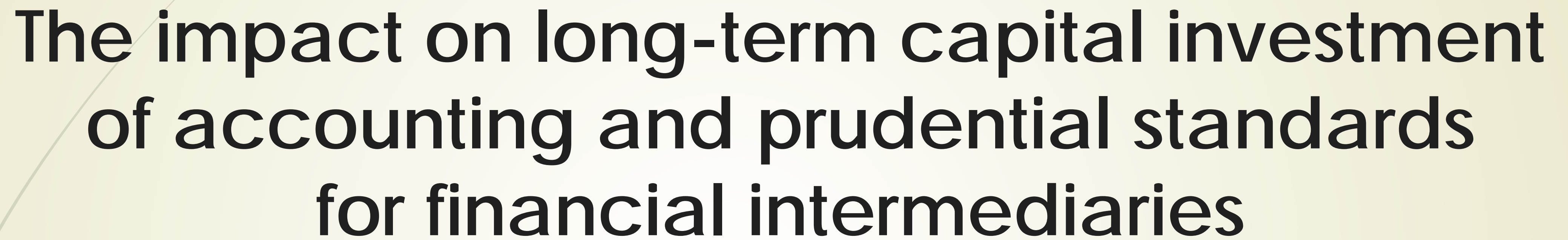

The impact on long-term capital investment of accounting and prudential standards for financial intermediaries

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Bruegel - Potential Impediments to Long Term Investment

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Plan

1. Global Research context – Issue - Methodology
2. The impact of accounting standards on long-term investment
3. The impact of prudential standards on long-term investment (banks)
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1. Global Research context –
Issues - Methodology

1- Global Research context - Issues

- **Paradox**: Weak investment and plentiful savings
- Insufficient capital investment = a major obstacle to economic growth for 30 years
- **Reasons**: changes in the interrelated demand for and supply of capital
- **Focus on capital supply** i.e. inefficient allocation of savings, resulting from the short-term bias of market participants and financial intermediaries
- **Consensus :**
  - academic literature(Zingales 2015 , Coeuré 2015, Philippon et Reshef, 2012 ; Kneer, 2013…)
  - regulators (Volcker 2009, Turner 2009)
  - finance professionals : (Larry fink, CEO BlackRock, 2014-2015-2016)
  - "We certainly believe that returning cash to shareholders should be part of a balanced capital strategy; however, when done for the wrong reasons and at the expense of capital investment, it can jeopardise a company's ability to generate sustainable long-term returns."
  - EU Commission : Green Paper on the long-term financing of the European economy (2013) with a discussion on inefficiencies in the intermediation chain with reference to Kay (2012)

1- Issues and research Interest

- **Several explanations advanced for short-termism** :
  - Regulatory requirements perhaps encourage financial investors who might otherwise make long-term investments to adopt a short-term bias.
- **The wide range of regulatory frameworks of financial intermediaries impose varying degrees of constraints and that evolve over time**
  - Prudential banking and insurance regulation (Basel III & Solvency II)
  - Accounting regulation (IFRS standards)
  - Enhance financial stability and transparency to strengthen the resilience of the financial system
- **Issues**:
  - Could the new requirements be in danger of hindering long-term investment financing?
- **Objective and Research interest :**
- Identify direct and indirect impact of those reforms on the intermediation activity of banks and insurance companies (lending and asset allocation)
- Most of theoretical and empirical research seeks to demonstrate the beneficial effects of fair-value accounting on transparency or of prudential standards on financial stability BUT very few studies have focused on the connection to investment.

1- Methodology

Data

- A qualitative approach: A representative European sample
  - 70 semi-structured interviews
  - Qualitative database from responses to the Public Consultation launched by the European Commission on its Green Paper on the long-term financing of the European economy, (March 2013).

Methodology

- The findings from these surveys are analysed in conjunction with the academic studies examined in our review of the literature
- This analysis allows us to do recommendations for making accounting more supportive of LTI

Main results :

- Our findings highlight that IFRS accounting affects funding for long-term investment in a variety of ways, depending on the activities in which banks and insurance companies engage.
- Current prudential rules are likely to prove even more detrimental to long-term investment financing

2. The impact of accounting standards on long-term investment

2- The impact of accounting standards on LTI

Financial instrument standards

Long-term investing and financing are primarily affected by IAS 39 – Financial Instruments, to be replaced from 1 January 2018 by IFRS 9.

