IFRS STANDARDS AND INSURANCE COMPANIES: WHAT STAKES FOR LONG-TERM INVESTMENT? A FRENCH CASE EXPLANATORY ANALYSIS

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ABSTRACT:

This paper investigates to what extent IFRS standards may cause incentives or constraints on long-term investment strategies of French insurance companies, based on 43 semi-structured interviews of insurance companies’ managers, regulators and professional organizations in France. Our results show that practitioners highlight some issues related to the capacity of current IFRS accounting rules to give a fair representation of their activities related to their specific profile. First, they underline an artificial mismatch between assets and liabilities measurement related to IAS 39 and IFRS 4 phase 1. Second, they point out effects on their asset allocation strategies due to the increased short-term volatility introduced by fair value measurement. After investigating solutions to recognising the long-term horizon in asset category, we discuss the necessary consistency of accounting standard for representing long-term business.

Keywords: Insurance industry, long-term investment, IFRS accounting.
INTRODUCTION

Although there is no legal definition of long-term investment, there is a consensus to say that it is a critical issue because it should meet the significant and growing needs for long-term financing notably to meet the challenge of climate change in developed and emerging countries. The recent financial crisis and the sovereign debt crisis, having destabilized respectively the financial banking intermediaries and the State in their ability to finance the economy, give rise to the question of stakeholders able to finance such. For all countries, this involves channelling savings of non-financial agents towards long-term investments, that is to say in projects related to the real economy, especially industry, transition energies, renovation of real estate, energy efficiency1... (Aglietta and Hourcade 2012). This issue was considered important enough by the European Commission for it to publish, in March 2013, a Green Paper on long-term financing of the European2. This paper offers the opportunity to open the debate on growth in the European Union by identifying the driving forces of sustainable growth and job creation in accordance with European 20203 strategy. Among the topics4 discussed in this Green Paper are included the recent regulatory reforms and their impact on long-term investment. The issue of accounting standards, in particular as fair value for financial intermediaries and its impact, is clearly stated. Of the 292 responses received following the public hearing of the Green Paper, the majority came from the financial sector and insurance companies or their representatives in particular. Such interest shows that these players consider themselves very concerned with the long-term investment and accounting developments. Accounting standards represent a main stake for insurance companies because they are one of both regulatory constraints with prudential requirements. These last ones have two different objectives: to prevent insurance insolvability and financial instability via capital

1 The developed countries, in addition to the problems related to incentives, should stimulate household long-term savings which have been declining steadily for the last ten years.
2 The working document accompanying the Green Paper estimates the long-term needs to 20,000 billion by 2020.
3 See http://ec.europa.eu/europe2020/index_fr.htm
4 Related to funding sources, the characteristics of the long-term investment and improvement of long-term financing.
requirements related to a particular risk. Actually the European insurance industry apply Solvency I prudential agreements which are based on evaluation of investment on amortized cost approach. But the European Commission is working on the Solvency II project\(^5\) which will use a full fair value basis. The prudential balance sheet under Solvency II will use accounting figures for ones that are in fair value and requires new valuation for others. It appears that solvency requirements are independent of the accounting one. Indeed the prudential statement is completely restated and it can use accounting figures or not. In this paper we only focus on accounting requirements for insurance.

Since 2005 French insurers that are listed or publicly traded\(^6\) on a European market are subject to International Financial Reporting Standards (IFRS). These standards are produced by a private international institution, the International Accounting Standard Board (IASB). IASB promotes a global corpus of standards for all companies, without sectorial specificities, whereas the French standards previously applied and still required for social statements give industry requirements for banks and insurance. However, concerning accounting standards, conceptual foundations differ and thereby evaluation methods. According to the French approach, accounting should be cautious, conducted with an assumption of going concern, the information is intended for stakeholders. While from an international point of view, accounting is primarily intended for current and potential investors who would be interested in relevant information representing the resale value. In the IASB perspective, management must tell investors what resources the company acquired, why it acquired them, how they used them and what the timely value of them is (Hoogervorst 2013)\(^7\). It is important to recognize that accounting principles such as fair value are developed with the objective of providing information that will best serve the interests of investors, businesses and policy makers over the long-term (Pricewaterhouse Coopers 2008). In this study we analyse the two main standards for

\(^5\) The Solvency II project aims to review the prudential regime for insurance and reinsurance undertakings in the European Union.

\(^6\) Which make a public call on savings.

\(^7\) Since July 2011, Hans Hoogervorst is the chairman of the IASB.
insurance industry: IAS 39 Financial instruments and IFRS 1 phase 1 Insurance contract\(^8\) (La Martinière (de) and Trainar 2003; Post et al. 2007).

Applied to the case of insurance companies, the method of valuation relates to both assets and liabilities. This is crucial because it may influence the composition of the portfolio (strategic asset allocation). Thus, any change in the method of evaluation can have an impact on the asset allocation target of insurance companies. Therefore, accounting can modify the trade-off between risky/illiquid and safe assets.

Moreover, accounting standards represent a financial and economical stake related to the funding of the economy. Insurers may participate in economic growth (in allocating to equity or private equity or bonds) because they supply sectors short of capital and debt funding which is complementary with banking credit. The challenge is even greater because the insurance companies can be considered as potential long-term investors due to the nature of their long-term liabilities. This feature should logically involve a specific long-term management. Therefore, the problem is to identify investment strategies of such actors and to what extent current valuation methods take this into account. The objective of this research is to know if IFRS accounting standards induced incentives or constraints for long-term investment in the French insurance industry according to long-term investment principles. We focus on the French case because French GAAP was considered to be among the most divergent from IFRS particularly in the accounting for insurance (Ding et al. 2007). Indeed French GAAP are globally based on a cost approach while IFRS promote a fair value view. This fundamental opposition impact financial statement of French insurer because of the allowance to use French GAAP for the recognition of insurance liabilities while insurance investments are under the requirements of IFRS.

From an accounting theoretical point of view we noticed the lack of recent research devoted to the insurance accounting issue, and furthermore on the link between long-term investment and accounting. Current literature is mostly professional in order to give a comparative presentation of standards with previous rules (Duverne and Le Douit 2009; Gougeon 2009; Zemp and Wagner 2012) or with US GAAP (Lindberg and Seifert 2010;)

\(^8\) Actually IASB is working on standards aiming to remove these two standards, but these projects are still not achieved. Even we briefly present these projects, this paper only focus on current accounting.
Vaughan 2012). This paper aims to fill this gap using a qualitative methodology based on 43 semi-structured interviews with insurance managers, consultants and supervisors (April to November 2013). Our results show that practitioners highlight some issues related to the capacity of current IFRS accounting rules to give a fair representation of their activities related to their specific profile. First, they underline an artificial mismatch between asset and liabilities measurement related to IAS 39 and IFRS 4 phase 1 which do not fairly represent their long-term business. Second, they point out the effects on their asset allocation strategies due to the increased short-term volatility introduced by fair value measurement, implying a change in their strategy towards conservatism in asset allocation. After discussing the consistency of the IFRS theoretical foundations in regard with the long-term activity of the insurance industry, we investigate the opportunity of a new accounting class in a perspective of recognising long-term management. This paper contributes to the accounting literature in deeply investigating accounting practices of French insurer regarding the long-term specificities of this sector. These results could also be an interesting debate for standards setters (French and international). Lastly our results and proposition could be useful for the insurance accounting profession.

The remainder of the paper is organized as follows. Section 1 presents the research context, both the description of accounting for insurance companies and the characteristics of long-term investment strategy related to the insurance industry. Section 2 presents and discusses the methodology employed. Section 3 assesses accounting constraints for French insurers. Section 4 proposes a discussion about the matching between accounting rules and insurer long-term practices. The concluding section discusses the limits of the study, and offers suggestions for further research.

1. RESEARCH CONTEXT

We first deal with the main accounting requirements for insurer under the IFRS framework (1.1). Then we investigate the theoretical background of IFRS standards (1.2). Finally we analyse long-term management strategies (1.3).
1.1. IFRS standards and insurance companies

Since 2005, listed or publicly traded French insurance companies on a European financial market are submitted to two different normative reference guides: the IFRS standards for the publication of their consolidated financial statement and the “code of insurances” for their social statement which provide specific rules for industrial accounting. In short, French GAAP requires an accounting based on conservative approach (recognition of unrealized loss but no recognition of unrealized gain) both for assets and liabilities\(^9\). Due to their inverted production cycle\(^10\) which consists of allocating their investments assets according to the maturity of their liabilities, insurance companies are specially mainly affected by two standards: IFRS 4 insurance contracts which give requirements to recognise insurance liabilities (1.1.1) and IAS 39 financial instruments which give requirements to recognise and measure financial assets which are allocated in representation of the insurance liabilities\(^11\) (1.1.2).

