POSITION PAPER

ESBG response to the EBA's Discussion paper on the impact on the volatility of own funds of the revised IAS 19

ESBG (European Savings and Retail Banking Group)

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ESBG

The European Savings and Retail Banking Group (ESBG) represents savings and retail banks in Europe. Savings banks across Europe and globally have an embedded social commitment to the communities and regions in which they operate. This is an integral part of their identity and one of their distinctive features amongst retail banking financial institutions. Traditionally, savings banks have contributed in each of their countries to the improvement of living conditions, have supported local economic development and built greater social cohesion in their local communities.

ESBG thanks the EBA for the opportunity to submit its views on the current discussion paper on the impact on the volatility of own funds of the revised IAS 19.

1. General comments

The stated purpose of the discussion paper is to assess whether the revised IAS 19 together with the deduction of net pension assets and changes in net pension liabilities lead to undue volatility of an institution's own funds in accordance with Article 519 of the Capital Requirements Regulation (CRR). Taking into account the EBA report, the Commission shall by 31 December prepare a report to Parliament and the Council on the issue, together with a potential legislative proposal to introduce a treatment which adjusts defined net benefit pension fund assets or liabilities for the calculation of own funds.

In the discussion paper the EBA focuses primarily on the deduction of net defined benefit assets from CET1 capital and ESBG will consequently, in this position paper, point to the volatility related to the calculation of pension liabilities according to IAS 19 as a major problem.

It is the experience of our members that the treatment of defined benefit pension schemes in the CRR and in the Capital Requirements Directive (CRD IV) in combination with changes in IAS 19 has significantly contributed to an increase in the pro-cyclicality of capital requirements. The previously permitted corridor approach in IAS 19 and the prudential filters used in several Member States under Basel II had a smoothing effect on short-term volatility caused by changes in the market parameters of pension obligations.

The revised IAS 19, which came into force on 1 January 2013 combined with the lack of explicit filters in the CRR introduced volatility in institutions' net pension liabilities and had an impact on the CET1 capital of reporting institutions. As a result institutions reporting net pension liabilities are now experiencing significantly increased pro-cyclical volatility in capital levels, with a resultant increased need for capital in stressed scenarios, leading to an increase in the pro-cyclical supply of credit under normal economic conditions.

The effects are likely to be more pronounced in small non-euro Member States where there is no liquid market for corporate bonds and where the market for long term government bonds is relatively limited. The pro-cyclical behaviour could be reduced by the introduction of a prudential filter in the CRR. Against this background we urge the EBA to highlight these problems in its report on whether the revised IAS 19 leads to undue volatility of institutions' own funds.

We ask that the EBA carefully considers the de facto commitments that institutions face according to relevant national rules and agreements on the safeguarding of pension commitments. We therefore believe that valuation of net pension liabilities should, from a capital adequacy perspective, be calculated according to applicable and confirmed national principles rather than according to the IAS 19 accounting standard. The mechanisms to filter out effects from CET1 capital should be customised to the specifics of each institution's pension model.

It is also worth pointing out that not all institutions in the EU Member States are required to prepare their financial statements in accordance with international accounting standards. Consequently, the rules in IAS 19, governing the valuation of defined benefit liabilities, apply for most but not all institutions. The remaining institutions do not face the corresponding problem with volatility in CET1 capital under CRR as the institutions that need to comply with IAS 19.

Pension regimes may vary significantly between different European institutions and the regulation should take into account those differences to ensure a level playing field and to reduce the procyclicality and volatility of capital requirements. Different pension regimes also mean that the obligations and associated risks are different, which should be reflected in the way pensions are treated for regulatory purposes.

ESBG also asks the EBA to elaborate on how pension risks should be considered in respect of Pillar 2 assessments. As a result of amending IAS 19 volatility now impacts institutions' CET1 capital meaning that pension risk has become a significant part of the capital assessment under Pillar 2. Depending on the methodology institutions may need to set aside significant amounts of capital under Pillar 2 to cater for future volatility, even if there is no capital deficit in the pension fund according to national rules and agreements on the safeguarding of pension commitments even in a stressed scenario.

In the UK the Prudential Regulation Authority (PRA) has published a supervisory statement[1] regarding pension obligation risks in the Internal Capital Adequacy Assessment Process (ICAAP). According to this statement "actuarial funding valuation prepared for the scheme's trustees rather than the valuation required under accounting standards (FRS 17 or IAS 19) … provide firms with the most relevant starting point from which to assess their Pillar 2 Pension obligation Risk Capital (P2PRC)".

The assessment of capital requirements under Pillar 2 could show very different results depending on whether the starting point is a valuation of pension liabilities within the pension fund or a valuation according to IAS 19.

2. Comments on the questions from the Consultation Paper

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

According to article 519 of the CRR the EBA shall assess whether the revised IAS 19 in conjunction with the deduction of net pension assets and changes in net pension liabilities lead to undue volatility of institutions' own funds. The report appears focused on the deduction of assets and we believe that the EBA should also assess the impact when actuarial losses will result in a net pension liability (according to IAS 19) and hence whether changes in net liabilities lead to volatility in institutions' own funds.