The effective date for the new standard will be deferred for the insurance sector

Insurance contract Standards

2- The impact of accounting standards on LTI

- **For 54% of respondents, Fair value would have a negative impact on long-term investment funding**

- **<u>Effect of IAS 39</u>:**
- **For Bank (lending)**:
  - We found that IAS 39 has not affected long-term financing activity by banks.
  - The standard calls for measuring loans and receivables at amortised cost (similarly to French GAAP), which makes long-term management of such portfolios possible
- **For insurers (asset allocation):**
  - We observed a number of effects, some reflecting the low suitability of IFRS on:
    - Financial statements
    - Behaviour of insurance fund managers

2- The effects of IFRS 4 and IAS 39 on insurance companies

Technical impact of the standards on LTI	Impact of the standards on financial statements	Impact of the standards on investment managers
IAS 39: HTM category ill-suited to accounting for long-term investments due to the “tainting rule”, which sanctions the sale before maturity of an asset classified as HTM.	Fair value accounting has introduced **volatility into insurance companies’ financial statements**. Long-term investments are remeasured at the close of each reporting period, with any changes recognised in OCI (through equity). **Those remeasurements reflect changes in the market rather than in the actual performance of long-term investments.**	Confronted with fluctuations in long-term investments, insurance fund managers adopt momentum strategies and review their asset allocation more frequently, with the result that **the holding period for long-term assets has become shorter.**
As IFRS 4 phase 1 does not regulate measurement and recognition of insurance liabilities, they are still carried at cost, as they are under French GAAP, for example. This leads to inconsistency between fair value accounting for assets and cost accounting for liabilities.		Fund managers adopt **procyclical behaviour in that they adjust their investment strategies to reflect changes in the market value of assets.** Bull and bear market cycles become more pronounced as a consequence.

2- The impact of accounting standards on long-term investment

Potential effect of IFRS 9: Applicable in 1/2018 (or 2021 for insurers) to replace IAS 39

- **For banks and insurers**
  - IFRS 9 will therefore potentially affect long-term investing activity by banks and insurance companies

- **For banks :**
  - Furthermore, IFRS 9 will have an impact on lending by banks, as it will change the criteria for determining the measurement category (fair value or cost) and the provisioning method

2- The potential effects of IFRS 9on banks and insurance companies

- **IFRS 9**: Applicable in 1/2018 (or 2021 for insurers) to replace IAS 39
- IFRS 9 will therefore potentially affect long-term investing activity by banks and insurance companies in the following ways:
  - It will heavily penalise investments in equities
  - It will penalise investments in alternative assets (private equity, infrastructure investments)
  - On the whole, it will boost investment in bonds
  - Short-term investments will be unaffected
- Under IFRS 9, gains and losses on the sale of equities cannot be recycled.
  - This means that the performance of investments will never be recognised in profit or loss.
  - Banks, insurance companies and non-financial companies are all confronted with this issue

2- Potential effects of IFRS 9 on long-term investing by banks and insurance companies

	Introduction of the pure cash flow criterion to determine the measurement category	**Elimination of the tainting rule**	**Stocks are measured by default at FV-P&L**	**More flexible hedge accounting procedures**
Changes in standards	The standard requires an asset to meet the SPPI test to qualify for measurement at cost or at FV-OCI.	Assets that meet the SPPI test may be measured at cost provided they are managed under a long-term business model.	Only stocks classified as strategic can be measured at FV-OCI, but in this case without recycling to profit or loss upon disposal.	Simplified eligibility criteria for hedge accounting and more flexible criteria for assessing hedge effectiveness
Potential effects	Many assets will be moved to another category (to FV-P&L): quoted and unquoted equity instruments, non-plain vanilla bonds, loans with structured rates, specific tranches of securitised loans and infrastructure investments.	Higher investment in bonds that qualify for cost accounting	Lower investment in stocks	Long-term asset hedges more accurately represented
Effects on long-term investing	**Unfavourable**	**Beneficial**	**Unfavourable**	**Beneficial**

