Hans Hoogervorst, 9 April 2013, London

Accounting and long term investment – 'Buy and hold' should not mean 'buy and hope'

As a former politician, I am all too familiar with the pitfalls of short-termism. Harold Wilson once famously said that a week is a long time in politics. He made that comment well before the age of the internet and the 24—hours news-cycle. Unfortunately, short-termism is a big issue in the economy as well. Two, related factors are conducive to short-termism. First; in our modern market economy, more than ever before, people work with other people's money. Secondly, with the increasing complexity of the economy, the distance between investor and investee has increased dramatically as well.

Corporate governance and regulation have been struggling to keep up with the complexity of financial intermediation and its many temptations. Not many investors are capable of keeping a close eye on the managers they have entrusted their money to. In addition, conflicts of interest are rife. Investment companies who should be holding their investee's management to account, might also be interested in managing their pension fund. How critical are these investors going to be?

All this is an ideal backdrop for short-termism. Money managers have huge incentives for making momentum-driven investment decisions. Indeed, recent research has confirmed it to be a very profitable exercise[1]. In the short run, going with the flow is often the safest bet, no matter how irrational this flow may be. As long as the going is good, the money manager does not face criticism; when the music stops, he can blame it on the markets.

On top of that, macro-economic policies are currently not particularly helpful for investors who want to take a long-term view. Central banks around the world are employing highly expansionary policies to make sure there is still an economy tomorrow. What these policies will bring for the day after tomorrow is highly uncertain, but they might very well end in tears.

Many observers are worried that the prevalence of short-term horizons in the financial markets is detrimental to long-term investment and economic growth. Recently, the Financial Stability Board, Group of Thirty and the European Commission have published reports on this issue[2]. While accounting standards are not a central theme, some of these reports do contain suggestions that, some believe, could make accounting standards more helpful to investors with a long-term horizon.

What is the role of the IASB in promoting healthy, long-term investment? I would say it is an essential part of our job. The purpose of accounting standards is to keep

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[1] A market strategy that keeps on rolling, Financial Times, 8 March 2013

[2] FSB : Financial regulatory factors affecting the availability of long-term investment finance, 8 February 2008
Group of 30: Long-term Finance and Economic Growth
European Commission, Long-Term Financing of the European Economy, 25 March 2013
http://www.ft.com/cms/s/0/077de35e-93bc-11e2-b528-00144feabdc0.html#axzz2OUkkNNrf

capitalism honest, as my predecessor, David Tweedie, used to say. Financial reporting forces management to show how they have discharged their responsibilities to make efficient and effective use of the company's resources. This is the principle of stewardship. In essence, it means accountability.

A couple of years ago, we removed the term 'Stewardship' from the Conceptual Framework. Some critics regret this removal of the word stewardship. Some see it as an indication that the IASB would no longer attach sufficient importance to the interests of the long term-investor. To these critics, we usually answer that the word Stewardship was only removed because it was so difficult to translate in other languages. We also point out that the essence of the principle is still covered by the Conceptual Framework. Close-reading the Conceptual Framework reveals this is true. Yet I can imagine that some might find the essence of the Stewardship principle a bit hard to find.

There can be no mistake that holding management to account remains a very important purpose of financial reporting. Management must tell investors what resources the company acquired, why it acquired them, and how it used those resources. Management must tell what obligations the company incurred, why it incurred them, and how it satisfied those obligations. Information of this kind is not only useful for buy, hold and sell decisions, it also helps investors decide how to vote on management's actions. If Stewardship is impossible to translate, perhaps we could replace it by a better word, such as accountability.

Whatever we call it, there should be no ambivalence about Stewardship being a central goal of financial reporting. Apart from our general principles, are there other ways in which our standards could affect long-term investors? It is often said that IFRSs discourage long-term investment by relying excessively on fair value or other forms of current measurement. Excessive use of fair value would, supposedly, encourage financial engineering and short-term profit taking.

So what are the facts? The truth is that, outside the financial industry, most companies have little to do with fair value accounting. The bulk of their assets and liabilities are measured on a cost basis. Those who follow our discussions on the Conceptual Framework know this is not likely to change. Even in the financial industry amortized cost is still an important measurement base. Most of a bank's traditional assets, such as loans, are measured at amortized cost, now and in the future. It is no surprise, that most academic research shows that fair value accounting was not a major driver of volatility during the financial crisis.

Still, in the financial industry current measurement techniques play a bigger role than in other parts of the economy. As many financial instruments are traded around the clock in active markets, market value often gives the most relevant information. Where fair value <u>was</u> used during the crisis, it often gave much more timely information on the poisonous instruments that had been injected into the system. Preparers and investors who paid attention to fair value signals were often much better at limiting damage than those who chose to ignore them. The use of current measurement techniques in the financial industry will be substantially increased by our upcoming insurance standard. As you probably know, the IASB is close to finalising an exposure draft on insurance contracts. The proposed standard will prescribe current measurement of the insurance liability, while many insurers currently still use historic cost. The public discussions on this standard provide a microcosm of the debate on long term investment versus short-termism.