Since it is not only defined benefit pension funds that has an impact on own funds the ESBG would also ask the EBA to consider all other post-employment schemes covered by IAS 19 including medical care for retirees. An overall impact should include all post-employment schemes and not only defined benefit pension funds.

[1] http://www.bankofengland.co.uk/publications/Documents/other/pra/policy/2013/pensionobligationrisklss6-13.pdf

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

We believe that the analysis would have been improved by the use of a longer time series. This would have captured any behavioural changes over a cycle thus capturing periods of both economic peaks and troughs. Theoretical examples which would allow for the isolation of individual factors would be appropriate when evaluating the impacts over time. In the appendix we have performed some simulations based on historical Swedish market data to show the difference in outcome compared to the results of the EBA draft study.

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?

As stated under question 1 the report focuses on the deduction of assets. We are of the opinion that the EBA should also assess whether changes in net liabilities lead to volatility in institutions' own funds. Furthermore, we support the approach of using the full application of the prudential requirements rather than the transitional when calculating the impact on own funds.

Additionally we believe that it would be prudent to update Article 26 § (d) of the CRR to state the following: "accumulated other comprehensive income including actuarial gains and losses."

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 in own funds (such as actuarial gains and losses)?

We think that the main, immediate, impact on own funds will be experienced by entities which applied the corridor approach. This approach was removed when IAS 19 was amended and all actuarial gains and losses are now accounted for in other comprehensive income.

Both changes to actuarial assumptions and changes to the terms and conditions of pension agreements will have an impact on net pension assets or liabilities. Changes in different market parameters will also influence net pension assets and liabilities. That said we believe that only market parameters should be the focus when evaluating the cyclical behaviour of defined pension obligations in a going-concern entity. Most actuarial assumptions are long term estimates i.e. estimates for the remaining time of service of the individual employee while market parameters are current parameters rather than estimates.

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.

We agree that the main impact of the amendments to IAS 19 comes from the immediate recognition of actuarial gains or losses in other comprehensive income and the immediate recognition of all past service costs.

We do not agree with the statement on page 18, §38 of the Discussion Paper which says that there is no expected impact on own funds from the changes discussed in §38. All actuarial changes will have an impact on own funds. The amendments to IAS 19 will accelerate these and therefore increase volatility in own funds. If they should be considered in a simulation is another question. Please refer to our answer to question 4 for more details regarding our views on this.

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?

We do not agree with the analysis, as outlined in our answers to questions 4 and 5. We would ask that the EBA and the European Commission, when moving forward with this project take into consideration the following points:

- Consider the impact on both net pension assets and net pension liabilities;
- Use long time series to capture possible pro-cyclical behaviours of defined benefits schemes;
- Use a theoretical sample, the outcome will otherwise become heavily dependent on the present financial position of the institutions covered by the stress test; and
- Focus on market parameters like plan assets and the discount rate. Other parameters will normally not be highly correlated with the market parameters since the market parameters are current values while other parameters are long-term assumptions covering the average expected value during the remaining time of service for the employees.

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 need to be taken into account.

We agree that the institutions that suffered the main initial impact are those who applied the corridor approach and had significant amounts of unrecognised actuarial gains and losses and historical service costs.

We however believe that the methodology and thus the analytical outcome could be much improved. The EBA has collected quantitative information for a 3-year period, 2010-2012 and the outcome of their study is shaped by the specific economic situation during the three year period in combination with the fact that the majority of the selected banks held excess values in their pension systems.

ESBG believes that the analysis would be improved if it took into consideration the fact that the IAS 19 calculation is heavily pro-cyclical. Therefore we believe it would be more appropriate to consider a much longer time period in order to capture both periods of economic peaks and troughs. We further believe that the analysis would be improved by the use of a theoretical example designed in such a way that actuarial losses will result in a net pension liability. One such example can be found in Appendix 1 to this position paper.

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 require-

ments of the revised IAS 19? Is there any difference compared to the previous IAS 19? Please provide additional elements that need to be taken into account.

We agree that the discount rate and the inflation rate are significant actuarial assumptions and we also believe that salary increases and turnover rates are significant. There is no difference between the original and the amended version of IAS 19 in regards to the discount rates, but the removal of the corridor approach has introduced a significant element of volatility into CET1 capital. Other impacts stem from the corporate bond market and the appreciation of what is a deep liquid market within the euro-zone.

In appendix 1 to this position you will find an analysis based on historical changes to the discount rate in Sweden over a period of 27 years. The analysis highlights possible extreme volatility in the CET1 due, solely to changes in the discount rate. We believe that if possible volatility in plan assets due to changes in market values would have been included the volatility would be significantly higher.

