Public hearing

EBA Draft RTS on the prudential treatment of software assets under Article 36 of the CRR

Paris, 23 June 2020

Agenda

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Background

- As part of the Risk Reduction Measure Package adopted by the European legislators, the current regulatory treatment of software has been amended introducing an exemption from the CET 1 deduction for prudently valued software, the value of which is expected to be recovered, even in a situation of gone concern.

- In particular, according to the amended version of Article 36 of the CRR:

  - institutions shall deduct from CET1 items "*intangible assets with the exception of prudently valued software assets, the value of which is not negatively affected by resolution, insolvency or liquidation of the institution*" (Art. 36 (1) CRR).

  - the EBA has been mandated to develop draft regulatory technical standards "*to specify the application of the deductions [of software assets], including the materiality of the negative effects on the value which do not cause prudential concerns*" (Art. 36 (4) CRR).

Approach followed in developing the draft RTS
Overview

In developing these draft RTS, consideration has been given to different aspects, including the following:

1	**2**	**3**	**4**
The differences in the **valuation** and **amortisation** of software assets and the **value realised** from their sale	The **international developments** and the differences observed in the regulatory treatment of investments in software	The different prudential rules that apply to **insurance undertakings**	The **diversity of the financial sector** in the European Union, including non-regulated entities, such as financial technology companies.

In particular, as part of its mandate, the EBA has, inter alia, investigated :

▪ the treatment of software under the accounting standards applied in the EU (i.e. IFRS and national GAAPs) and

▪ the practices observed for the purpose of software valuation in a sample of concrete cases of past transactions involving the EU banking sector (being institutions in liquidation, resolution or mergers/acquisitions cases), including the recoverable amount of the software at stake.

Moreover, numerous bilateral interactions have been held with different stakeholders and representative of banking associations with the aim of collecting their initial thoughts and proposals for a prudential framework on software

Approach followed in developing the draft RTS
Overview

In addition, the high level principles listed below have been followed, according to which the revised prudential treatment of software shall:

- be simple to implement and applicable to all institutions in a standardised manner as this is the case today with the deduction treatment;

- be easy to supervise by competent authorities;

- not to be prone to circumvention by institutions;

- not lead to undue benefits/undue relief of CET1 capital; and

- continue to entail a certain margin of conservatism/prudence in the valuation of software for prudential purposes.

Approach followed in developing the draft RTS
Main takeaways from the investigations performed

> **Collection of concrete cases of software transactions**

- <u>Full detailed information was not always retrievable</u>, in particular for resolution and liquidation cases in a pre-BRRD world, and sometimes due to some confidentiality issues. Moreover, even when accessible, the degree of information contained in evaluation reports was quite limited.

- <u>Recovery and resolution plans generally do not include detailed information on software assets</u> and when they do, they show very large ranges of values with no specification of the related valuation methodologies.

- Whether software could have a recoverable value in a gone concern scenario is controversial and difficult to generalise. Indeed, all cases investigated were quite specific and the valuation was usually <u>based on a case by case assessment</u>.

Approach followed in developing the draft RTS
Main takeaways from the investigations performed

> **Collection of concrete cases of software transactions**

- Based on the collected evidences, <u>all software without a distinction of specific categories seems to have a similar probability to be written off or recovered.</u>

- Usually the valuation of software (or its expected useful life) is revised by the acquirer after the acquisition date, on the basis of an assessment of the IT systems to be replaced, as a result of the migration process, which, according to the collected evidences could range <u>between 1 and 3 years</u>.

- On the basis of the collected information and the presented cases, software has no recoverable value in case of liquidation, whilst it is worth pointing out that in some cases, software assets continue to be used during the liquidation process, contributing to an orderly liquidation, and, therefore, enhancing the overall liquidation value of the institution.

Approach followed in developing the draft RTS
Other frameworks considered

Treatment applied in other jurisdictions

- At the international level, the regulatory treatment applied in case of investments in software largely depends on their accounting classification as intangible or tangible assets.

- In this regards, it is worth noting that while a significant number of jurisdictions require or allow the application of IFRS (as in the EU), some differences have been observed in other international accounting frameworks, as in the case of the accounting principles applicable in the United States (US GAAP).

- Indeed, as a difference with IFRS, US GAAP does not explicitly state whether capitalised software shall be classified as a tangible or an intangible asset.

