

Why the financial industry is different

The relevance of current measurement for the financial industry - speech at the joint ICAEW and IFRS Foundation Financial Institutions IFRS Conference, London, December 3, 2013

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We at the IASB cannot get enough of setting standards for financial instruments. We love it so much, that we simply refuse to get it done! We have been working on IFRS 9 since 2008 and are still happily plodding on.

On a more serious note, the end of the tunnel is—fortunately— now in sight. IFRS 9 will get done and it will get done soon. But there is no denying that we have at times been struggling. And it is not just the IASB that is struggling with financial instruments, but also our colleagues at the FASB.

There are two reasons why standard-setters are wrestling with financial instruments. First, they are inherently very complicated. More importantly, the financial industry is extraordinarily sensitive to accounting rules. Relatively small changes in accounting rules can make a big difference to banks. Enthusiasm for greater transparency in accounting is greatly tempered by the possibility of this leading to further bank bailouts! So every change the IASB proposes is subject to intense scrutiny.

Why is this the case? What is it that sets the financial industry apart from other sectors of the economy when it comes to accounting? To be able to answer this question, I will first make some observations on accounting for non-financial entities.

The IASB has often been accused of being too focused on the balance sheet and on fair value measurement. This could allegedly lead to lack of prudence and excessive accounting volatility.

I have always thought this criticism to be largely unjustified. In our Discussion Paper on the Conceptual Framework, we make perfectly clear that we view Profit or Loss as a key indicator of performance and that we do not give precedence to the balance sheet. Nor do we give precedence to fair value accounting, although we certainly do not demonise it either!

It is for good reasons that we have chosen a nuanced approach between the balance sheet and the income statement. The truth is that the importance of the balance sheet differs greatly from industry to industry. For most companies in the manufacturing and service industries, the balance sheet gives only a partial view of the financial situation of an entity.

The current value of many of their assets is not of primary importance if they are being used in combination with other assets to produce goods or services.

In most situations for going concerns, the fair value of Plant, Property and Equipment, or PP&E is of limited relevance. For example, it is not extremely relevant for a car-manufacturer (or its investors) to know the present market value of its robots if the company intends to keep them producing cars. Moreover, valuing PP&E at fair value would in many cases also be very costly and would possibly open the door to earnings management. If profit

or loss included frequent adjustments in the fair value of PP&E, an entity's earnings performance could become seriously muddled.

This is not to say that cost-based accounting does not have serious drawbacks. Especially in an inflationary environment, historical cost quickly loses its relevance. In addition, a cost-based balance sheet may prevent investors from seeing hidden treasures, such as the value of the land under an otherwise decrepit office building. But by and large, historical cost, adjusted for depreciation, is generally considered to be a cost-effective way of measuring many of the assets of non-financial companies.

The accounting treatment of intangibles is another reason why the balance sheet only gives a very partial reflection of many companies' true economic position. For high-tech companies such as Apple or Google, intangibles such as technology, design or sheer market power, are much more important to their future earnings power than the value of their PP&E. Because most intangibles cannot be measured reliably, they are not included in the balance sheet even if it is clear that they are there.

All this does not mean that the balance sheets of non-financial companies are unimportant. The balance sheet contains important information on the gearing of an entity. That is the reason why we are spending so much energy on our upcoming Leases Standard. The balance sheet should also inform the investor about the state of inventory and PP&E. But for the prediction of future cash flows, the investor will in many cases need additional analysis of earnings and intangibles.

The IASB is fully aware that an uneven focus on the balance sheet would not provide the investor with useful information.

The financial industry is different. Banks and insurance companies have huge balance sheets and those balance sheets matter hugely. Relatively small changes in the balance sheet can have an enormous impact on earnings. Future cash flows are very much dependent on the financial instruments on banks' and insurance companies' balance sheets.

For many financial instruments, it is their current value that counts. Some are actively traded on financial markets and are therefore subject to market fluctuations. So the balance sheet and current measurement techniques, which include fair value accounting but are not limited to it, are much more important to the financial sector than to the non-financial sector.

It is exactly this undeniable importance of current measurement techniques that makes accounting for the financial industry so controversial. Current measurement is much better at picking up mismatches between assets and liabilities. It is also much more sensitive to market fluctuations.

As a result, current measurement is more likely to lead to volatility. In this respect, bankers and insurers are no different from all other preparers: they all hate volatility!

And they especially hate volatility that they perceive to be induced by accounting.

At the height of the financial crisis, there was a widespread belief among the banking community that they were the victims of artificial volatility caused by fair value accounting. They argued that relying on market prices exacerbates the economic cycle in both upturns

and downturns. These critics believed that fair value accounting thereby strengthened procyclicality and created artificial volatility.