2- Potential effects of IFRS 9 on long-term lending by banks

	Loan measurement	**Loan provisioning**
Changes in standards	*SPPI test* applied to loans The application guide sets out the criteria for application to loans	Shift from an incurred loss model to an expected loss model
Potential effects	A majority of loans will be considered plain vanilla and may be measured at cost. Non-plain vanilla loans will be measured at FV-P&L	Higher provisions Higher lending costs
Effects on long-term financing	**Neutral**	**Negative impact on long-term loan categories (greater default risk)**

- IFRS 9 will have an impact on lending by banks
- Because it will change the criteria for determining the measurement category (fair value or cost) and the provisioning method

2- Accounting recommendations to promote long-term investing

Proposals principle: Underpinning our proposals is the **asymmetric prudence principle**, which calls for recognising unrealised losses only, but not unrealised gains.

In contrast to the view of prudence upheld by the IASB, which can be equated with a neutrality principle that leads to recognition of both unrealised gains and losses.

No proposal for long-term debt instruments because IFRS does not make it complicated to account

Proposals relevant to both banking and insurance : to tackle negative effect of IFRS 9 on recognising and measuring portfolios of quoted and unquoted equity instruments held for the medium and long term.

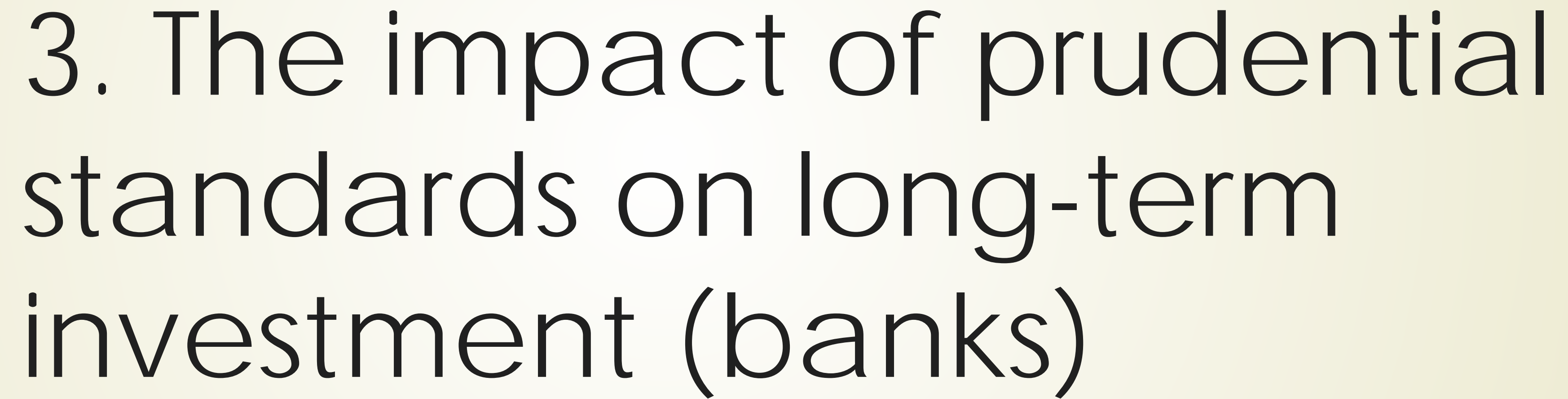
- **For (quoted) equities held for the short term (less than 1 year)**, use FV-P&L accounting. The management intent with regard to such instruments is to maintain high turnover so as to achieve the highest possible returns in a short time span.
- **For (quoted and unquoted) equities held for the medium term (between 1 and 5 years)**, use the FV-OCI category, while allowing gains and losses on the sale of those instruments to be recycled to profit or loss.
- **For (quoted and unquoted) equities held for the long term (over 5 years)**, use cost accounting by **creating a new category for longer-term equity investments.**

2- Accounting recommendations on how to promote long-term investing

The creation of a long term accounting category (quoted and non quoted equities, infrastructures) **BUT UNDER CONDITIONS**! :