- Therefore, US banks generally do not classify software as intangible assets and, from a prudential perspective, they include it in their risk-weighted assets, instead of deducting from own funds.

Approach followed in developing the draft RTS
Other frameworks considered

Treatment applied to EU insurance undertakings

- Insurance and reinsurance undertakings in the EU are subject to Delegated Regulation (EU) 2015/35 supplementing Directive 209/138/EC (Solvency II Directive), according to which, all intangible assets, including software, shall be valued at zero (i.e. shall not be recognised) unless:

  (a) they can be sold separately; and

  (b) it can be demonstrated that there is a value for the same or similar assets, which is based on quoted market prices in an active market

- In addition, for those intangible assets for which a positive value is recognised, insurance companies are required to hold capital up to 80% of their value

However, based on the information collected, it seems that only in limited circumstances insurance undertakings report a positive value for their intangible assets and that the reported amount normally does not include software. This is also consistent with the fact that software is generally not expected to be sold separately and, in the majority of the cases, an active market is unlikely to exist for certain type of software, given its tailor-made features.

Proposed prudential treatment of software assets
Main features

The aim of these draft RTS is to achieve an appropriate balance between:

The need to maintain a certain margin of conservatism/prudence in the treatment of software for prudential purposes, especially given its limited value in a gone concern scenario

The relevance of software assets from a business and an economic perspective, in a context of increasing digital environment

A regulatory treatment of software assets based on their amortisation for prudential purposes is deemed to strike an appropriate balance between the objectives described above.

In addition, it would reflect the pattern under which the recoverable value of software is expected to decrease over time, in case of occurrence of an external acquisition, in particular following the resolution, insolvency or liquidation of an institution.

Proposed prudential treatment of software assets
Main features

- Under the approach established in the RTS, for each software asset institutions shall:

  a. deduct from CET1 items the positive difference between:

     i. the accumulated amortisation calculated for prudential purposes and

     ii. the sum of the accumulated amortisation and any accumulated impairment losses recognised in accordance with the applicable accounting framework;

  b. subject to a 100% risk-weight the residual portion of the carrying amount of the software asset at stake, in accordance with the current CRR provisions.

- The prudential amortisation period would be set at maximum 2 years, in line with the evidences collected on the length of the migration process (between 1 and 3 years)
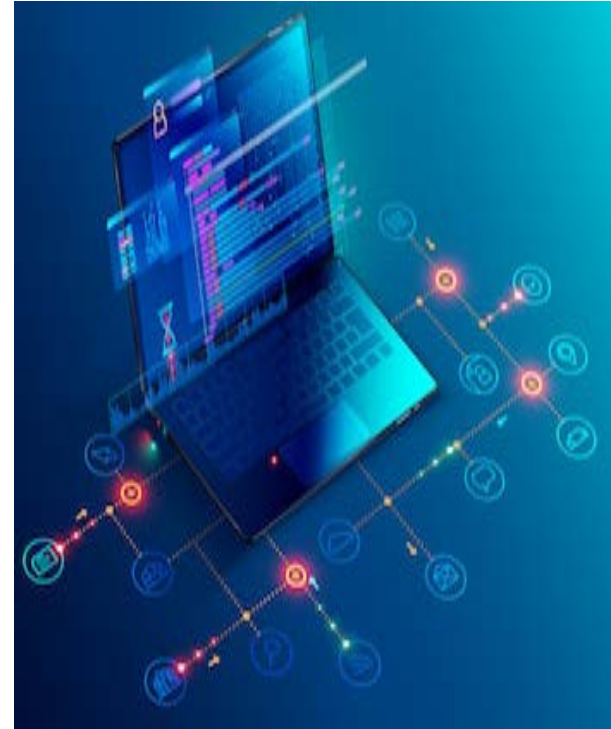
Proposed prudential treatment of software assets
Starting date of prudential consolidation

Alternative Approaches	Advantages	Disadvantages
Option A • **Starting date of amortisation: date of initial capitalisation**	▪ Encourages institutions to accelerate the finalisation of their internal projects; ▪ Allows institutions to benefit from the relief stemming from the new treatment since the date of capitalisation of software.	▪ Potential additional burdens for institutions, since the costs related to the development of an internal project are generally capitalised in different periods of time until the completion of the project itself.
Option B • **Starting date of amortisation: aligned with accounting:** • **CET1 deduction of cost capitalised until amortisation**	▪ Encourages institutions to accelerate the finalisation of their internal projects; ▪ Easier to implement and to monitor; ▪ It would reflect the fact that if the project would not be completed, the capitalised costs would not have any loss absorbency capacity.	▪ In the case of certain software assets, the prudential relief stemming from the new treatment would be postponed until the beginning of amortisation; ▪ It could be perceived as discouraging investments in internally generated software in comparison to purchased software.