The analysis highlights that high interest rate environments may cause higher volatility than low rate environments, but the analysis also shows extreme volatilities in CET1 due to interest rate fluctuations in a low rate environment. The analysis further highlights that severe negative value changes in pension liabilities may coincide with generally stressed market conditions highlighting the pro-cyclical behaviour of IAS 19 without filtering mechanisms in the CRR. A possible way of avoiding these fluctuations would be to filter out all actuarial gains and losses stemming from changes in actuarial rates from CET1. Finally the analysis highlight that a lot of the changes are very temporary in nature. Deferring those temporary changes could therefore significantly reduce pro-cyclicality in the capital situation of banks, and consequently the supply of credit to the real economy under normal economic conditions.

3. Appendix 1

In this analysis we used a fictional bank operating in Sweden with the following characteristics at the beginning of each year:

CET1	100,000
Plan Assets	20,000
Defined Pension Liabilities	20,000
Average Remaining Time of Service	20 Years

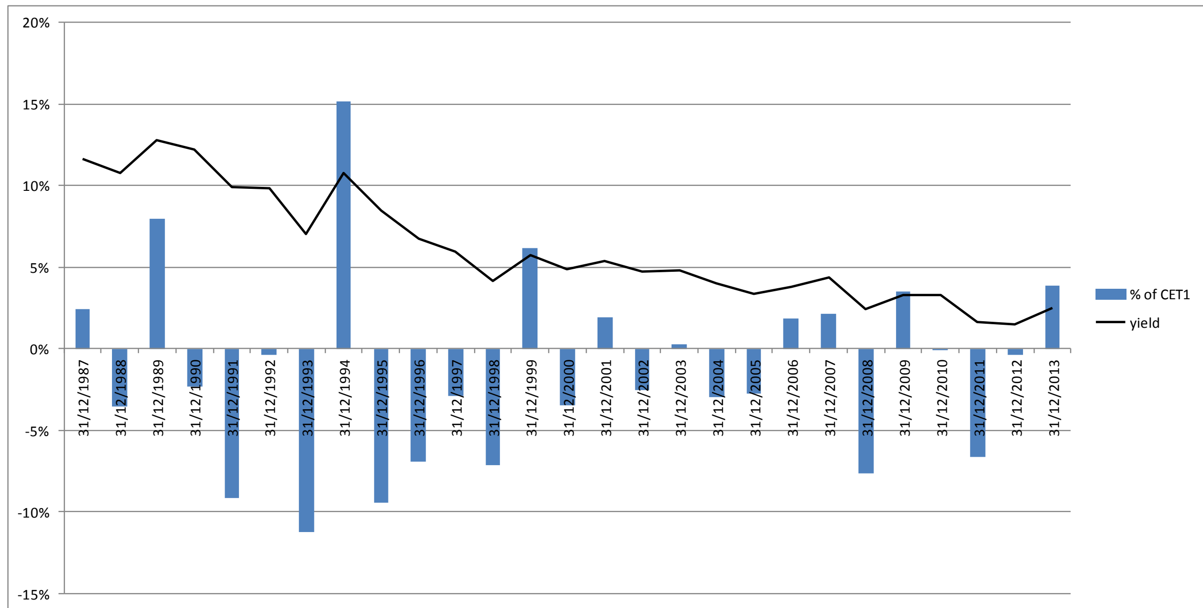
We isolated the analysis to the volatility caused solely by one year changes in the discount rate (thus reflecting actual 10-year government bond rates in Sweden). If we had complemented the analysis with the volatility caused by the volatility in the plan assets the aggregated net volatility would have been even more significant.

A big advantage of looking at a fictional bank is that we can look at the theoretical outcome without any disturbing effects from different kinds of management actions that may have taken place when trying to use data from single institutions.

Stress of the discount rate

We have chosen a period from 1987 until today thereby covering both the Swedish financial crises in the 90’s as well as the latest financial crisis. We evaluated the volatility in equity (CET1) caused by

annual changes in the discount rate used to discount the defined pensions liability. The calculations are all made using the current discount rate every single year. We provide annual changes to the CET 1 in the figure below. For illustrative purposes the 10-year government bond yield is also included.



The substantial volatility is substantial in high and low interest rate environments. In a case with interest rates trending downwards, such as during the period between 1995 and 1998, the situation appears particularly troublesome with consecutive negative effects. It is worth observing that during the latest financial crisis (i.e. including the EBA sample period) the stress period shows two extreme decreases in CET1 associated only with changes in the discount rate. One of these changes is also strongly correlated with the lowest point of the last financial crisis. This highlights the pro-cyclical behaviour driven by IAS 19.

About ESBG (European Savings and Retail Banking Group)

ESBG brings together savings and retail banks of the European Union and European Economic Area that believe in a common identity for European policies. ESBG members support the development of a single market for Europe that adheres to the principle of subsidiarity, whereby the European Union only acts when individual Member States cannot sufficiently do so. They believe that pluralism and diversity in the European banking sector safeguard the market against shocks that arise from time to time, whether caused by internal or external forces. Members seek to defend the European social and economic model that combines economic growth with high living standards and good working conditions. To these ends, ESBG members come together to agree on and promote common positions on relevant matters of a regulatory or supervisory nature.

ESBG members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,300 billion, non-bank deposits of €3,480 billion and non-bank loans of €3,950 billion (31 December 2012).

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