1.1.1. IFRS 4 insurance contract: a transitory standard

The work on the insurance project was launched in 1997, but the difficulties in finding a consensus had led to IFRS 4 phase 1 in 2004, just before the European mandatory application in 2005. This standard must be transitory, and a second phase is still in progress. The IASB has published in June 2013 an exposure draft for a new version of IFRS 4 phase 2. The final standard would be promulgated in 2015 for a mandatory application from 2018. This article will only focus on the current requirements of IFRS 4 phase 1, because it is impossible to know what requirements will be retained and when the final standard will be endorsed.

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\(^9\) See appendix one for a short presentation of French requirements for financial instruments.
\(^10\) According to La Martinière (de) and Trainar (2003) “in insurance, it is not assets that create liabilities, but liabilities that create assets”.
\(^11\) If we look at the balance sheet of a French insurer like AXA, we can noticed that the weight of financial investments from insurance activity (under the requirements of IAS 39) represent about 80% of total assets and insurance contracts (under the requirements of IFRS 4) represent 76% of total liabilities (AXA annual report, 2012).
IFRS 4 phase 1 defined an insurance contract as an arrangement where one party (the insurer) accepts risk by agreeing with another party (the policyholder) to compensate the policyholder or designated beneficiary if a specified uncertain future event (the insured event) adversely affects the policyholder (IFRS 4, Appendix 1, 2004). The main characteristic of IFRS 4 is that it does not require a method to estimate and recognise insurance contracts, but permits continued application of previous practices defined in local GAAP. So in the French context, an insurer maintains accounting rules based on a cost approach issued by the “Code of insurances”. So this means that in consolidated statement under IFRS, insurance liabilities are recognised at their historical cost besides insurance assets are valued at fair value.

IFRS 4 phase 1 is a standard for the recognition of the liabilities issued by an insurance contract, “it does not apply to other assets and liabilities held by an insurer such as financial assets and financial liabilities within the scope of IAS 39 Financial instruments» (IFRS 4, §3). This distinction is the result of the IASB standard-setting process which lays out standards by types of operations such as Property, plant and equipment (IAS 16), Leases (IAS 17) or Shared-based payment (IFRS 2). The IASB standard setting process rejects an industry approach, so contrary to French GAAP, the insurance specificities are not taken into account. By consequence a global insurance standard which gives requirements for assets and liabilities does not actually exist. So this conducted Lindberg and Seifert (2010) to affirm that the fundamental issue of IFRS is that valuation principles applied to assets (IAS 39) and liabilities (IFRS 4) may differ.

1.1.2. IAS 39: Financial instruments

All the IAS\textsuperscript{12} and IFRS standards are feasible for the insurer, but IAS 39 financial instruments is the more significant due to the huge quantity of financial assets owned by insurance companies. Concerning the categorisation and the measurement of financial instrument, IAS 39 promotes a mixed approach with cost and fair value measurements.

\textsuperscript{12} Such as IAS 40 investment property, IAS 17 Lease contract, IFRS 3 Business combination and IFRS 10 consolidated financial statements.
IAS 39 regulates many issues relative to financial instruments, but here we focus on the method of classification and measure of financial assets. There are three main categories:\(^\text{13}\):

<table>
<thead>
<tr>
<th>Class</th>
<th>Held to Maturity (HTM)</th>
<th>Held for Trading (HFT)</th>
<th>Available for sale (AFS)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition</td>
<td>Financial instruments with fixed or determinable payment that an entity intends to hold to maturity</td>
<td>Financial assets acquired or held for the purpose of selling in the short-term or for which there is a recent pattern of short-term profit taking are held for trading</td>
<td>All other type of financial instruments</td>
</tr>
<tr>
<td>Measurement</td>
<td>Amortized cost</td>
<td>Fair value changes on trading are recognised directly in Profit &amp; Loss (P&amp;L)</td>
<td>Fair value changes on AFS assets are recognised directly in equity through Other Comprehensive Income (OCI)</td>
</tr>
<tr>
<td>Types of assets</td>
<td>All types of bonds</td>
<td>Derivatives</td>
<td>All types of bonds and equity (listed and private)</td>
</tr>
<tr>
<td>Specificities</td>
<td>If an entity sells an HTM investment for a significant amount outside of the dual events determined by the standard, the entire HTM portfolio is affected in the Available for sales category for the current and next two reporting years. This is the tainting rule</td>
<td>Equity listed</td>
<td></td>
</tr>
</tbody>
</table>

*Table: Class of financial asset (source: authors and IAS 39)*

The financial portfolio of an insurer is under the requirements of IAS 39. Financial instruments with fixed return and which are held to maturity, such as bonds could be measured at cost. If the holding intention is shorter or for instruments like equities the fair value must be used. Variations of fair value (minus or plus) are passed in P&L for instruments that are hold for trading and derivatives or in OCI for instruments that are available for sales.

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\(^{13}\) The fourth class of asset is loan financial instrument which are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than held for trading or designated on initial recognition as assets at fair value through profit or loss or as available-for-sale. Loans and receivables are measured at amortized cost
Since 2008, IASB worked on a complete revision of IAS 39 which is the IFRS 9 standard. A first version of IFRS 9 was published in 2009 but was not endorsed by the EU\textsuperscript{14}. Actually, the IFRS 9 standard is still in discussion. The final standard will be promulgated in 2014, for a mandatory application from 2015. IFRS 9 will promote a new approach of the financial class. The choice of a category will depend of how the entity manages its financial instruments (its business model) and the contractual cash flow characteristics of financial assets.

<table>
<thead>
<tr>
<th>Class</th>
<th>Cost</th>
<th>Fair Value P&amp;L</th>
<th>Fair Value OCI (option)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business model</td>
<td>The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows</td>
<td>All other strategies</td>
<td>The asset must be held in a business model whose objective is both to collect contractual cash flows and to sell financial assets</td>
</tr>
<tr>
<td>Cash flow</td>
<td>The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding Plain vanilla</td>
<td>All other types of cash flows</td>
<td>Plain vanilla</td>
</tr>
<tr>
<td>Measurement</td>
<td>Amortized cost</td>
<td>Fair value changes on trading are recognised directly in P&amp;L</td>
<td>Fair value changes on AFS assets are recognised directly in equity through OCI</td>
</tr>
<tr>
<td>Types of assets</td>
<td>Bonds</td>
<td>Derivatives</td>
<td>Bonds with recycling on derecognition</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Equity</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bonds</td>
<td></td>
</tr>
</tbody>
</table>

*Table : IFRS 9 asset classification (source: authors and IFRS 9)*

A company can use FV OCI to value its bonds portfolio, in approximately the same conditions than with AFS. Contrary to the equity portfolio which is primarily affected to FV P&L and under an exemption can be passed in OCI. But in this case the entity couldn’t recognize the benefit when the equity was sold. This 'no recycling' constraint may turn out to be very dissuasive from an economic point of view. So this future standard seems to be very problematic for the equity portfolios of insurance companies.

\textsuperscript{14} In 2009, UE decide to not adopt the first proposal of IFRS 9 because it was considered as an increasing factor of volatility which is contrary to political demands.
We investigate how the current standards (IFRS 4 phase 1 and IAS 39) are relevant or not for the long-term investors, that is to say, to what extent IFRS standards cause incentives or constraints in long-term investment strategies of French insurance companies.

1.2. Theoretical principles of international accounting standardisation

The IFRS theoretical framework is based on two main economic foundations: the agency theory (Colasse 2009; Whittington 2008) and the market efficiency hypothesis (Barneto and Gregorio 2010; Milburn 2008) both established in the 1970’s. The agency theory explains the relationship between principals (such as shareholders) and agent (management of the firm). To be brief this theory aims at aligning interest of principals and agents in term of information asymmetry and attitude towards risks. The IFRS framework established that “The primary users of general purpose financial reporting are present and potential investors, lenders and other creditors, who use that information to make decisions about buying, selling or holding equity or debt instruments and providing or settling loans or other forms of credit. (...) The primary users need information about the resources of the entity not only to assess an entity's prospects for future net cash inflows but also how effectively and efficiently management has discharged their responsibilities to use the entity's existing resources (i.e., stewardship)” (IASB, 2010). So international standards aim at giving the best financial information for investors. According to (Barlev and Haddad 2003; Perry and Nolke 2007) fair value accounting standards are expected to increase management efficiency, reduce the principal-agent conflict and agency costs. The quality of this information lays on a fundamental concept which is the fair value accounting. According to (Mistral 2003) fair value based on market reference is the cornerstone of the theoretical framework of international accounting both for IASB and FASB. In IFRS 13 standard “fair value measurement” fair value is defined such as: “The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date”. IFRS 13 identify 3 levels of fair value according to the liquidity
and the depth of the market\textsuperscript{15}. Only the first level refers to a market value, the two other refer to similar market or to mark to model information.