The fact is that most banks were exposed to fair value accounting in a limited way. Fair value accounting was mainly limited to the trading book and derivatives. Most people will agree that for such instruments there is no alternative to fair value accounting. Moreover, for the majority of banks, most of their banking book consists of traditional assets, such as loans, which have continued to be measured at amortised cost.

So it no surprise that most academic research has concluded that fair value accounting did not have a major impact on the crisis.

Where fair value did play a role, it was often beneficial. Banks that carried poisonous CDOs at fair value were often more quickly aware of the dangers that confronted them. While the use of fair value may be associated with lack of prudence, using fair value as an indicator of impairment can be quite the most prudent thing to do!

The truth is that the accounting merely reflected the very real economic volatility that is at the core of the business model of the banking industry. In fact, it is hard to imagine an industry that is as prone to real economic volatility as the financial sector.

Both sides of a bank's balance sheet are vulnerable. Its assets can be very sensitive to the economic cycle, whether they are derivatives or loans backed by bricks and mortar. Traditional bank loans, such as mortgages, have long seemed solid, cut and dried business. Since 2007 we have known that long-term trends in house prices and delinquencies can be extremely misleading. Even gold-plated, triple-A government bonds can turn sour very quickly, as we have seen in the case of Ireland and Spain.

The banking industry's liability side is also notoriously vulnerable. Funding, whether it is wholesale or retail, can evaporate with the speed of a mouse-click.

As if all of this is not risky enough, the banking industry has operated on the flimsiest of capital margins. Just before the crisis, tangible common equity of many banks was negligible. It was generally only 1 to 3 per cent of the balance sheet, and some banks even had a negative net tangible equity.

Thanks to our stringent consolidation requirements, the extreme leverage of the banks was there for everybody to see. The fact that market participants chose to ignore this information is one of the most astounding cases of collective cognitive dissonance in economic history.

Despite the, at most, peripheral role of accounting in the crisis, both the FASB and the IASB were put under severe pressure to further reduce the impact of fair value accounting. The changes that were made were not very big, but the banking industry was in such bad shape that every improvement, no matter how small or cosmetic, was considered to be helpful. It was a classic example of bending the rules to make things look better because the reality was too ugly to be faced up to. If the banks had been properly capitalised, this ugly episode in standard-setting would never have been necessary.

There was one aspect of our Standards—namely the issue of 'own credit'—where we agreed that fair value accounting could lead to counterintuitive results. At the height of the

crisis, the fair valuation of own credit sometimes led to bizarre results. Banks under severe stress would report profits as a result of the fair value of their own debt going down.

We fixed this problem in IFRS 9 and recently decided to make this fix available in isolation as part of our general hedge accounting changes.

The financial crisis also made it clear that the current impairment model does not work well. The current incurred loss model was designed to prevent earnings management through 'big bath' provisioning. During the crisis, it became clear that the model was vulnerable to a different kind of earnings management, namely excessive postponement of loss recognition, even when it was abundantly clear that losses could not be avoided. That is why we decided to replace the incurred loss model with an expected loss model.

We have now developed a model that is operational and much more forward-looking than the incurred loss model.

As soon as a financial asset has experienced a significant increase in credit risk, the expected lifetime loss needs to be recognised. The new impairment model will address one of the main pitfalls of amortised cost accounting, which is that it lends itself more easily to the masking of inevitable shortfalls in future cash flows. Our field work shows that it will lead to a significant rise in the level of provisioning.

The financial crisis also led the IASB to accelerate its work to replace IAS39 with IFRS 9. In this Standard, the IASB is continuing with a mixed measurement approach, but we have tried to put the criteria for classification and measurement on a more objective footing.

The classification of a financial instrument depends on both the nature of the cash flows and the business model. To put it roughly, if an instrument has basic loan features and the business model is to hold it for collection, it is measured at amortised cost. If an instrument does not have basic loan features and the business model is to trade the asset, it will be measured at fair value through profit and loss. If an asset is held both for selling and for collecting the contractual cash flows, it will be measured at Fair Value through OCI.

IFRS 9 will not drastically change the present situation, in which most banking assets are carried at cost. So does this mean that the banking industry can continue to live in the blissful stability provided by amortised cost? Obviously, this is a rhetorical question, because we all know that reality is much more complex than that.

The savings and loan crisis in the 1980s in the United States is the classic example of the limitations of amortised cost accounting. In the early eighties, the savings and loan industry was, de facto, bankrupted by a terrible interest rate mismatch between their deposits and their outstanding loan portfolios. As the Federal Reserve Chairman of the time, Paul Volcker, increased interest rates dramatically, the savings and loan industry had to pay a lot more interest on their deposits, while their interest income on long-term mortgages was largely fixed. It is clear that amortised cost accounting did not show the full extent of the losses that were inevitable. It gave a false portrayal of stability which everybody knew to be untrue.