- **Measurement at cost accompanied by a provisioning model that permits recognition of unrealised losses.**
- **Use of rebalancing**, which permits ore active management, but with the consistent aim of meeting the long-term strategic allocation objective. This implies proper control of turnover. The goal remains long-term allocation to achieve long-term returns.
- **Choice of a minimum holding period.** A 5-year period would be in line with the consensus response on the concept of long-term investing.
  - Five years is also the period adopted by the EC for the European Long-Term Investment Fund (ELTIF), which entered into force on 15 December 2015.
- **Mandatory disclosure of the following information in the notes to the financial statements:** the composition of the portfolio, changes in that composition with justification provided for rebalancing and the fair value of the assets held.
- **This new accounting category could be applied to all investors who hold financial assets for longer periods.**

3. The impact of prudential standards on long-term investment (banks)



3- Negative effects on the banking sector and their causes according the respondents

- 94.2% of respondents (from both the financial sector and non-financial companies)considered that prudential regulation negatively affected the long-term financing capacity of intermediaries
- **Two different lines of arguments:**
  - The liquidity requirements and their effect on banks' ability to perform maturity transformation (loan, investment, securitisation portfolios, etc.)
  - The capital requirements and the higher costs of financing (through securitised and non-securitised lending).
- Each effect may be caused by several regulations
- **Several negative effects:**
  - *Effect 1: A reduction in long-term financing*
  - *Effect 2: Shorter loan terms*
  - *Effect 3: Higher financing costs and a tighter supply of financing*
  - *Effect 4: Less higher-risk investment (in quoted and unquoted equities) and more so-called risk-free investment (in government bonds)*
  - *Effect 5: A threat to the economic viability of securitisation; securitised assets with longer terms to maturity will be penalised by higher solvency ratios*

3- Negative effects on the banking sector and their causes according the Green Paper respondents

- **Two opposing approaches to assessing the impact of the capital requirements:**
- **Respondents from the banking sector :**
  - The additional requirements will force them to recapitalise and therefore to charge clients more for financing.
  - This will drive their ROE down, making the banks less attractive to potential shareholders.
  - The regulatory capital required will lead them to shun assets with higher risk weights
  - This in turn will result in credit rationing and more expensive loans = "double whammy" for borrowers.
  - To these respondents, the deleveraging process, a consequence of the new prudential requirements, will therefore become a major cause of the inadequate supply of long-term financing to the European economy and of low economic growth.

3- Negative effects on the banking sector and their causes according the Green Paper respondents

- **This viewpoint calls for qualification :**
  - The leading US and European banks enjoyed very high ROE in 2000's (unsustainable on the long run).
  - Between 2002 and 2014, ROE in US and European industry ranged from 10% to 13% whereas at universal banks it ranged from 10% to 20% between 2002 and 2005, and from 20% to 30% between 2004 and 2007, after which it declined drastically (ECB, 2010; Villeroy de Galhau, 2015).
  - Pressure from shareholders >> Incentives to select risky projects that are profitable in the short term and by turning down long-term investments likely to produce lower immediate returns.
  - A high ROE tells us very little about the risks they take in terms of leverage, capital structure, dependence on short-term wholesale funding, asset quality, risk concentration
  - All strategies for restructuring bank balance sheets to generate long-term value and move to a more stable business model tend to drive ROE downward
- **Arbitrage between invesment funding and Financial stability:**
  - **Banks should rethink the stark emphasis on return on equity that characterised a number of their models in the 2000s.**

3-A discussion of stakeholders' arguments and recommendations

To conclude our discussion of the three ratios, to give banks adequate incentives to finance long-term capital investment projects without sacrificing traditional bank intermediation and financial stability:

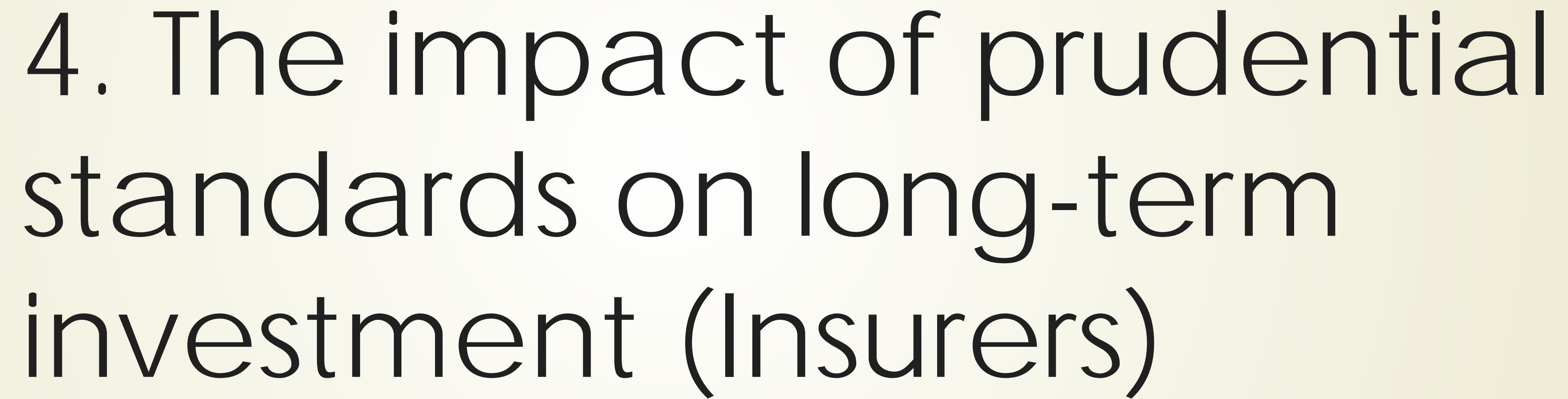
Recommandations on prudential ratios: lighter requirements UNDER CONDITIONS!

- Risk weightings for long-term assets funding should be reduced (min/ horizon holding, productive assets)
- a wider range of assets should be made eligible for the liquidity buffer
- above all investments that finance the real economy

Recommandations *on securitization:* *M*aking securitisation safe UNDER CONDITIONS!

- the obligation to trade securitised assets on regulated exchanges >> The centralisation and standardisation offered by those exchanges would ensure that individual risk is not transformed into systemic risk.
- Requiring the originating bank to keep part of the risk on its books to give banks an incentive to select and monitor borrowers more carefully.
- Loans to SMEs should be a primary focus, along with those used to finance capital expenditure. Mortgage loans should not be the only underlying assets.
- Only those securitised assets that meet the above requirements should be given preferential prudential treatment

- The unintended effects they produce may run counter to the stated goals.
- Those limitations are due to :
  - the tendency of prudential rules to accumulate and interact
  - their increasingly complex and technical nature
  - their instability
  - the growth of shadow banking. empilement et l'interaction des textes ;


4. The impact of prudential standards on long-term investment (Insurers)

4-Negative effects on the insurance sector and their causes

- 73.8% felt the programme's approach to valuing assets and liabilities of Solvency II would be detrimental to long-term investment

- **Two lines of critics** (according to Green Paper respondents)
- **Short bias 1:** The choice of a prudential framework based on Full fair value
  - Issue: regulatory capital is calculated under the new accounting framework (not the IFRS framework)
- **Short bias 2** : Prudential calibration: the prudential treatment of specific long-term assets (calibration)
  - Issue: regulatory capital risk weights assigned to specific long-term assets.
  - Among those effects are powerful disincentives to finance infrastructure investments and invest in quoted and unquoted equity instruments, leading to a preference for government bonds and short-term strategies – magnified by the use of one-year VaR as a risk measure.

