

EBA/DP/2014/01: Discussion Paper on the impact on the volatility of own funds of the revised IAS 19 and the deduction of defined pension assets from own funds under Article 519 of the Capital Requirements Regulation (CRR)

Banking Stakeholder Group Submission

GENERAL COMMENTS

The Discussion Paper meets the mandate of Article 519 of Regulation (EU) No. 575/2013 (Capital Requirements Regulation-CRR) that gives the EBA the obligation to prepare a report on whether the revised International Accounting Standard 19 Employee Benefits, in conjunction with the deduction of net pension assets from Common Equity Tier (CET) 1 capital as set out in Article 36(1)(e), leads to undue volatility of institutions' own funds.

On the one hand, the changes in IAS 19 lead to a more accurate measurement of the liability for pension obligations in defined benefit plans, which are presented in the balance sheet net of the related plan assets as a net liability or otherwise as a net asset. On the other hand, in the case of a net asset for pension obligations, this item is to be deducted from CET 1 capital, which could be decreased with the possible result of an "undue volatility" derived from the changes described. The amount of the changes in the net asset item depends on the accounting policies followed by each institution before the application of the amendments from the IAS.

The Banking Stakeholder Group (BSG) welcomes the Discussion Paper as a valid and useful exercise of assessment of the changes that both the CRR and the revised IAS 19 could induce in the equity of institutions with the new accounting standards. The revision of IAS 19 is effective for annual periods beginning on or after 1 January 2013, and for that reason those changes are already in force when the institutions apply the provisions of the CRR.

The main changes in IAS 19 are the following:

- The measurement of the liability for pension plans should be stated as accurately as possible, removing the so called 'corridor approach' that allows the recognition only of the actuarial gains and losses exceeding a range of between 10 per cent above or below the estimated value of the liability.

- Actuarial gains and losses are required to be recognised immediately in other comprehensive income, being excluded permanently from profit and loss. That means that all the subsequent adjustments of the initial estimation are recognised as additions or deductions of the amount of equity of the institution without modifying the balance of the profit and loss account of the year.
- Expected returns on plan assets will no longer be recognised in institutions' profit and loss accounts.
- Unvested past service costs can no longer be deferred and recognised over the future vesting period, being charged to profit and loss when the corresponding event occurs.

From the changes mentioned, the most important impact on the equity of institutions is expected to be from the first and second bullets above: this is because the institutions concerned tend to use the 'corridor approach' that generally allows for non-recognition of the deviations if they are within the range of plus/minus 10 per cent of the "true" value, and if the deviation is out of this range allow for the distribution of the effect on the liability in subsequent periods. So, actuarial gains and losses are in some way managed by controlling the amount that is recognised and the timing of the recognition.

Actuarial gains and losses are produced by:

- a) changes in actuarial assumptions, being the set of demographic (staff turnover or mortality) and financial (salary increases, changes in state benefits or in the medical costs) variables used to determine the liability for pensions of an institution;
- b) experience adjustments (the effects of differences between the previous actuarial assumptions and what has actually occurred)

In most cases the funds from pension liabilities are invested in assets (plan assets that comprise assets held by pension plans and qualifying insurance policies). For financial reporting purposes, liabilities for pensions and plan assets are presented net, so giving a net asset (if the amount of assets is higher than the liabilities) or a net liability (in the opposite case).

For regulatory purposes, considering that the plan assets are not available to pay debts from depositors (i.e. to pay other debts than those covered by the pension schemes) the amount of net assets is deducted from the CET1 capital, according to Article 36(1)(e) of the CRR.

In order to mitigate the possible effects of those deductions in the institutions affected, Article 473 of the CRR establishes a transitional period when the Member States could allow for the deduction of only a portion of the total amount of net plan assets, being from a minimum of 0 per cent in 2014 to a minimum of 80 per cent in 2018. After the 31th of December 2018 the total amount of net plan assets is to be deducted from CET 1.

There are transitional provisions available to Member States in other parts of the CRR, such as Articles 469(1)(a)-(b), 472(7), 478 and 481. Therefore the Member States can develop a policy in order to minimize the effect of the transition to the new IAS 19 if institutions need to reach progressively the final goal, so mitigating for regulatory purposes the “undue volatility” observed in the accounts. BSG welcomes this degree of freedom and urges member countries to make full use of it.

QUESTIONS

1. [Is the scope of the report appropriate? Are there additional elements to include in the scope of the report based on this mandate?](#)

The analysis seems to be complete as it provides an assessment of the impact of the implementation of the revised IAS 19 Employee Benefits on the volatility of own funds of banks, taking into account the actual accounting practices of those institutions as well as the main regulations in force across the different Member States.

2. [Do you agree with the proposed methodology for the objective of the report? Please indicate whether additional areas need to be considered.](#)

The methodology followed includes: 1) a qualitative assessment of the relevant changes triggered by the new prudential and accounting requirements; 2) a quantitative assessment of the impact of these changes on the volatility of own funds both in the initial application and in subsequent years, using a broad sample of cases from major institutions and Member States, and 3) a discussion of the

impact on the volatility from future changes in the assumptions used to perform the analysis as well as from additional related factors that give rise to volatility.