More than thirty years later, protecting the interest margin is, more than ever before, a central task for bank managers.

The reality of banking is much more intricate than taking in deposits with one hand and collecting contractual cash flows with the other. The name of the game is to earn a stable net interest margin, which requires very dynamic and sophisticated Asset Liability Management.

While the loan officers of a bank are quietly collecting their contractual cash flows, their colleagues at the treasury department are very actively monitoring the interest rate markets. They manage their interest exposures on a daily basis. These activities are based on current measurement of interest rate exposures and require massive use of financial instruments such as derivatives, which are measured at fair value.

So if collecting contractual cash flows is only part of the business model of a bank, it is also clear that amortised cost in isolation cannot give a faithful representation of its financial condition. In fact, the instruments used to manage interest exposures are usually measured at fair value. The inevitable result of this mixed measurement approach is that a bank's financial statements are rife with accounting mismatches between amortised cost and fair value.

These accounting mismatches make it very hard for banks to explain their financial performance to investors, so most banks actively use our general hedge accounting Standard to address this issue. This way, they succeed in avoiding a part of accounting volatility. However, it is no secret that the existing hedge accounting requirements deal with some hedge relationships, but not others, using rather arbitrary criteria. More importantly, current hedge accounting is not capable of properly reflecting the management of net positions in open portfolios.

For this reason, the IASB is currently developing a Discussion Paper on a new macro hedging model. This model will make it possible to better represent in the accounts such risk management activity relating to open portfolios, rather than restricting hedge accounting to specific financial instruments. Accounting for macro hedging would basically make it possible to match the current value of interest rate exposures that are embedded in open portfolios with the fair value of the derivatives that are used to hedge those exposures.

When I recently read the memoirs of Bob Herz, the former chairman of the FASB, I realised that our macro hedging proposals are very close to his thinking on financial instruments. In this very readable book¹, he recounts his efforts to convince his colleagues at the FASB to adopt a measurement model for financial instruments that would be based on the present value of cash flows, discounted at current interest rates.

His proposal was in essence a 'third way' of accounting, which tried to avoid the pitfalls of both amortised cost and fair value accounting. A discounted cash flow model would give much more insight into interest rate and maturity mismatches than amortised cost, while ignoring some of the 'noise' of fair value accounting, which is caused by general market and liquidity factors. At the time, Bob Herz did not succeed in convincing his fellow

¹ Bob Herz: Accounting Changes, Chronicles of convergence, crisis and complexity in financial reporting, 2013

board members, but I think he will certainly recognise elements of his thinking in our forthcoming Discussion Paper on macro hedging. The present value of cash flows is indeed central to the risk management of banks and also to our macro hedging proposals.

If this accounting is properly conceived and applied, it could much better reflect the actual business model of banks and it could result in a significant reduction of accounting mismatches. I do emphasise—if properly conceived and applied—because if it is not sufficiently disciplined, macro hedging could also degenerate into custom-made accounting without rigour or comparability.

Our objective is to improve transparency, not to mask economic volatility. For that reason we are treading very carefully in developing our proposals.

Since it is clear that it will still take significant time to finalise our possible proposals on macro hedging, we have separated it from the rest of IFRS 9. IFRS 9 is practically finished and will soon be ready to be endorsed. Because of the significant improvements that IFRS 9 makes in classification and measurement, and also in general hedging and impairment, I have no doubt that it will be endorsed around the world.

For reasons of time, I have spoken very little about accounting for insurance contracts. Those who have been following our efforts to create a new Standard know that our building block model also has features of what I just now called the ‘third way’ of accounting. It is neither cost-based, nor fair value-based. Instead it is a discounted cash flow model using current interest rates.

While there is still a lot of public discussion about many aspects of our proposals, most market participants agree that the only way to achieve a meaningful presentation of the insurance liability is through current measurement. Especially in the current macroeconomic environment, in which interest rates are being suppressed over a prolonged period of time, the use of historic interest rates would obviously result in misleading information. So, current measurement techniques are also of the utmost importance for the insurance industry.

Ladies and gentlemen, I now come to the conclusion of my speech. I hope I have demonstrated convincingly that in general the IASB does not give precedence to the balance sheet over Profit or Loss. I am also sure that I was preaching to the converted when I argued that for the financial industry, the balance sheet does indeed matter very much.

I also hope that most of you will agree that current measurement of many financial instruments is absolutely crucial to risk management in the financial industry. Indeed, bank managers who do not do so on a daily basis, certainly warrant close scrutiny by the regulators!

We are working hard to make it possible for your accounts to better reflect these risk management activities. We will need your views and support to make our proposals work. So I encourage you to be fully engaged with us as we finalise our proposals on financial instruments and insurance contracts. Thank you for your attention.