This anchor of accounting in market reference reveals the recent changes in financial and economic theory that show that market prices integrate not only more information but also more relevant information on assets than historical values (La Martinière (de) and Trainar, 2003). The fair value accounting lays on the market efficiency hypothesis\textsuperscript{16} supposing that market prices always “fully reflect” available information. Indeed, the main role of capital market is to allocate the economy's capital stock. In general terms, the ideal is a market in which prices provide accurate signals for resource allocation: that is, a market in which firms can make production-investment decisions, and investors can choose among the securities that represent ownership of firms' activities under the assumption that security prices at any time “fully reflect” all available information. According to (Magnan 2009) there is consistent empirical evidence, accumulated over the past 20 years, that a firm’s stock price is more closely associated with the market value of its underlying financial or real assets than with their historical cost, i.e., their purchase price plus related expenses. In other words, fair values, or marked to market values, have been found to be more relevant indicators of firm value than traditional historical cost-based figures. The implementation of fair value accounting explicitly confirms the primacy of financial markets and of investors in the determination of accounting standards. Nevertheless several authors (Milburn 2008; Magnan and Thornton 2009; Bourghelle 2012) underline that the legitimacy of market value accounting is linked to the validity of efficient market hypothesis (quality of information, liquidity, rationality).

This paper will see to what extent the use of principles based on these frameworks could suit to a long-term business such as the insurance one.

\textsuperscript{15} Level 1 inputs are quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date. Level 2 inputs are inputs other than quoted market prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability.

\textsuperscript{16} (Fama 1970; Jensen 1976)
1.3. **Long-term investment management and insurance companies**

Traditionally, insurance companies have been seen as sources of long-term savings. They are supposed to build a portfolio around several asset classes with an investment horizon compatible with their long-term retirement liabilities. According to (Aglietta and Rigot 2009) and (Glachant et al. 2010), they can be considered like the most important categories of long term investors\(^\text{17}\) in terms of assets under management. Insurers hold long-term liabilities which are stable and of good quality. This fact theoretically provides to insurance company a strategic advantage over other investors who have short-term liabilities and liquidity constraints. This characteristic changes the situation in terms of asset allocation because it will determine the investment objective: namely the real returns consistent with the commitments of long-term liabilities. Indeed, when these actors commit to generate revenue flow over the long-term, the choice of portfolio is indeed critically important. Such an objective of sustainability (long-term return) is different from that of an investor concerned with short-term returns who will try to construct his optimal portfolio over a period of time (static allocation). The latest developments in the theory of portfolio choice allow us to identify allocation models compatible with the dual characteristics of potential long-term investors: the dynamic asset model of (Campbell and Viceira 2002) as well as the work (Sharpe and Tint 1990) on asset-liability management. Acknowledgement of a long-term horizon in the construction of an optimal portfolio will enable the long-term investor to make not only static asset allocation repeated over several periods but a dynamic allocation strategy, that is to say one that follows the dynamic properties of stocks and bonds. In fact, depending on the time scale, these long-term securities experience serious long-term fluctuations which are a driving force of return to the average. In other words, when these financial asset returns vary over time, the risk structure and the arbitrage between risk and returns are on a time proportion basis. It is therefore necessary to use dynamic allocation inspired by a generalization of standard theory.

\(^\text{17}\) More recently, the study of (Demaria and Rigot 2013) confirms this result while putting things into perspective, by distinguishing among insurers, the long-term players from medium and short term players depending on the actual duration versus statistical life and non-life insurance contracts and by highlighting the various definitions of life insurance depending on the country considered.
This predictability is important economically in the long-term because it reduces the risk attached to equity markets and thus leads to significantly increase the proportion of equities in the optimal dynamic portfolio compared to a static allocation (Bec and Gollier 2008; Campbell and Viceira 2002; Gollier and Janci 2010). The equity can take into account the inter-temporal coverage resulting from the correlation of returns over time associated with the mean-reversion. We could deny with difficulty mean reversion. It would mean there is no fundamental value. The risk of investing in equities and bonds decreases over time. The relative risk of equities compared to bonds and money market investments tends to decrease with horizon investment (Garnier and Thesmar 2009). More specifically, the inclusion of the inter-temporal coverage implies a contrarian strategy that is to say, that does not always follow the market trends contrary to momentum investing which considers only short-run price changes and disregards value. However, this dynamic strategic asset allocation should be flexible in the time since the long-term investor cannot simply accept a “buy and hold” management. This involves regularly review the allocation based on expected returns and its remaining investment horizon. In order to harness the forces of mean reversion, there is a need for an investigation of the fundamental values of long-term yields: identify structural changes, make medium-term macroeconomic scenarios and make a dynamic optimization to determine the optimal structure of large classes in the portfolio. Thus, if the investment strategies of long-term cannot be associated with passive buy and hold management, it is also incompatible with management arbitrageurs whose only concern is to take advantage of market opportunities in the short-term (using a rate high turnover of their assets). It allows a degree of active management with a turnover nonzero but this last one must be guided by concerns of long-term average in terms of more consistent horizon with the

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18 An empirical study by (Campbell and Viceira 2005), on the volatility of returns of stocks and bonds securities on the one hand, and the correlation of returns between stocks and bonds on the other hand, shows that these risk indicators are based on the investment horizon of investors. The results show that the variance of stock returns decreases with the horizon, the same phenomenon occurs for bonds but in a less pronounced way.

19 The dynamic strategic asset allocation involves management incorporating both the concerns of long-term and short-term development of the strategic allocation internally.

20 Active management can be defined by the fact that investor seeks to benefits from short-term favourable variation in the market.
real economy that players are expected to pay. This specific strategy is called rebalancing\textsuperscript{21}.

Another feature of the investment strategy of a long-term investor, it must take into account liability characteristics to build strategic asset allocation. Taking into account liabilities requires asset-liability management (ALM) that the liability becomes the benchmark. This is to maximize the surplus (assets minus liabilities) and separating the portfolio into two parts, one of which uses the contingent immunization (core) to protect the liabilities and other to research absolute return (satellites). In these satellites\textsuperscript{22}, it is investing in alternative assets (private equity, infrastructure, hedge funds). For insurers, the asset-liability management is especially crucial with the immunization of their commitments to their liabilities. Indeed, they have a business reversed compared to non-financial\textsuperscript{23} companies since it is the nature of the liabilities, in particular its duration, which determines the choice of asset allocation model.

Both theoretical principles of asset allocation are crucial for long-term investors in the long run, applying could play a triple role of financing the real economy by channeling savings into innovative productive projects in defined areas, play a stabilizing role in the markets with a contrarian strategy that opposes a momentum (which follows the movement of the market) behaviour and finally improve corporate governance by extending the horizon of investment companies listed.

While in theory, the optimal portfolio of a long-term investor is mainly composed of bonds and a higher share of equity (inter-temporal hedging) and alternative assets too, in fact, the insurance industry generally allocated a large proportion of its investment portfolio to bonds. With the exception of UK, Singapore and Italy insurers which have the highest allocation to equity. In most countries, the life insurance industry heavily invest in bonds but more than non–life sector; and allocation to equity is lower in life insurance companies than non-life ones. In roughly half of reporting countries, the share

\textsuperscript{21} The rebalancing of investments is the action of bringing a portfolio that has deviated away from one's target asset allocation back into line.

\textsuperscript{22} Investments in satellites require active monitoring governance i.e. a more rigorous monitoring.

\textsuperscript{23} Non-financial corporations define their investment needs (assets) then seek the best financing solution (liabilities).
of equity in portfolios\textsuperscript{24} was below 10 percent in 2011 (OECD 2012). Investment allocation to direct real estate investments\textsuperscript{25} appears to be relatively small in most countries (OECD 2012). According to NAIC\textsuperscript{26}, insurers actively manage their portfolio\textsuperscript{27}, but they have modest turnover rates, in the range of 20\% to 25\% per year or less. They can also have higher turnover rates which can be justified by specific reasons: changing tax positions, a requirement for enhanced liquidity at the company, the implementation of a new investment strategy…

However, if the determinants of asset allocation of an insurance company are mainly determined by the structure of liabilities, others back into play including prudential and accounting constraints, including the method for valuing their liabilities and their assets.

2. METHODS

In this section, we present research methods (2.1) and the process of interviewing (2.2).

2.1. Research methods

The exploratory nature of the research issue led us to adopt an approach that permits us to identify the knowledge of stakeholders practicing long-term investment. The most suitable method of research is the semi-structured interview which enables the views of different stakeholders to emerge. A questionnaire would not achieve such a wealth of material. The questionnaire method is suitable when the researcher is in a phase of confirmation and wants to test specific hypothesis which is not the case with assumptions. Furthermore, a quantitative study was inconceivable given the nature of our

\textsuperscript{24} With allocations above 40 percent, non-life insurers in Finland and Austria had the highest equity allocation. France, Norway, Poland, Thailand, and the United States also had relatively important allocation to equities, above 20 percent.

