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Response to European Commission Green Paper on 'Long-term financing of the European economy'

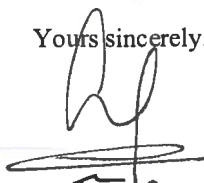
Dear Sirs,

I am pleased to respond on behalf of the European Economic Area member firms of Deloitte Touche Tohmatsu Limited¹ to the European Commission Green Paper on the 'Long-term financing of the European economy' (the "Green Paper").

We welcome the European Commission issuing a consultation paper on this important topic and the approach taken in addressing a broad range of different topics that may separately and together have an impact on the long-term financing of the European economy. Please find below our answers to certain specific questions in the Green Paper.

I would be happy to discuss any comments or questions you may have regarding these responses and can be reached as follows: +33 1 40882821 or gtremoliere@deloitte.fr.

Yours sincerely,



Gérard Trémolière
Managing Partner
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¹ Please see <http://www.deloitte.com/about> for a description of the legal structure of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its member firms.

Question 3 - Given the evolving nature of the banking sector, going forward, what role do you see for banks in the channelling of financing to long-term investments?

As the Green Paper recognises, banks will remain important players in channelling funds to long-term financing of investments. It is necessary that they do because the provision of direct lending to corporates and access to investment opportunities for depositors are already important intermediation channels in the real economy that are central to deposit taking institutions.

To understand how the structure and nature of the role of banks in long-term financing of the economy will change, it is instructive to separate the cyclical and structural components of investment. Investment has indeed fallen back much more than total output over the past five years, but this is to be expected as it has historically been more cyclical than other components of GDP. Market-driven deleveraging by banks and re-pricing of credit risk are in part a reaction to increased economic risk and to a prior mispricing of risk. Banks need to find ways of enabling long-term finance while not engaging in practices that prove as risky as before. Repeating the problems of the past will only lead to another retrenchment of the sort we have seen recently and will therefore be counter-productive.

The structural component, which includes the regulatory framework, remains key though. It is important that the calibration of the framework is examined as the Commission has proposed. That analysis should consider the overall impact of regulation, rather than individual initiatives in isolation, and the extent to which the level of financial resilience regulation seeks to achieve is consistent with what market forces might anyway require (it is important to keep in mind that the counterfactual level of financial resources that banks would hold in a world without regulation is not zero).

It is important to keep sight of the inherent riskiness of long-term investments. Prudential regulation is only one tool in achieving the desired risk trade off and it is not economically efficient or practical to attempt to manage that risk – or to protect depositors – entirely through prudential regulation. Other measures, such as resolution powers, which strengthen the financial system, should be also be relied on, so that where risk remains, it can be contained. A credible and effective deposit insurance scheme is also necessary to maintain a strong intermediation channel.

Finally, in considering the role of banks as a financing channel, the nature of bank liabilities is important. (Call deposits are a particular type of liability and serve a particular purpose. Banks should not presume that they are too sticky, but nor should depositors presume that they are risk free, in particular if at the same time they demand higher returns. Greater clarity of the risk-reward trade-off could be achieved if “deposit” liabilities fund banks’ relatively low risk investments, and alternative liability products, that offered greater credit and liquidity risk and therefore greater return, fund banks’ higher-risk investments. The design of those new liabilities should be informed in particular by new liquidity regulations, which in turn would mitigate the challenge for banks to meet those regulations. To be effective, such product innovation needs to be supported by consistent and dynamic supervision that, subject to the ambitions of prudential regulation, is alert to the commercial needs of banks.

Thought should also be given to the role of government and central banks in supporting maturity transformation, in particular by providing back-stop liquidity facilities. Even if the crisis has highlighted potential moral hazard that could arise from overly generous facilities, that consideration should not be extrapolated to rule out any facility as it is in the broader interests of the economy to provide banks with a reliable means to protect against liquidity risk in extremis.

However the role of bank lending evolves, public authorities should be cautious about the implications for what becomes non-bank lending. It is not clear that other types of financial institution in general have the same capacity or incentives as banks to monitor credit risk adequately, in particular where the risk is driven outside the regulatory perimeter. When this occurs, policymakers need to consider the implications from the perspectives of consumer protection and financial stability.

Question 10 - Are there any cumulative impacts of current and planned prudential reforms on the level and cyclicity of aggregate long-term investment and how significant are they? How could any impact be best addressed?

With key elements of planned prudential reforms – both within Europe and globally – still being negotiated it is difficult to be precise on the cumulative impact. It does appear though that in some aspects the cumulative impact will be greater than the sum of the parts, in particular along two dimensions:

- Due to constraints introduced in the allocation of financial resources. For example, ring-fencing of capital and liquidity within certain business lines, legal entities, or regions.
- Due to interactions between regulations. For example, prudential requirements from the package of CRD IV and CRR, EMIR and Solvency II potentially overlap to some degree and/or may be inconsistent in effect. For instance, as all three initiatives reinforce collateral use and reliance on secured funding, they may give rise to unintended combined effects.