4-Negative effects on the insurance sector and their causes

Short bias 1: Negative effects related to Full fair value paradigm

- Same negative effects mentioned and analysed in the accounting section on fair value:

  Higher volatility, greater procyclicality, shorter investment horizons, departure from "buy-and-hold" management, preference for less risky and less volatile assets (government bonds) instead of higher-risk assets (e.g., quoted and unquoted stocks, infrastructure investments)

Recommandations:

- These effects to be well-founded according on our critical analysis of the theoretical underpinnings of fair value accounting
- All the recommendations made in the accounting section apply here as well
- We are also in favour of expanding the range of assets eligible for the use of countercyclical mechanisms to mitigate those effects in the prudential framework.
  - All recommendations aimed at rendering investment strategies less procyclical and less volatile

4-Negative effects on the insurance sector and their causes

- **Short bias 2: negative effects**
  - Issue: the regulatory capital risk weights assigned to specific long-term assets – magnified by the use of one-year VaR as a risk measure
  - powerful disincentives to finance infrastructure investments
  - disincentives to invest in quoted and unquoted equity instruments
  - preference for government bonds and short-term strategies
- **Recommandations:**
  - these negative effects are well-founded based on our critical analysis of the theoretical underpinnings of fair value accounting,
  - Lighter prudential treatment for long term assets But UNDER conditions!

4-Negative effects on the insurance sector and their causes

Recommandations/ prudential treatment :

- **Lighter prudential treatment for long term assets But UNDER conditions!**
- **for low-risk infrastructure project assets**(non-carbon wherever possible) = kinds of long-term assets (investment in tangible assets) to promote for a return to sustainable growth.
- **for unquoted equity instruments**, provided that the explicit purpose of purchasing them is to channel financing to innovative companies, as in the case of private equity funds of funds (with programmes to invest in intangible assets).
- **for equities** = another vehicle for financing such investments but funding providers would need to fulfil the behavioural requirements set :
  - (i) they would have to keep portfolio turnover low or limit it to rebalancing
  - (ii) they would have to practice buy-and-hold asset management, an approach that insurers deem unworkable for them because of the current valuation methods.
- A one-year VaR horizon may not be appropriate for the insurance industry

Summary

Effect of the standards Neutral 0 Beneficial + Adverse –	IFRS accounting standards	Prudential standards	Aggregate effect: Cumulative effect ++ Cumulative effect – – Neutral effect +–
Banks			
Loan portfolio	Neutral (IAS 39)	Adverse (liquidity ratio)	0 +
High-risk asset allocation (equities, private equity, infrastructure)	Adverse (IAS 39 and IFRS 9)	Adverse (solvency ratio)	- -
Low-risk asset allocation	Adverse (IAS 39 tainting rule) Beneficial (IFRS 9 business model if SPPI test is met)	Beneficial (solvency ratio)	- + + +
Securitisation	Neutral (IFRS 10 and IAS 39-IFRS 9)	Neutral	0 0
Use of derivatives		Adverse (leverage and liquidity ratios)	-
Insurance companies			
High-risk asset allocation	Adverse (IAS 39 and IFRS 9) Investment property: Neutral (IAS 40)	Adverse (solvency ratio)	- -
Low-risk asset allocation	Beneficial (IAS 39 tainting rule) Beneficial (IFRS 9 business model if SPPI test is met)	Beneficial (solvency ratio)	- +

Conclusion

- Our research into the impact of IFRS on long-term investment and financing by banks and insurance companies shows that those accounting standards affect different financial intermediaries in different ways
- **Accounting standards:**
- IAS 39 has no impact on lending activity
- The combination of IAS 39 and IFRS 4 phase 1 has introduced short-term thinking into long-term management.
- IFRS 9, which will come into force in the 2018 financial year (for banks)may have a negative impact for its approach to measurement and recognition of medium- and long-term investments in equity instruments.
- The aim of our proposals is to introduce greater balance into IFRS, so that assets held for the long term can be measured in a more consistent manner, without being penalised by the accounting rules (creation of a new accounting long term category...)

Conclusion

- **Prudential standards:**
- The recent prudential rules have proven to be even more detrimental to long-term investing than those accounting standards.
- We have noted that prudential requirements (solvency, liquidity and leverage ratios) have a negative impact on portfolios of loans and high-risk securities such as quoted and unquoted equity instruments and infrastructure investments.
- But that negative impact should not be overstated although in light of the high ROE recorded which not sustainable on the long run.
- We have found that the cumulative negative effects of existing accounting and prudential standards make high-risk securities less attractive than government paper
- Lighter requirements until condition on funding of productive assets, long term asset holding and transparency...)