\textsuperscript{25} With allocations above 10 percent, life insurers in Norway and Switzerland, and non-life insurers in Greece and Slovenia, have relatively high real estate investments.

\textsuperscript{26} National Association of Insurance Commissioners.

\textsuperscript{27} Primarily through the allocation of new cash flow, with sales of existing holdings usually for specific reasons, such as credit concerns, duration management or the need for additional portfolio liquidity.
problems and the total lack of data. We positioned ourselves in an abductive approach that is to say that the interview guide was designed without an a priori theory; the aim was to accurately reveal the information from the field of research. Abduction is a third form of reasoning design, which completes deduction and induction. For (Peirce 1958) abduction is the only reasoning mode which can lead to new knowledge. According to (Boisot and Mckelvey 2010) abduction seeks inference toward the best explanation, one that is based on the coherence with which a novel or anomalous event can be related to a background theory. Abduction aims to identify the causes underlying the observed relationships. In abductive explanatory methods, researchers are principally interested in inductively finding an explanation to the regularities observed (critical realism) or an understanding of the regularities experienced (Avenier and Thomas 2013).

Our research approach complies with the process proposed for building theory proposed by (Eisenhardt 1989). We first define a research question without an a priori construction or hypothesis to test; we then go into the field of research in order to collect data about the practitioners who know about the subject. When we reach data saturation, we analyse them and the present findings. After this stage we put into perspective the results of suggested implementation accounting principles that meet problems observed by practitioners.

The validity of our findings is based on the large panel of interviewees (practitioners of 13 insurance companies, advisors, French, European and international regulators and supervisors). Nevertheless, the qualitative method for collecting data is always limited and subject to caution in terms of a scientific replica. But according to (Coleman 2013) the only way to gain direct insight into the decision process of investment managers is to ask them. So interviews are certainly not a perfect data source, but they do offer a perspective on investor thinking.

2.2. Semi-structured interviews

The study is based on a qualitative process from 43 semi-structured interviews conducted between April and November 2013 (Appendix 2). The interviews were conducted with
stakeholders of the insurance industry, and with various stakeholders such as standard setters, supervisors and advisors. Interviews took place in France, Belgium and the United Kingdom. The selection of interviewees was done initially through research networks, to which researchers belong, then by recommendation of another contact by each interviewee. Interviewees held various organizational positions: asset manager, responsible for accounting standards, risk manager, CFO, CEO (Appendix 3). The diversity of the respondents led to the collection of a sufficient amount of empirical information to answer the research questions. The interviews were usually held in the office of the respondents, which gained trust amongst the interlocutors. We stopped the process of information collection when we reached data saturation point. Each interview began with a confidentiality agreement on the information retained and on the identity of the interviewee; this allows a more open debate. This is why the names of the institutions will not be linked with the status of the respondent; we present verbatim information indicating the person's position and the sector where the person works. The interviews were conducted from an interview guide structured around three major topics: the long-term investment, the accounting standards and the prudential standards with regard to long-term investment (Appendix 4).

This type of interview allows respondents to answer more freely and openly than to a questionnaire. The principle of the semi-structured interview allows researchers to ask additional questions based on the progress of each conversation. The interviews ranged from 40 to 160 minutes. They were fully recorded, transcribed word for word, and then validated by the interviewees. The transcripts were coded by researchers with the N'Vivo 10 software. At first, in accordance with the recommendations of Strauss and Corbin (1998), we made an open coding based on the themes of the interview guide, and then in the second step we made an axial coding to identify relationships between different levels of coding and link them to the problem of long-term investment. The coding scheme was conducted jointly by researchers. The findings synthesis corresponds to the most frequently raised theme by respondents to characterize accounting rules for long-term investment in the insurance industry context.
3. IFRS CONSTRAINTS FOR LONG-TERM INVESTORS: A FRENCH PRACTITIONERS POINT OF VIEW

This section presents the main findings of the field inquiry. During interviews, we asked “If IFRS standards induce incentives or constraints for long-term investment? And in either case: which standards and in what ways do they represent an incentive or a constraint?” On the whole insurers responded that IFRS represent a constraint for long-term investment and affect asset allocation. French insurance practitioners underline that current accounting practices (IAS 39 and IFRS 4) lead to a false representation of insurance activities due to an accounting mismatch between assets and liabilities (3.1). Otherwise interviewees highlight consecutive effects of IFRS standards on the long-term investment allocation related to volatility (3.2).

3.1. Limits of current IFRS standards for representing on long-term activities

3.1.1. IAS 39: issue of categorization for long-term investments

According to practitioners interviewed, time is taken into account by IASB in a short-term view. Indeed the widespread use of fair value accounting for recognition and measurement of operations is a difficulty for the accounting of long-term business. Despite the fact that IAS 39 offers a possibility to classify long-term asset at cost, it appears that insurers do not use this opportunity because of the restriction included in the standard. Although according to practitioners, all assets, that hold a long-term maturity such as bonds that should be recognised at cost and placed in the HTM category, are recognized at fair value.

“Finally, only 15% of our assets are in HTM while it should be a majority in our investment intentions. Economically, it is a majority and because of this constraint, where once you filed, you cannot get out, well it is cautious about that element. (...) So there was a sharp distinction between accounting and reality” (Insurance, Chief risk)
“For an insurer, it may seem strange, but it has very few bonds in the HTM category. This is because the constraints were such on that category” (Insurance, Head of accounting policies)

“The HTM is rarely used, because it was very penalizing.” (Supervisor)

The HTM category should be the best representative of the French long-term business model. But because of the tainting rule this category is too restrictive. As previously said, the tainting rule restricts sales before term of assets. These sales could lead to the downgrade in AFS (valued at fair value) of all HTM portfolios during 2 years. It can be observed that there is a consensus among practitioners and standard-setters to question the relevancy of the tainting rule within a long-term business. This rule does not allow insurers to represent correctly their activities. Most of the investment assets are recognized in the AFS category which requires a fair value measurement with recognition of variations in OCI.

“All our assets are in AFS (...) because of the exit criteria of HTM which are too restrictive” (Insurance, Director of investment)

“Yes, because there is a rule in IAS 39 which is quite hard, quite brutal, which says: “Ok, you've put that in HTM, that's fine, but you no longer have the right to touch it. You cannot do arbitration, and if you make the slightest infringement of this sacrosanct principle, at that point, you are disqualified. And you are forced to downgrade your portfolio from HTM to fair value. And so they did not use it, because the slightest deviation led them to having to make a reclassification in unstable conditions” (Standard-setter).

So the majority of financial assets (bonds and equity listed or private) composing the investment portfolio of insurers cannot be valued with the cost method, even if bonds for which a horizon of detention is defined are measured at fair value. For example we can look at the allocation by asset class of bonds and equity owned by Axa group in 2012:

<table>
<thead>
<tr>
<th>Example of AXA</th>
<th>HTM</th>
<th>Trading</th>
<th>AFS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds 378 228 M€</td>
<td>2%</td>
<td>8%</td>
<td>90%</td>
</tr>
<tr>
<td>Equity 17 075M€</td>
<td>0%</td>
<td>35%</td>
<td>65%</td>
</tr>
</tbody>
</table>
Insurers interviewed estimate that the AFS category is less bad than recognition of fair value variation in P&L. This is due to a question of financial communication, because in France practitioners and analysts consider that the real performance is represented by the net income. So accountants want to avoid as much as possible to impact the P&L with fair value variation which do not represent the real performance.

“Insurer has done a big lobby for the AFS category because it allowed us to have the market value on the balance sheet instead of in P&L” (Insurance, Head of accounting policies)

“Already because usually you publish your incomes more than your equity” (Insurance, Head Assistant of accounting).

Tainting rule contributes to the increase in the mismatch between assets and liabilities which are valued at cost.

### 3.1.2. IFRS 4 and IAS 39: an accounting mismatch

The most important difficulty for French insurance accountants is the split between accounting rules for financial assets (IAS 39) and for insurance contracts (IFRS 4 phase 1). As seen previously IAS 39 measures assets at the fair value while IFRS 4 permits an application of local GAAP which means in France, an evaluation at cost. This accounting mismatch is a French issue, indeed certain others European country (like UK) applied a fair value measurement for liabilities under local GAAP. This is all the more detrimental in that the insurance business model is based on the best asset-liabilities matching.