Deloitte LLP's recent response to the European Parliament Committee on Economic and Monetary Affairs public consultation on enhancing the coherence of EU financial services legislation sets out in more detail our thoughts on areas of overlapping regulation.

The potential problem is substantial. It is best addressed by an holistic assessment of competing regulations. That analysis needs to be done in parallel to the further development of regulations. In reaching a judgement as to the appropriateness of the overall impact, the analysis will need to weigh up the financial stability benefit against macroeconomic cost of higher prudential requirements impeding growth. Estimates of this trade-off vary. As an example, the UK National Institute of Economic and Social Research (NIESR) estimated that a one percentage point rise in capital adequacy target would have reduced the probability of a crisis in the UK in 2007 and 2008 by five to six percent, and at the same time reduced output by at most 0.08 per cent in the long-run (<http://www.fsa.gov.uk/static/pubs/occpapers/op38.pdf>). Other researchers have come up with different results. As noted earlier, it is important to keep in mind that the counterfactual level of financial resources that banks would hold in a world without regulation is not zero.

New regulation should be introduced in a measured, staged way, and provision made for adjustments, so that unintended consequences can be addressed as they are identified and before regulations have their full effect.

Question 20 – To what extent do you consider that the use of fair value accounting principles has led to short-termism in investor behaviour? What alternatives or other ways to compensate for such effects could be suggested?

It would be inappropriate to say that it is fair value accounting that leads to short-termism in investor behaviour. No evidence has been provided so far for such a statement. This would also suggest that, in the absence of fair value accounting, investors would necessarily adopt a long term view. Yet, it is observed that markets react abruptly to a variety of factors, not necessarily related to accounting. Markets tend to react chaotically to societal or political events (scandals) even when they do not appear to have a bearing on the short term or long term prospect of an entity, an industry or the economy as a whole.

It would be more appropriate to consider that fair value accounting may contribute, albeit to a limited degree only, to short-termism in investor behaviour. It is often argued that fair value measurement results in more volatility than historical-based measurement basis. This may be explained by the fact that, as fair values are updated regularly, new information is provided to the markets on a regular basis due to the (relative short) frequency of financial reporting. Such new information can render markets prone to immediate reactions, losing sight of long term prospects.

When performance is measured on a fair value basis (and therefore net results and earnings per share also), the short term effect of fair value accounting on investor is not solely theoretical or psychological:

- There is often a direct relationship between net results/earnings per share and distributions to investors. As such, investors are actually affected in the short term by fair value accounting even if they hold a long term view of investing.
- Data that is being used by prudential regulators is also often based on accounting data. Therefore, volatility reflected by accounting may have a direct effect on an entity meeting its capital requirements, thereby affecting investors' behaviour.

This does not mean that fair value information should not be communicated to investors. It would be hard to argue that fair value information is not always (or at least generally) useful to help existing and potential investors, lenders and other creditors to estimate the value of a reporting entity. There is also a generally held belief that transparency contributes to market stability overall and that fair value is a transparent measurement basis (at least when it is based on market observable data). Some also believe that the non-application of fair value would potentially increase the risk of hiding the real value of an entity's exposure and liabilities.

It is worth noting that, at present, only certain items are required or even allowed to be measured at fair value under IFRS.

Still, there appears to be room for debate on the place of fair value in financial reporting. To what extent should it be used in the measurement of assets and liabilities on the balance sheet (which usually is considered to provide a patrimonial picture of an entity at a point in time), in the measurement of performance, or as supplemental information in the notes to the financial statements?

A response to this question requires that the following elements be considered:

- The role of the business model:
 - Financial statements are prepared using agreed upon conventions (i.e., accounting standards). The question to consider is the extent to which these conventions should delineate the use of fair value measurements depending on the business model of an entity. Fair value is a notion that reflects a current exit (sale) value. Some question the relevance of using such a measurement basis in determining an entity's performance, particularly where entities are involved in assets and liabilities management over a long-term horizon (e.g. insurance companies, pension funds, decommissioning activities, etc...).
 - Recent IFRS Standards (most notably, IFRS 8, Operating Segments, and IFRS 9, Financial Instruments) recognise the relevance of reflecting the business model in the information given to users, although there is still an issue for long-term equity holdings that has not been considered yet by the accounting standard setters.
 - Discussions are currently taking place about the role of the business model in financial reporting, in particular as part of EFRAG's proactive projects and the IASB's revision of the IFRS Conceptual Framework and the definition of performance.
- Alternative measures to fair value:
 - Today, there are not many alternative measures to historical cost and fair value (which maximizes the use of current observable market data) that have been explored.
 - Without expressing a view on such a method, a thorough analysis would require assessment of the "target-date accounting approach" proposed by the G30 working group on Long Term Finance and Economic Growth.
- Ensuring that the information delivered does not create further uncertainty:
 - Whilst it is generally agreed that investors need the most up-to-date information, if fair value information is provided say in the notes, it may be investigated whether any drastic deviation from the amounts reported on the face of the balance sheet would rather create uncertainty, which may be detrimental to steady investments ultimately.