However, point 2) above has been made following a retrospective approach. The institutions contacted have provided a historical analysis of the changes as if they were in force for the period 2010-2012, so simulating the effects of the new accounting standards in the financial statements of previous periods. Although the economic and time restrictions to perform the study could explain the use of this methodology, the validity of this “retro-simulation” technique to forecast the future is subject to the maintenance of past economic parameters in the future, including the items of income and expenses and the relative weight of the other pressures on the institution’s equity as well as the actuarial and financial assumptions made. In other words, if the simulation results are to represent an accurate scenario for 2014-16 in forecasts of the effects of accounting for pension plans for these years, the economic scenario for these years needs to be the same as in the sample period used for the simulations (2012-14). There is no guarantee that this will be the case and hence there is a significant margin of error.

3. Do you agree with the identified prudential requirements relevant to the scope of the report? Are there additional elements to include in the analysis of the prudential requirements?

The analysis is complete (for entities applying the ‘corridor approach’ in jurisdictions where the deduction of net assets was not mandatory the impact of the new requirements may be significant). Nevertheless, those Member States concerned may use discretion regarding the possibility of phasing in and phasing out the changes so as to mitigate the impact, as offered by the transitional provisions in the CRR.

4. Do you agree that the main drivers of the change in the amount of net defined benefit pension funds would be items for which a corresponding gain or loss is recognised on own funds (such as actuarial gains and losses)?

According to the analysis made, this is the main driver of the change. However, the amount of the gains or losses to be recognised in own funds is closely related to the previous option for the ‘corridor approach’, because the institutions have already a deficit/surplus to deduct/add to own funds.

From an accounting point of view, the recognition of actuarial gains and losses is now a transfer between liabilities and equity (OCI): when there is a deficit of pension provision the liability increases with a charge to equity, and when there is a surplus of provision the liability decreases producing an increase in equity.

5. Do you agree with the analysis performed on the amendments to IAS 19? Do you agree that the changes in IAS 19 relevant to the scope of this report are the immediate recognition of actuarial gains and losses and past services costs? Please provide input on additional changes in IAS 19 that need to be taken into consideration in assessing the impact on own funds at initial application and application in subsequent periods under the scope of the report.

Mandatory immediate recognition of actuarial gains and losses and unvested past service costs from the initial application of the new standard are the primary causes of the volatility in the first year of application of IAS 19. In subsequent years the first cause remains and the volatility will be mainly dependent on the evolution of the actuarial assumptions both demographic and financial. This is the 'natural' volatility of the provision for pensions, which is unavoidable (see below, Question 8).

6. Do you agree with the analysis performed for the changes of IAS 19 that are not expected to have an impact on own funds with regards to the scope of this report?

Yes, the analysis seems to be complete. The other changes do not affect the amount of the pension provisions or the net asset position of the plan.

7. Do you agree with the methodology of the analysis performed and the interpretation of the qualitative and quantitative data? Please provide additional data that needs to be taken into account.

While we broadly agree with the methodology used, we want to distinguish the validity of the analysis performed for the effects in the initial application of the changes and for subsequent periods.

Regarding the effect in the initial application, the sample of 51 European institutions in 20 countries is enough to extract valid inferences on the expected changes in own funds and in the CET 1. Only 11 out of those 51 banks have a possible higher effect (i.e. more than 50 bps in CET1 ratio) from the initial application of the revised IAS 19, and in most cases the problem derives from the

previous use of the 'corridor approach'. In some of these cases it will be plausible for the Member States to use the possibility of deferring the recognition in CET 1 of those changes).

The analysis of the subsequent impacts is made in the Discussion Paper by simulating the effect of the changes as if it was applied in 2010, estimating the CET1 ratios under that simulation and comparing them with the actual observed ratios in 2010, 2011 and 2012. In other words, EBA has performed a retro-simulation. The results are just a proxy to measure the volatility that the changes will induce in own funds and the corresponding ratios in 2014 and afterwards.

We accept the methodology and the results but we note that future behavior could be different depending on the economic industry, demographic and financial factors that need to be taken into account for the estimation of the pension liability. If the future behaves in a different way than the past, the volatility will be different from the results obtained in the simulation exercise.

With these limitations, the methodology followed is reasonable and the conclusions reached could represent a picture of the expected volatility in own funds from institutions across the EU. In this case the effect on CET 1 ratio volatility is considered low for 34 out of the 51 institutions in the sample and important for the rest, medium for 10 and high for the other 7 institutions. In this case the Discussion Paper calls for application of national transitional measures, especially in extreme cases. BSG welcomes this element of flexibility and urges national authorities to make full use of it when appropriate.

8. [Do you agree with the elements included in the additional qualitative assessment for the possible developments that could impact the volatility of own funds?](#)

[Do you have any particular consideration with regard to the impact of the discount rates used for the measurement of the defined pension plans under the requirements of the revised IAS 19? Is there any difference compared to the previous IAS 19?](#)

In this part of the Discussion Paper the consideration of the effect of the revised IAS 19 is particularly valuable in the amount of the pension liabilities, disregarding if this balance is, or is not, to be covered by assets. The conclusion is that the main source of volatility of net pension assets is the change in the underlying provision, which in turn is due to changes in actuarial assumptions.

On the other hand, this part recognises that there are both internal and external factors that could modify the liability and are not directly related to the new prudential and accounting rules, and in this way the macroeconomic environment and other factors can lead to changes in actuarial assumptions that affect the liability for pensions.

Regarding the discount rates we consider that the analysis is reasonable but the Discussion Paper needs to take into consideration that the volatility in own funds is produced only by the application of the discount rate to the net plan assets, and for this reason the analysis should mix the effect of the changes in the return on assets with the modification of the discount rate used to evaluate the liability.

Submitted on behalf of the EBA Banking Stakeholder Group

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