“I would say that in fact, we are now in a great discomfort because we have a philosophy of standards in assets that do not respond at all to the philosophy of the liability standards” (Insurance, Director of investment)

“You cannot have assets valued in some way and then liabilities in a way quite different. After that, you are forced to have some consistency between the method of valuation of your assets or liabilities. So, we will not solve the problem only with the IFRS 4” (Insurance, Professional association)
This practitioner’s point of view is attested by a supervisor of the insurance sector:

“What is problematic is the IASB approach which is by type of operation, so that means, for example, IFRS 4 Insurance contracts; it is liabilities for insurers, while IAS 39-IFRS 9 is financial instruments. So the whole problem is actually moving from an approach by type of contract where it will perhaps take options or accounting choices that will not necessarily be in quotes “consistent” between the two standards, and insurers who actually invest in assets to cover their liabilities, may be able to have a problem. So the whole issue is to ensure consistency between the accounting standards so that the global business model of insurers of asset-liabilities management can be well represented” (Supervisor).

Moreover a board member of the IASB confirms that actual standards are not consistent for representing insurance’s assets and liabilities. But he asserts that the board is working hard to promote standards which are coherent for the two sides of the balance sheet.

“They must be consistent. We have to be. This is why IASB manages the two projects in parallel. And there is an interaction of IFRS 4 on IFRS 9 standard” (Standard-setter).

This incompatibility of methods of measurement for insurance assets and liabilities introduces an artificial accounting volatility in the equity on the balance sheet statement. Thus long-term liabilities are valued at cost according to French requirements and medium and long-term financial investments are valued at fair value under IFRS. Given that insurance companies make asset liability management, they are impacted by short-term market variations which do not represent their long-term business.

3.2. Effects of IFRS standards on long-term strategies

Traditionally accounting is seen as a picture of the firm activity. But we may question if this simple picture seems not to be modified by IFRS’s standards. This issue is particularly present in the insurance industry. Indeed, according to interviewees, the long-term business model of insurance companies seems not to be well represented by international standards. They underline the incompatibility between IFRS and long-term
business representation. Indeed long-term investment strategies supposed to invest in risky/illiquid assets (such as equity, private equity…) based on a long term fundamental analysis of these assets returns’ determinants, to perform in the long run. French practitioners identify two main consequences of IFRS on their long-term business, first the effect of volatility introduce by IAS 39 on the asset allocation (3.2.1) and secondly the difficulties to manage in a long-term perspective assets portfolios (3.2.2).

3.2.1. Volatility and asset allocation

The use of fair value measurement (IAS 39) for a large part of insurance companies’ portfolio of insurance companies seems to introduce an artificial volatility for assets held with a long-term intention. The question is: does this change in accounting measurement induce a change in asset allocation? If yes, is this change prejudicial to long-term assets? Insurers interviewed raised the fact that the widespread use of fair value (IAS 39) leads to a revision of asset allocation strategy. In IASB point of view, almost all financial assets should be measured at fair value (through OCI or P&L) whatever their holding intention. So insurers are forced to adapt their choice of instrument to limit the impact of fair value variation. In that way, fair value may introduce an artificial accounting volatility in the insurance portfolio which doesn’t represent the economical business. So this could lead to favouring more conservative strategies with more secured assets (such as bonds) to the detriment of risky assets such as equity or illiquid assets.

“You are led to put less non-bonds and not backing assets than you could put economically because you simply cannot afford to recognize losses on these assets.” (Insurance, Director of investment).

“Actually, we are going to find the strong impacts on what I call the categories of diversification. That is to say, yes, it is mainly equity in part, but mainly on alternatives, infrastructure, etc., and derivative instruments as I pointed out earlier, that seem to be a category of instruments very necessary for us to use and which are very abused.” (Insurance, Director of investment)
“Completely “full fair value” measures of performance (...) and of solvency are volatile and they lead, would lead, and will lead insurers to reduce the amount of the corporate bond so as not to be exposed to fluctuations in the equity share and spread in order not to be subject to fluctuations in the equity markets.” (Insurance, Professional association).

“Yes and at the same time, we should be positioned on assets where we control the volatility, we need to reposition on assets whose market value can finally be better controlled” (Insurance, Assistant of Head accounting).

These words highlight the fact that insurance companies are no longer managed solely in an economic perspective (liabilities related to their insurance contracts). But they incorporate more and more accounting constraints for investing choices. This situation has consequences for insurance companies. The artificial volatility introduced by IFRS’s standards in the balance sheet by the measurement of long-term activities at fair value is not representative to the long-term management of insurers. Moreover, accounting rules convey a distorted picture of the real business model of insurance.

“When the IASB proposes that we only have Fair value, we are against, because we consider that as we have a long-term activity we cannot take into account, in our income statement, the impact related to timely market assessment because it does not reflect our activity; because we manage contracts in perspective, we do not have to be subjected to these market fluctuations.” (Insurance, Head of accounting policies)

The volatility introduced by the IFRS standards could also have effects on the management of long-term investments portfolios.

3.2.2. Difficulties to manage in a long-term perspective

The first effect of volatility on an insurer is to shorten the long-term management while its objective should be long-term return. Indeed the measurement at fair value of financial assets which have a long-term horizon of ownership (such as corporate or sovereign bonds, private equity) could not represent the managerial intention. For the insurers interviewed it appears that the fair value measurement of long-term assets is difficult to
manage and explain in financial communications. Long-term assets are used to back long-term liabilities, and are intended to stay on the portfolio for many years. So it does not seem appropriate to value an asset at each closing date which can be sold in 5 or more years. The need to constantly diffuse the instant value has an impact on the choice of asset allocation and is in contradiction with a dynamic asset allocation.

“That means that you will greatly shorten your time horizon” (Insurance, Director of investment).

“The notion of cycle, that is to say when we catch a retirement contract, we know we're going 25, 30 or 40 years with an insured person, so are we to count the result of this retirement contract in the same way as when a manufacturer is producing a phone where the production cycle lasts one week and 10 days, in order to sell?” (Insurance, CEO)

“We have a schedule of realization of assets which takes into account the time and this vision of fair value in the short term which shrinks our horizon.” (Bank-Insurance, Head of accounting standards).

Furthermore, according to interviewees, IFRS standards promote a strict view of the management intention. In terms of asset allocation, it consists of applying a “buy and hold” management principle in a restrictive way. In other words, IFRS has a long-term definition only related to bonds (to hold an asset until its maturity):

“If the company invests in a bond in order to collect cash flow from interest capital during the lifetime of the title, it will be registered on the balance sheet at the historical cost, and conversely if the investment is made in a placement approach, saying, "I'll pull out when the market opportunities give me a good price, I sell and I re-invest something else" at that moment, we say “whatever best represents the value, the value of this instrument, the realizable value is the market value, not the historical cost.” (Standard setter)

So from this perspective, when an insurer holds a bond in a long-term view (at cost with HTM category), this bond is nearly blocked for the period of holding because of the tainting rule. The application of the tainting rule seems to forbid an active management of asset which benefits from a positive/negative market evolution. This is the case for bonds and private equity but not for equity which by definition has no term and no fixed
revenue and by consequence cannot be classed in HTM. Consequently in this view, there is no long-term investment in equity for which insurers have a turnover. IASB does not take into account the holding intention as far as equity class is concerned. So equity cannot be valued at cost but only in fair value. From an IFRS point of view investment in equity is by definition a short-term investment which must be valued at fair value “They believe that equity cash flows are too uncertain to be measured in a different way than fair value mode. So for them, as something uncertain, the best mode of representation is the fair value.” (Supervisor FR).

“Then, the problem is that it does not make much sense to use the cost to measure equity. So, finally, the only way to measure equity in accounting is the fair value, is the market value.” (Supervisor CE).

Moreover, IASB thinks that fair value evaluation and holding equity in a long-term investment view are compatible. Indeed investors who read financial statements must know at any time the value of their positions taken by the management even if they are in long-term. Long-term investment and fair value should be consistent and profitable for all: “The person who drives a long-term investment, the fact of knowing at any moment the instantaneous theoretical value of its investment, especially if he takes into account the people who lent him money, who invested through him, if he is a manager for third parties; will that change his strategy? Why should that change his strategy?” (Standard setter).

It is even more obvious in the work on IFRS 9 in which value variation of equity must be passed in P&L. Nevertheless, it is possible to recognize equity with fair value through OCI, but in this case there is no recycling when the instrument will be sold28. This option is very restrictive and economically dissuasive.

“I do not know how the director of investment will manage its buffer, but in any case, it is clear that for the P&L part, if our equities are only in fair value through P&L, I guess, we will think twice before investing in stuff like that.” (Insurance, Head of accounting policies).

28 There is no recycling in the P&L on derecognition, that is to say that the minus or surplus of the sell do not appear in the income statement.
Respondents assert that the insurance business needs to follow regularly the position of their assets and may be required to arbitrate about their position which could be damaged by the market situation. So they need accounting rules that enable representation of the specificities of long-term investment which are a long-term management horizon with necessary active management.