Another aspect to consider is that, as set out in paragraph OB2 of the IASB's Conceptual Framework, "the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit".

- Hence the conventions used in preparing financial statements must be established considering the needs of investors, lenders and other creditors. In determining what is relevant to the identified users of general purpose financial statements, is it appropriate to privilege the needs of long-term investors over those of short-term investors?
- If the time horizon of investors is not aligned to that of an entity's business model, which one should be put forward in measuring an entity's performance?

Question 24: To what extent can increased integration of financial and non-financial information help provide a clearer overview of a company's long-term performance, and contribute to better investment decision-making?

The narrative part of the company annual report has been subject to increasing scrutiny by investors (the primary providers of financial capital) and other stakeholders over recent years. Companies are responding to this and the quality of reporting has been improving in certain Member States at least². Many companies are attempting to 'tell their story' in a concise way, providing one clear narrative that explains how their objectives, business model, strategy, risks and key performance indicators link together. This is clearly in the spirit of integrated reporting.

We recognise the role the IIRC is playing in stimulating debate about the role of non-financial reporting within corporate reporting. Reporting in many EU Member States is moving in the direction of 'integrated reporting' already and it is a trend we support.

Under the current Accounting Directive, companies are to report "to the extent necessary to understand the company's development, performance or position" and "where appropriate" on non-financial key performance indicators relevant to the business, including information relating to environmental and employee matters. The April 2013 EC proposal to amend the Accounting directive(s), which we broadly welcome, goes further and includes a requirement for large companies to include a non-financial statement containing information on policies and results of policies (or an explanation why the company does not have such policies) and risks and how the company manages them, relating to at least the following matters: environmental, social and employee matters, respect for human rights, anti-corruption and bribery matters. Under the same proposal, EU companies listed on a regulated market in the EU would be required to include in their corporate governance statements a description of their diversity policy for their administrative, management and supervisory bodies or an explanation as to why they have no such policy. Given the consistently improving trend in the quality of narrative reporting we would anyway recommend that the European legislator be cautious in introducing further requirements. A Deloitte/ACCA survey³ found that the majority of CFOs surveyed thought less regulation and more discretion leads to better overall disclosure. This is particularly true as practices are just evolving and there is still a lack of consistent measurement metrics or indicators available for non-financial information that would enable comparability between entities.

In certain Member States, such as France and UK, companies are already currently required to provide information about environmental matters, employees and social and community issues. In such countries, this is being extended to include human rights and disclosure around gender diversity.

² For example, the Deloitte member firm in the UK, Deloitte LLP, carries out an annual survey of UK listed companies and the last survey 'Joined up writing' found that the quality and integrity of narrative reporting has probably never been higher, see http://www.deloitte.com/view/en_GB/uk/services/audit/0f5d074f3229a310VgnVCM1000003156f70aRCRD.htm

³ http://www.accaglobal.co.uk/content/dam/acca/global/PDF-technical/narrative-reporting/hitting_the_notes.pdf

Non-financial information is very valuable to an investor in assessing a company's future potential, in addition to past performance⁴. In certain EU Member States, for example the UK and France as regards listed companies, companies are required to describe their business model and strategy and this disclosure should demonstrate to investors all the factors, including non-financial factors, which would influence the company's future performance. This would also link through to the company's disclosure of principal risks. Where a company is particularly dependent on human capital, say in a service industry, it would be difficult to envisage a company making no mention of this in their annual report under the current requirements.

Ultimately, the primary users of the annual report are usually considered to be investors, lenders and other providers of capital. With calls to 'cut clutter' in annual reports, it is important that only that information regarded as essential is reported. Where the non-financial information is core to the business model and the ability of the company to generate returns, it should be included. As such, the extent of non-financial reporting depends on the activity of the business.

A concise, transparent, well thought out report may put investors in a position to judge whether a company has a clear and well executed business model and strategy. In that respect, we note that it is very important that the information provided by companies be relied upon and trusted. Therefore, in requiring or encouraging non-financial information to be provided, regulators should also consider the type of external assurance and reports that should be provided on such information. This would need to be thought through in liaison with the standard setters on auditing, and in particular the IAASB.

⁴ The recent ACCA study on «Understanding investors: directions for corporate reporting» may provide further insight as to the expectations of UK and Irish markets investors with respect to corporate reporting, see <http://www.accaglobal.com/content/dam/accaglobal/PDF-technical/financial-reporting/pol-afb-ui02.pdf>