Many in the insurance industry are concerned about what is coming. They criticize the new standards for creating too much volatility. They claim that this volatility will discourage them from making long-term investments and from providing products with guaranteed results. So what is fact and what is fiction? Let me start out by saying that the insurance industry is a hugely important investor. In Europe alone, the insurance industry has a 5.4 trillion euro investment portfolio. Life insurance is a long-term liability business, so the industry potentially has an enormous appetite for solid long-term investments.

Unfortunately, current monetary policies make life very difficult for the insurance industry. EIOPA, the European Insurance regulator recently raised the alarm bell about the effects of persistent low interest rates on the industry. On the liability-side, low interest rates increase an insurer's obligations in today's terms, while the return on assets is depressed. Said differently, if low interest rates persist, insurers may find that their assets do not generate the cash flows needed to pay policyholders' claims.

EIOPA is concerned that a considerable number of insurance companies will not be able to meet their capital requirements. EIOPA refers to Japan, where persistent low interest rates caused some insurers to fail, while others had to lower the returns they had promised to their customers.[3] If the insurance industry is a victim of the crisis, it has been a rather silent victim thus far. Part of the reason why it has not made more headlines is that the problems cannot be seen for lack of a proper accounting standard.

In many jurisdictions, insurance companies measure their insurance liabilities at cost. They still show reasonable results, but these results might be based on completely outdated interest rates from, say, 10 years ago. EIOPA says about these firms: 'the fact that the effects of low interest rates are slow to emerge in balance sheet terms does not mean the problem is not there and there is a real risk that firms could build up hidden problems.'

Our new standard will bring these problems to light because it requires measurement of the liability using current interest rates. This will allow investors to gain a much more reliable view on the true performance of the industry. Markets will gain much more insight into how effective insurers are in matching their liabilities with assets. Critics say that interest rates and other market fluctuations go all over the place and that our standard will lead to unnecessary short-term volatility.

[3] EIPOA: Supervisory Response to a Prolonged Low Interest Rate Environment, 28 February 2013

We have not turned a blind eye to these criticisms. Indeed, our exposure draft will contain a host of proposals to reduce accounting volatility. But we have rejected proposals that reduce volatility in an artificial way. Some insurers have brought forward proposals which are echoed in the report of the Group of Thirty which I mentioned earlier. One proposal is that the measurement of the insurance liability should be based on the expected return on the assets held by the insurer. While some in the insurance industry are enthusiastic about this idea, we have our doubts. We call this "hope-and-wish"-accounting. We do not think it is prudent to base the measurement of a liability on an uncertain yield of assets. 'Buy-and-hold' should not turn into 'buy-and-hope'.

The appendix to the report of the Group of Thirty contains a yet more radical idea to eliminate short-term fluctuations, the so-called "target-date accounting approach". In this approach, a diversified portfolio of equities would be put in a "target-date fund" with a binding commitment to hold them for a long horizon. The fund would then be valued at a time-weighted average of cost and market value with the objective of smoothing out short-term volatility.

This proposal is fraught with difficulties as well. If the books of a company were based on averages that are different from market values at the reporting date, trust in financial reporting might be seriously jeopardized. Market participants will react by simply converting the whole target-date fund back to market values. I think we should save them the trouble. We remain convinced that a model based on current measurement gives the best insight in the financial position of an insurance company. Our new standard will be a huge improvement in that respect. Where it leads to more volatility, it is probably a reflection of real economic risks. Only adequate levels of capital can deal with this risk; accounting standards should not serve to cover it up.

Finally, I would like to stress that even long-term investors cannot afford to ignore short-term fluctuations, if only because you never know how short the short-term will be. Central bankers call current interest rates "exceptionally low". The fact is that exceptionally low interest rates have been around for almost 15 years in Japan! In the West we have been going at it for more than five years and nobody knows when interest rates will revert to normal levels.

It is estimated that an airplane flying from London to New York will only spend 10% of the time pointing in the right direction. The direction of the plane is not determined by the pilot alone, but also by external factors such a wind speed and direction.

The pilot needs to make continuous short-term corrections in order to achieve the long-term goal – to arrive safely in New York. Business is no different. The renowned Swedish long-term investor Boerje Ekholm recently said that while his company always has a long-term objective, "we'll be terriers in the short term on how you run the business". He stressed that in reaching your long-term objective, you have to evaluate every day[4]. If you

[4] Scandinavia: Model Management, Financial Times, March 21 2013

do not adjust your business in time, the risk of a much larger correction further down the line grows exponentially.

So, beware of people who tell you that they only care about the long term and who do not want to be bothered by market values. For a company to take a long term view, it has to be able to withstand the inevitable short-term fickleness of the market place. The real problem is that we allowed a historically unprecedented build-up of leverage to take place in our economies. Extreme leverage has brought large parts of the financial industry very close to the edge. Even after Basel 3, banks will be able to finance 97% of their assets with debt. How this level of indebtedness can be conducive to long term growth, is a mystery to me. Now even insurance companies are treading hazardous territory. They flee into the bond market, not because of accounting, but because they do not have enough capital left to sustain the risks of equity investments.

The IASB cannot contribute to a solution of these problems by pretending these risks are not there. Our standards would not be right if they tell the pilot he is flying to New York, while is plane is actually blown off track. Those who care about the long term, should also know where they stand today. Our job is to provide maximum transparency both for the short and the long term. Our contribution is to provide the long term investor with the best information he needs at <u>all</u> times.