“Within the meaning of IASB, which is an intention and a form of ownership, and self-restraint not to arbitrate, no, I'm not in this sense a long-term investor: when I see the ship sinking, I do not go down with the ship. I can't be on auto pilot as the board of the IASB assumes.”(Insurance, Chief risk)

“When it is necessary to enhance the market value of losses immediately, this is an incentive for the insurer to the bank to sell its shares quickly enough. So they could keep it if they did not have to promote it to the market value.” (Bank-Insurance, Chief risk)

“Indeed, it would be better to do active management, in fact. It is irrelevant. Therefore it should be more prudent.”(Consultant)

On the other hand, many supervisors underline the fact that if the actual standards are not satisfactory, they do not know how to promote accounting standards with long-term incentives: “it's hard to say what should be done in accounting standards to assist this long-term investment” (Supervisor).

4. HOW CAN ACCOUNTING RULES BE ADAPTED TO COMPLY MORE WITH INSURERS LONG-TERM PRACTICES?

The previous section shows that the specificity of the insurance sector raises a major problem of accounting and measurement of liabilities and assets. For (Vaughan 2012) « where the business is long-term, it makes sense to reflect that in accounting ». So in this section, according to interviews, using academic and professional literature we investigate possible solutions to increase the accuracy of accounting for recording insurance long-term business. First, we put into perspective theoretical foundations of international accounting in regard of long-term insurance management (4.1). Second, we
discuss the different methods of evaluation according to the long term management (4.2).
Finally, we investigate methods to solve the issue of recognition and measurement of long-term portfolio (4.3).

4.1. Is market efficiency hypothesis relevant in the insurance industry?

If accounting standards are a very technical subject, they cannot be reduced to a technical debate as if they were a set of neutral rules. They are a main theoretical stake; in general based on a theoretical framework which underpins a representation of an activity, more precisely the activity of a corporate. The nature of information (to be produced) to reveal this activity depends on the representation we have of it. The three last decades, the conception of firm has deeply changed. At the instigation of the new theories of firm, the finance conception of the firm has replaced managerial commitments to investment and innovation in production. Managerial goals of increasing stock prices in the short-term displaced increased market share. The actual IFRS accounting standards are coherent with this new representation of firm. If this representation were clear and approved, the debate between users and setters of standards will only focus on technical aspects. In this way, accountant professional have a better capacity to deal with issues related to their professions given their technical expertise.

However, because accounting is a kind of language, corporates or specific corporates like financial intermediaries and insurance companies are legitimate to take part to this debate about the theoretical founding principles of accounting standardisation. Besides, the distrust between them finds its origin in misalignment between their economic model and in two words, the model on which IFRS is based is a good representation of their business and specificity of long term categories of investors. Consequently, it is worthful to question this issue analysing to what extent the representation for corporate of IFRS is coherent with this new representation of firm.

29 The focus on stock prices was reinforced by the linking of top management pay to stock options rather than long-term market share, sales, or production based profit. The increased financial engagement of non-financial business, the rise of shareholder activism and the development of a market for corporate control shifted managerial orientations from long-term goals of corporate growth to short-term goals of profitability (Ken-Hou and Tomaskovic-Devey 2013).
compatible with specificity of financial intermediaries and potential long-term investors like insurers and to propose some recommendations to promote alternative standards. Before the mandatory adoption of IFRS standards, many academics and professionals of banking and insurance industry had claimed that these standards were inappropriate to their sector. In particular in the insurance sector the struggle between long-term business and short-term accounting raises difficulty to produce relevant financial statement.

IFRS framework based on fair value accounting provides a short-termism of the financial information which is not satisficing for activity which need time (Perry and Nolke 2007; ANC 2013). According to (Barneto and Gregorio 2010) the agency theory gives preference to short-term vision of the accounts at the expense of long-term. This conceptual schematic is consistent with the efficient market hypothesis that supposed to give back all available information instantaneously. But recent crisis succession had highlights the shortcomings of market value accounting. Indeed when markets become illiquid we can observe that the desired efficiency has led to instability (Colasse 2009). In long-term point of view, fair value accounting is difficult to apply, because insurers hold illiquid asset (private equity, real estate) or long-term instrument (bonds with maturity upper to 5 years or more). But what is the fair value of a bond holds to 30 years to cover a retirement contract? According to La Martinière (de) and Trainar (2003) the length of the insurance production cycle has two main consequences: on one hand, it further reduces the relevance of the reference to mark to market and on the other hand, it makes it even more important that accounting standards be correctly adapted to the realities of the insurance sector, where approximation in accounting seem harmless in the short-term, but can have dramatic consequences if used systematically for the long-term. Beyond the duration of investments is the question of liquidity of the market and the illiquidity of some class of financial assets of insurance portfolio. According to (Allen and Carletti 2008), when financial market are imperfect or illiquid the historic cost accounting suits better to bank and insurance industry. Finally, we can wonder how standards anchored in fair value accounting can be relevant to represent a long-term business. But how can we introduce better information for long-term activity into IFRS standards? And more precisely for the huge part of financial assets valued in fair value despite a long-term holding intention?
4.2. Insurance long-term investment and valuation models

The definition of long-term strategy given by the IASB seems quite restrictive because it reduces it to a buy-and-hold management (method of valuation at historical cost) and not allowing any possible tactical allocation or active management (method of valuation at fair value OCI or P&L). In other words, any other type of management is considered as a short-term management involving active management with a turnover more and less high. Regardless of whether the insurer has a high turnover effective or not, the fact that he has not made the choice to buy and hold an asset is equated with an intention to active management and thus cannot be considered as a long-term approach. If this point of view is applicable for bonds with a maturity even if they are negotiable, it is not the case for equity that will by definition have no term. There is a need for relaxing accounting rules as far as equity allocation is concerned depending on how long insurer effectively holds equity.

Similarly the definition of long-term investment given by insurers is not unequivocal. They ideally would like a valuation at cost for assets highlighting their long-term business model (due to their long-term liabilities), encouraging them to make an –asset-liability backing. Indeed, this method of valuation is comfortable because it allows them to maintain a stable balance sheet value, knowing that in case of significant impairment, the mechanism allows provisioning to appear the potential impairment. The amortized cost is anchored on the principle of prudence opposes the recognition of unrealized gains. This valuation method would allow insurers to inhibit any volatility exacerbated by not introducing changes in short-term market for their long-term assets. Consequently, insurers would have no constraints to actively manage their portfolio. In contrast, a valuation at fair value with recognition of variation in OCI is less comfortable according to insurers interviewed because changes in market values are assigned to equity. Given their large portfolios of financial assets and normative restrictions on amortized cost, the effects can be heavy on the amount of equity.
Finally a value of financial assets at fair value with changes in P & L, introduces a very significant volatility on net income of insurance companies. Knowing that in France, the net income is the key indicator of the performance of the company. For insurance industry, this valuation model could pollute very significantly effective performance by introducing market variations for financial assets that are not held for sale. Both methods based on the fair value also as a result of introducing a significant pro-cyclicality in the financial statements of insurers because fair value accounts as well as unrealized gains and losses. Given the mass of financial assets of insurers and swings up or down markets, the effects on the accounts can be very large and in the opposite direction from one year to another.

This raises the question of whether an investor who has the characteristics of a long-term investor may adopt long-term strategies outside a management “buy and hold” and then do a little active management. The answer is yes but with certain conditions. This need of active management should be guided by concerns for the medium to long-term (investment horizon) and not short-term in order to be more compatible with the real economy (funding of firms) (Demaria, Rigot, 2013). In other words, accounting should consider a continuum of management from the management “buy-and-hold” to the active management (arbitrage) of equity, at different levels, with the appropriate valuation methods. This requires leaving the binary opposition historical cost associated with long-term fair value associated with the short term. We can wonder: what kind of valuation model for assets held by an insurer who intends to hold these assets without renouncing to get rid of, for the sake of realization of capital gains in the short-term.

4.3. **A new accounting category for long-term investment?**

The issue of the adequacy of categorization of financial assets with long-term management can be solved from two perspectives: to remove the tainting rule allowing insurers to use this class; the creation of a specific category for long-term investment using the unit of account concept.
First, the actual tainting rule appears to be too restrictive, and penalizes the representation of long-term investment of financial assets which have an effective duration horizon such as bonds and private equity. A suppression of this rule could be beneficial for the presentation of the French insurer business model by avoiding the issue of artificial accounting mismatch. The IASB aware of this issue have, in the IFRS 9 project, no longer proposed the tainting rules. But they have introduced a cash flow constraint (solely payments of principal and interest which are called plain vanilla instruments) to permit a recognition at cost. The interest must solely represent the time value of money and the credit risk associated with the principal amount outstanding during a particular period of time. This new rule permits the recognition of only very simple instruments with no options which in fact corresponds to a very small amount of bonds portfolios. Otherwise the cash flow criterion must be applied for all the portfolios. Actually in France, the application of IFRS 4 phase 1 leads to a recognition at cost of insurance liabilities. So the suppression of the tainting rule and its replacement by the cash flow criterion would permit to recognise more financial instruments at cost which could be acceptable solution in a long-term investment perspective.