Both the above mentioned alternative options have been reflected in the Consultation Paper and the EBA seek views from stakeholders on their application.

Impact assessment
Overview

- The Consultation Paper also provides an impact assessment of the different policy options considered for the purpose of developing the prudential framework of software assets illustrated in the RTS.

- This impact assessment is based on evidences stemming from the data collection on software assets, on a sample of 64 EU institutions, launched by the EBA as an extension of the regular EU-specific Basel III monitoring exercise. The reference date of the data collection was 31 December 2018.

- For the purpose of the impact assessment, the baseline scenario (i.e. the scenario against which the impact is assessed) is the current situation, where software assets are deducted from CET1 items, in accordance with the CRR provisions currently applicable. In particular, based on the collected data, the current regulatory treatment of software has a negative impact of approximately 34.6 bps on the CET1 ratio of the institutions in the sample.

- To note, due to data limitation, some assumptions were necessary for the purpose of the development of the impact assessment.

Impact assessment
Policy options taken into consideration

As part of the impact assessment exercise, the impact stemming from the application of the following policy options has been estimated:

| Option 1: Full CET1 Deduction	Option 2: CET1 deduction by software category	Option 3: Alignment with Solvency II requirements	Option 4: Prudential amortisation
▪ This option would result in confirming the current regulatory treatment of software established in the CRR, given the high degree of uncertainty related to the recoverable value of these assets in a gone concern scenario.	▪ The impact of this option would vary depending on which category of software would be exempted from the deduction from CET1 items and subject to a 100% risk weight. ▪ Based on the performed impact assessment, under this option the increase in the CET1 ratio of the institutions in the sample would range between **0.1 bps** to **18.7 bps**, depending on the category excluded from CET 1 deduction.	▪ This option would entail the adoption of the same regulatory treatment applicable to insurance and reinsurance undertakings in accordance with the Solvency II requirements ▪ However, based on the information collected, those software assets classified within intangible assets in accounting are normally reported at a nil value for Solvency II purposes.	▪ In the EBA view, this is the preferred option. ▪ In particular, the EBA is of the view that a prudential framework based on software amortisation would appropriately reflect the pattern of the recoverable value of software in a gone concern scenario, in line with the requirements of the Level 1 text.

