accounting standard to companies' profiles should also provide the means to restore the quality of the dialogue between the management and the analysts by providing the terms of a common language.

For a long-term investor, the good accounting standard would be first the standard that would deal, in a articulated and a parallel way, the valuation of the assets and of the liabilities, because it is deliberately ignoring the profound nature of the activity to introduce heterogeneous valuation methods that create inconsistency between the two sides of the balance sheet where the entire purpose of the management is to make them coincide in time and space.

Secondly, the good understanding of the activity involves the consideration of an entire portfolio because asset management is not done in the "line-by-line", but in the constitution of diversified portfolios to spread risk and adjust backgrounds and sensitivities to the fine characteristics of liabilities. The Analysis of the "line-by-line" value may provide useful information for external observers and it would be entirely justified to provide the results in the appendix of the accounts, but it cannot be used to measure the "Asset & Liability Management" performance in the long time.

Finally, under the rule of "substance over form", it would be appropriate to revisit the treatment of investments in shares to explore the concepts of "value in use" or the "output predictive value" that would be more relevant than the instantaneous value of market to account for the success or the failure of an "asset-liability management" over time. It has never been imagined to value the factories in "resale value" either in "scrap value", so they are able to deliver products for which we established them.

Thus the reference to the "business model" accepted by the "conceptual framework" requires a specific standard and suitable for this type of activity. The European economic situation does not allow overlooking such enrichment of IFRS; accounting standards should not be recognized as responsible for blocking the long-term investment (infrastructure – R&D - Sustainable Development) which is crucial for the future of our societies.

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