Another possibility, in order to fit in the long-term view of insurance business models in accounting, should be the use of the concept of unit of account, in a standard on financial instruments (IAS 39 or IFRS 9) as a proper category of financial assets. (Hales, Venkatarama,, and Wilks 2012) remark that for many business contracts, such as insurance ones, the issue of the ‘unit of account’ is particularly important. It is possible to imagine that financial assets with a long-term perspective could be aggregated together in a long-term portfolio valued at cost or another way representing a long-term stable measure. The long-term criterion could be the asset holdings duration which must be related to liabilities duration or compatible with the horizon corporates need to develop

30 For example: convertible bonds, non-senior tranches of structured debt, securities whose performance is linked to an index, bonds held in mutual funds are by definition excluded of the cost category according to IFRS 9 regardless the intention of management.

31 This accounting notion is defined by (IASB 2013) in the discussion paper about the conceptual framework as: “In order to recognise and measure assets and liabilities in the financial statements in a way that provides useful information to existing and potential investors, lenders and other creditors, it is usually necessary to aggregate individual resources, or other rights, and obligations. The level of aggregation required is usually referred to as the ‘unit of account’. “
their strategy. According to Demaria and Rigot (2013), this duration should be superior or equal to 5 years. Illiquid financial investments like bonds and private equity are natural assets for this category as well as equities only if they are not sold before about 5 years. In these cases, insurers commit to affect to this portfolio only investments which are managed with an effective long-term perspective of ownership. But these categories should not forbid arbitration in order to correctly manage investment, acknowledging the fact that arbitration must be reinvested in this long-term portfolio.

As the strategic asset allocation of an insurer company should be guided by intertemporal hedging and mean reverting, we can wonder what would be an active asset management for a long-term investor in general. If this strategy may allow investor to catch higher return, it leads him to follow a momentum strategy which can be detrimental for financial stability. A momentum behaviour in bear market can lead to a speculative bubble and then a crash. To what extent long-term investor may play a role of stabilisation of market due to the specificity of their liability profile, they cannot follow this strategy. They have to adopt another investment behaviour in not fuelling the inflation of price market with a contrarian management. For this kind of investor, active management should be associated to rebalancing that consists in making sure that actual allocation is close to (long-term) strategic allocation in each class of assets of the long-term portfolio. This long-term rebalancing strategy could be limited by thresholds of profit or loss. This target zone could be determined by boards of insurance companies. Administrators could take their decision using some relevant high early warning indicators to anticipate a crisis or via other measures of evolution of risks.

Besides, it should be necessary that this portfolio be accurately disclosed in notes and each change be carefully certificated and justified. This type of accounting method can lead to a stable long-term portfolio included all types of assets with long duration which represents better the insurance business model. We are aware that the creation of a new accounting category with sectorial specification would generate a huge debate in the accounting standard setting (local and international). But this proposition seems to find some supports on the professional industry. Already La Martinière (de) and Trainar (2003) suggested the creation of a specific category for assets “to hedge insurance liabilities” that would be measured in a manner compatible with the corresponding
liabilities, essentially at amortised cost. More recently, in the summary issued of the European green paper, the European Commission retain the idea of “adapting IFRS to take into account the specific business of long-term investment, by creating a specific category assets and liabilities” (European Commission 2014). We can conclude with a sentence of (Taub 2013) “believes that this issue is actually an example of complexity and that it is necessary to make financial reporting relevant”.

CONCLUSION

The overall aim of this article has been to address the question: Do IFRS accounting standards have an impact on long-term investments of French insurers? The empirical evidence provided in this paper is grounded on a material of 43 semi-structured interviews with stakeholders of the French insurance industry. Practitioners underline that financial standards promoted by the IASB are not relevant for their long-term activities. Fair value accounting for investments that are held with a long-term horizon seems not to be representative of the business model. Insurers complain of the incompatibility of accounting classifications (IAS 39) that create an artificial market value for a part of investment which should be measured at cost. Actually the most important issue is the accounting inconsistency of recognition and measurement of assets and liabilities (IAS 39 and IFRS 4 phase 1). This situation leads to accounting mismatches that do not fit the economic reality. In effect, the limited choice of financial categorisation of financial assets causes constraints for long-term investment measurement for French insurers. Putting these findings into perspective through interviews and literature, leads us to focus on two main assessments. First work needs to be done on the internal consistency of accounting standards and the possible recognition of long-term business with the suppression of the tainting-rule. Then with the use of a new long-term accounting class which could be managed in active way using rebalancing methods and appropriate measurement method. If we think in a long-term perspective fair value accounting seems not to be the relevant measure. But is the cost method better? Why shouldn’t create a new valuation method linking assets to liabilities of insurers: a mark to funding estimation.
That is to say, assets must be evaluated related to liability to obtain a more stable value a more stable allocation. These two propositions, which emerged from the empirical material of the interview process, should be corroborated with another phase of in depth interviews with stakeholders or it could also be tested with empirical economic models. For the moment interviews were only conducted with French insurers, this constitutes a bias for the comprehension of international accounting standards. We aim at extending our panel of interviews to compare the French point of view with other European contexts (Great Britain and Germany). Apart from that, in this paper we focus on the accounting interaction with long-term investment of insurance companies but we do not address the prudential issue although this was widely discussed with practitioners. It appears that in the insurance industry prudential standards are an important constraint on long-term investment perspectives. It will be interesting to conduct further research to see to what extent prudential capital requirements constraint long-term investment. It will also be interesting to investigate the comments received by the European Commission in response to the green paper on long-term investment. We will make a comparison of the comments sent by practitioners to see if they are consistent with the responses collected by the interview process.

**BIBLIOGRAPHY**

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file:///C:/Documents%20and%20Settings/SaM/Mes%20documents/SaM/Études/Th%C3
Taub, Scott. 2013. “One for All or All for One? The Unit of Account Issue.” Compliance Week.
APPENDIX

Appendix 1: French requirements for financial instruments accounting

French GAAP (CRC regulation n°2000-02 and 2005-01) gives complex requirements to recognize and measure financial instruments. Indeed there are six different class of financial title from short to long-term:

<table>
<thead>
<tr>
<th>Class</th>
<th>Title of transaction</th>
<th>Title of investment</th>
<th>Title of placement</th>
<th>Title of portfolio activity</th>
<th>Other title with long-term maturity</th>
<th>Large equity stake</th>
</tr>
</thead>
<tbody>
<tr>
<td>Objectives</td>
<td>Speculation</td>
<td>Hold to maturity</td>
<td>Nor speculation,</td>
<td>Capital gain at medium-term</td>
<td>Long-term relationship without influence on management</td>
<td>Influence on management</td>
</tr>
<tr>
<td>Assets types</td>
<td>Negotiable title</td>
<td>Title with fixed revenue</td>
<td>Title with fixed or variable revenue</td>
<td>Companies Title</td>
<td>Companies Title</td>
<td>Companies Title</td>
</tr>
<tr>
<td>Horizon</td>
<td>Short-term</td>
<td>Long-term</td>
<td>Medium-term</td>
<td>Medium-Term</td>
<td>Long-term</td>
<td>Long-term</td>
</tr>
<tr>
<td>Measurement</td>
<td>Fair value</td>
<td>Historical cost</td>
<td>Amortised cost</td>
<td>At the lower of historical cost or value in use</td>
<td>At the lower of historical cost or value in use</td>
<td>At the lower of historical cost or value in use</td>
</tr>
<tr>
<td>Unrealised gain or loss</td>
<td>Unrealised gain and loss recognised in P1L</td>
<td>Impairment</td>
<td>Depreciation of unrealised loss</td>
<td>Depreciation of unrealised loss</td>
<td>Depreciation of unrealised loss</td>
<td>Depreciation of unrealised loss</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Nothing for unrealised gains</td>
<td>Nothing for unrealised gains</td>
<td>Nothing for unrealised gains</td>
<td>Nothing for unrealised gains</td>
</tr>
</tbody>
</table>

In brief fair value accounting (market value and recognition of unrealized loss and gain) is only applied for speculative instruments. In all other cases, the conservative is maintained and latent gains are not recognized. We can note that French GAAP distinguish several classes of long-term assets according to the investment objective. This point is the main difference between French GAAP and IFRS; indeed the holding intention is taking into account in French requirement while it is ignored in IFRS.
Appendix 2: Panel of semi-structured interviews