Impact assessment
## Focus on prudential amortisation

Increase in CET1 capital

▪ Based on the information gathered through the data collection exercise and on the assumptions adopted for the purpose of the impact assessment, the application of prudential amortisation (Option 4) would lead, for the institutions in the sample, to a maximum increase in CET1 capital of EUR 13.6 billion in 2018, EUR 15.3 billion in 2019, EUR 15 billion in 2020 and EUR 15 billion in 2021.
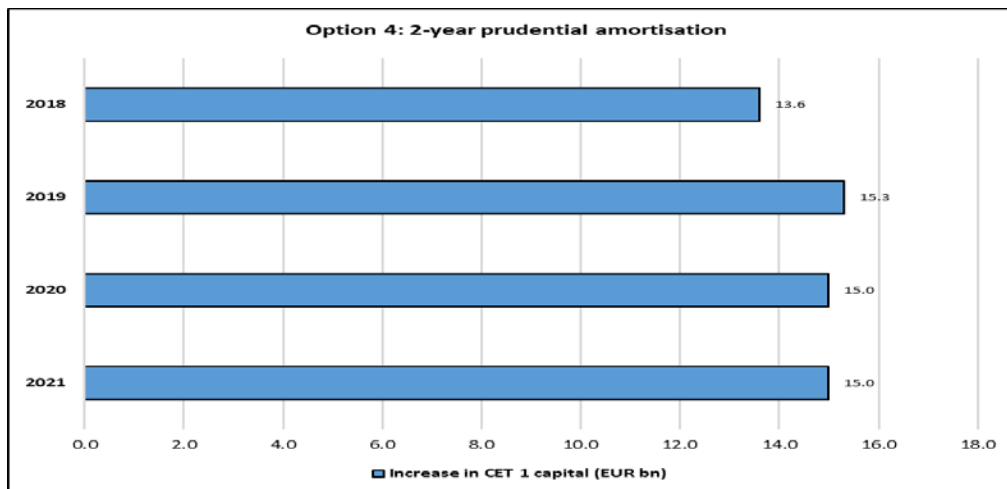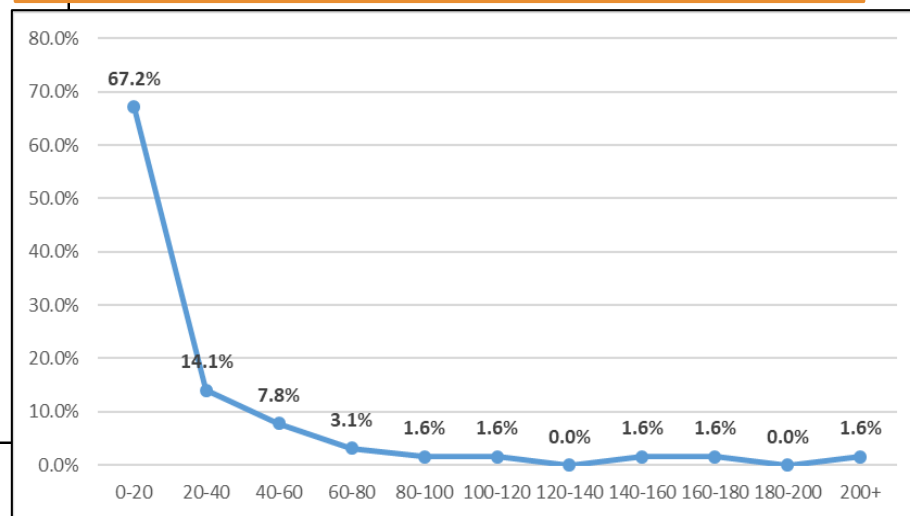
Impact assessment
Focus on prudential amortisation

Increase in CET1 Ratio (bps)