<table>
<thead>
<tr>
<th>Insurance companies</th>
<th>Others</th>
<th>Standard setter - Supervisor</th>
</tr>
</thead>
<tbody>
<tr>
<td>AG2R La Mondiale (2 interviews)</td>
<td>Allen &amp;Overy</td>
<td>ACPR</td>
</tr>
<tr>
<td>Axa</td>
<td>Cabinet Ricol et Lasterie (3 interviews)</td>
<td>ANC</td>
</tr>
<tr>
<td>Axa private equity</td>
<td>Deloitte et IFRS IC</td>
<td>IASB</td>
</tr>
<tr>
<td>Cardif (3 interviews)</td>
<td>AF2I</td>
<td>European Commission (3 interviews)</td>
</tr>
<tr>
<td>CNP (2 interviews)</td>
<td>Fixage</td>
<td>EFRAG</td>
</tr>
<tr>
<td>Crédit Agricole Predica (2 interviews)</td>
<td>Insti7 (2 interviews)</td>
<td></td>
</tr>
<tr>
<td>FFSA</td>
<td>Premium consulting</td>
<td></td>
</tr>
<tr>
<td>Générali (2 interviews)</td>
<td>PWC</td>
<td></td>
</tr>
<tr>
<td>Macif</td>
<td>OCDE</td>
<td></td>
</tr>
<tr>
<td>SCOR</td>
<td>CDC (6 interviews)</td>
<td></td>
</tr>
<tr>
<td>SMABTP</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SwissLife</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

| 18 interviews                    | 18 interviews             | 7 interviews                |

Number of interviews: 43
Number of institutions: 28
Total recording time in minutes: 3162
Either in hours: 52.7

Appendix 2: Interviewee’s position

![Interviewee's position chart](chart.png)
Appendix 3: Thematic of the semi-structured guide

1. Background of respondent.
2. Is long-term investment a relevant concept? What can be a definition?
3. Do accounting standards impact positively or negatively the long-term activity? What standards? How?
4. Do prudential standards impact positively or negatively the long-term activity?

Appendix 4: supplementary verbatim

Supplementary verbatim section 3.1

<table>
<thead>
<tr>
<th>HTM</th>
<th>Insurer</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Our business would rather be in HTM for bonds or for a large part of the bond portion. Provided that there are exit opportunities out if the liability requires this. While at this time, with today's regulations, with HTM there is only one way out, and that is if the issuer is in default. Otherwise, it calls into question the whole classification, including the group level of XXX, so it's pretty detrimental</td>
</tr>
<tr>
<td></td>
<td>So then on those held to maturity, the way the text is currently made, if a line of securities is sold before maturity, therefore, we will downgrade this entire line of titles for all of the Group BNP Paribas. That is to say that we, if we have a company or a subsidiary in Japan that has a security held elsewhere in the Group PNB Paribas, that was classified as held to maturity, if it is sold before maturity, normally, it downgrades the entire line of titles for the Group. I think this part is always minimized compared to what it would have been because of this rule, this constraint</td>
</tr>
<tr>
<td></td>
<td>And there are categories today, that quietly, enable to respond to it, in this case in the IAS 39 in this case and even IFRS 9, the problem is with the criteria and constraints which are given on the accounting categories that are currently not perfectly adapted to these particular business models.</td>
</tr>
<tr>
<td></td>
<td>Reclassification yes, because there is a rule in IAS 39 which is quite hard, quite brutal, saying &quot;ok, you've put that in HTM, that's fine, but you do not have the right to touch it. You cannot do arbitration, and if you make the slightest departure from the sacrosanct principle, this time you are disqualified. &quot;They called it the tainting rule, there is a black mark, and these two black marks force you to downgrade and to reclassify your entire HTM portfolio to fair value. And so they did not use it, because the slightest misbehaviour obliged them to have to make a reclassification in uncontrolled conditions.</td>
</tr>
</tbody>
</table>
| AFS | Insurer | After that, effectively on certain points, we would be more inclined to massively expand the OCI Fair Value without knowing its cost, in the category that should finally be better for us from an accounting point of view.  
(...)  
Impact on equity is also annoying. It may indeed compel them to sell, but it is not as impacting as an immediate impact on the P&L. |
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Professional association</td>
<td>Indeed, the balance sheet assets are valued at fair value in the immediate market, while all the changes in value pass through OCI. So for us it is not a subject to look at. This is not an issue ... Because ultimately what counts ... well the accounts, the accounting is used to measure the performance of the company and display a result. If we put everything in OCI, it was neutralized.</td>
</tr>
<tr>
<td>IAS 39 and IFRS 4</td>
<td>Insurance Chief risk</td>
<td>Where there may be a real accounting issue, especially in the hybrid system in which we live, that is to say, we have assets in quotes &quot;in fair value&quot;. If I ruled the real estate etc., I would have liabilities that are not in fair value, which are in local GAAP. So I have a problem: it is the worst situation imaginable, since it creates an accounting mismatch.</td>
</tr>
<tr>
<td></td>
<td>Professional association</td>
<td>It should still be necessary at the level of IFRS 9, we have the legal hook for the proper link with IFRS 4.</td>
</tr>
<tr>
<td></td>
<td>Advisor</td>
<td>The minimum would be to have standards that are consistent. We have laid down the principles and we haven't gone to the end. We stopped mid-way because we couldn't make it. The IFRS insurance standard was published for the assets. We gave a first one for the liability which was perfectly inconsistent with the one what we gave for the asset. We said we would publish a second to follow up, and more than 10 years later, it's still not done. So we put the principles behind us and we do not know the decline. And introduced much subjectivity.</td>
</tr>
<tr>
<td></td>
<td>Insurer</td>
<td>It is clear that there is a mismatch between assets and liabilities in the reassessment process. (...) After that, the problem is a problem of overall coherence. The problem is the asymmetry. If some are treated one way and some the other, it opens up gaps that make it not liveable, and due to the current budget, may take some engineering to get out of these situations. So for the moment, liabilities are valued more by insurance-standards.</td>
</tr>
<tr>
<td></td>
<td>Insurer</td>
<td>What is not logical is to develop one in one way, and the other in another way.</td>
</tr>
<tr>
<td></td>
<td>Insurer</td>
<td>Whereas with IFRS today, we are in a situation where we have assets at market value, either essentially by private equity, or by results. And liabilities remain in the same way today than when they are measured in French GAAP.</td>
</tr>
</tbody>
</table>
### Supplementary verbatim for section 3.2

**Impact on long-term investment strategies**

<table>
<thead>
<tr>
<th><strong>Insurer</strong></th>
<th>It decreases the risk appetite because they say &quot;Well, we'll take assets that are the least volatile possible, I order to have the lowest earnings volatility of the IFRS result&quot;.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Insurer</strong></td>
<td>These very short-term constraints do not reflect the inability to hold assets and the sustainability of our liabilities. We break it, at a given moment, if the market is broken. There you are. So these are the essential constraints for IFRS. So there are not very long-term visions for all that.</td>
</tr>
<tr>
<td><strong>Professional association</strong></td>
<td>It is a philosophy that is totally inappropriate for buy and hold investors.</td>
</tr>
<tr>
<td><strong>Insurer</strong></td>
<td>We are going to actually find strong impacts on what I call the categories of diversification. That is to say, yes, it is mainly equity in part, but then many alternatives, infrastructure, etc. And derivative instruments as I pointed out earlier, that seem to be a category of instruments very necessary for us to use and which are very abused.</td>
</tr>
<tr>
<td><strong>Professional association</strong></td>
<td>Where it is a problem, it is the equity portion, the portion of interest or even consolidated subsidiaries and there ... probably short-termism side that can, perhaps more than anything else influenced.</td>
</tr>
<tr>
<td><strong>Advisor</strong></td>
<td>It seems to me, however, quite certain is that changes in accounting standards and prudential standards are the weights of equity are expensive.</td>
</tr>
<tr>
<td><strong>Insurer</strong></td>
<td>We still have a lot of difficulties in accounting results that reflect very well the economy of operations. 90% of the balance sheet is clean, but what can make swings, actually, we have some concerns.</td>
</tr>
<tr>
<td><strong>Insurer</strong></td>
<td>Anyway, the problem we have today is that standards, especially accounting and future regulatory standards, greatly shorten the investment horizon.</td>
</tr>
<tr>
<td><strong>Insurer</strong></td>
<td>To say: «I do not invest because I think I’m going to hold over 15 years. Over 15 years, I made my projections. I think I have no risk; I'll take back my bet. Everything fits&quot;. To say &quot;I will not take it because it will be potentially fair value, I know that in two years, it may crash and then in 2 years, I'll have a shock... Whereas I plan to hold for 15 years&quot;. This is an aberration. The accountancy does not have to play for me. Finally, for me, it is my personal view. (...) In the same way, let’s say «I’m not undertaking such an operation because I am evaluated on the business plan basis. The business plan is in IFRS format, and you, with your text book, you oblige me to put it as a result. So it degrades my business plan. In this case, it is necessary that the rules of management control, underlying the business plan, be modified. This is an aberration.</td>
</tr>
</tbody>
</table>
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