Option 4: 2-year prudential amortisation

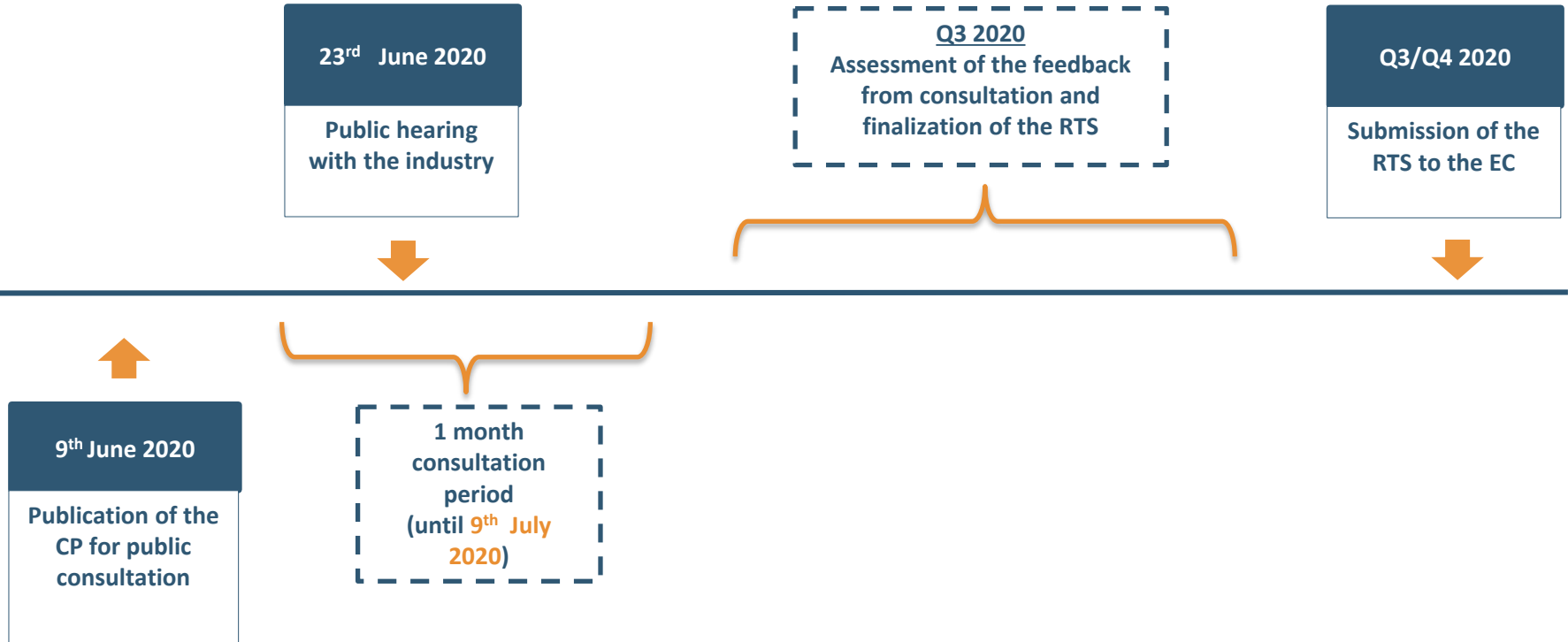| Year	Impact on CET1 ratio (bps)
2018	19.8
2019	22.4
2020	21.9
2021	21.9
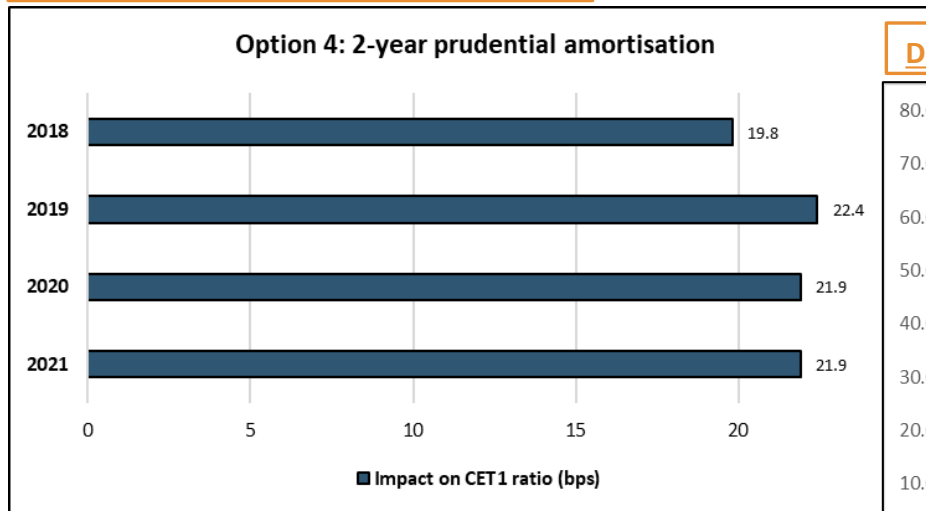
Distribution of the impact on CET1 ratio (December 2018) (*)

(*) For the purpose of this graph in the x-axis it is represented the CET1 ratio impact bucket (in bps), while in the y-axis it is represented the percentage of reporting institutions belonging to each impact bucket.

NEXT STEPS

Next steps

EBA EUROPEAN BANKING AUTHORITY

23rd June 2020

Public hearing with the industry

Q3 2020
Assessment of the feedback from consultation and finalization of the RTS

Q3/Q4 2020

Submission of the RTS to the EC

9th June 2020

Publication of the CP for public consultation

1 month consultation period (until 9th July 2020)

Overview of questions for consultation

Scope		Question
Proposed prudential treatment of software	**Q1**	In case some software assets are classified within tangible assets in your institution, what are the main reasons for doing so and what is the percentage of this classification compared with the classification as intangible?
	Q2	Do you have any comment on the proposed approach for the prudential treatment of software assets?
	Q3	What is your view on the calibration of the prudential amortisation period?
	Q4	What is your view on the proposed alternative approaches illustrated above?
Cost benefit analysis/Impact assessment	**Q5**	If considered needed, please provide any complementary information regarding the costs and benefits from the application of these draft RTS.
	Q6	If considered material, please provide your own estimate on the difference in the impact of prudential amortisation treatment between (i) assuming the capitalisation date of software assets as the starting point for prudential amortisation (ie. Option A illustrated in this CP) and (ii) assuming the date of accounting amortisation as the starting point for prudential amortisation, but fully deducting from CET1 items the costs capitalised until this date is (i.e. Option B illustrated in this CP) .
Other comments	**Q7**	Please provide any additional comments on the Consultation Paper.

Thank you!