APB ASSOCIAÇÃO PORTUGUESA DE BANCOS

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)

Deadline 14-04-2014

APB would like to start by making some general remarks regarding the current Discussion Paper (DP).

General Remarks:

- **Regarding the timeframe**

  Regarding the timeframe (2010-2012) that has been used as a reference in the current DP, APB points out that it misses a very important period of extreme volatility in Pension Funds.

  However, this DP will give rise to an important legislative proposal from the European Commission that will have to deal precisely with volatility in Pension Funds and adjust defined net benefit pension fund assets or liabilities for the purpose of calculation of own funds.

  Therefore, APB would like to emphasize that a larger period, or a more relevant one than the one that has been chosen, should mandatorily be taken into consideration for the matter of EBA's analysis and proposal.

- **Regarding the scenarios**

  APB considers that the scenarios that EBA has identified in the current Discussion Paper (DP) regarding the impact on the volatility of own funds driven by shocks in the defined benefit pension funds, are very limited.

  As a matter of fact, the scenarios that may give rise to the mentioned offsetting mechanism not taking place (e.g. defined benefit pension liability or assets transfer to the pension fund) are either rated as assumed that they will not take place, or are actually limited (paragraph 28).

  APB would like to alert EBA to the fact that these situations of high volatility indeed exist, and therefore, from a prudential perspective, a special regime to deal with them should be predicted within the CRR framework.

  Only then will EBA be able to achieve the goal of smoothing the impacts of volatility in own funds.

  Moreover, APB believes that the current DP seems to take a "truncated view" on the sources of volatility because it only addresses the assets side.

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?

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.

APB believes that the final objective of this report to assess undue volatility of own funds as a result of the treatment of defined benefit pension funds is only achievable if the analysis includes the "Other comprehensive income" items. For instance, there is no change in assets related to defined benefit pension funds from a devaluation of pension assets portfolio if this devaluation is compensated by a cash contribution, but there is a negative impact in "Other comprehensive income" that will reduce own funds.

Even though in the case of cash contribution, the offsetting mechanism may still prevail, provided no significant mismatch exists between the timing of recognition of the underlying transactions, in case of a net defined benefit pension liability the offsetting doesn't take place because negative DPFA (a liability) are not deducted from CT1 (as mentioned in the DP). What is deducted from CT1 is the actuarial loss (for example) that contributed to the negative DPFA. Therefore, additional elements need to be taken into consideration.

Once again, APB reminds EBA that the volatility analysis that it has performed was carried out during a very low Pension Fund volatility environment (2010-2012). This is a very short period, and during which there were no material actuarial changes and/or actuarial losses. This also means that the current analysis is very likely to be leading to very biased conclusions.

Therefore, APB strongly recommends EBA to repeat its analysis taking into consideration a larger period, starting never later than 2007. This second exercise should allow EBA to include in the analysis the closest period of volatility registered, which is the period between 2007-2009, and to confirm or to correct its conclusions and recommendations.

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?

No. As mentioned before, the report takes a somewhat truncated view on sources of volatility, hence the suggestion the report only addresses the assets side. "Other comprehensive income" items should also be considered, as well for an alternative treatment for the end of the corridor method under the revised IAS19.

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)?

Yes. However, APB also emphasizes that one cannot simply ignore that other sources of volatility exist, and that in some specific moments in time they may exert significant impacts in pension funds.

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.

The maintenance of a prudential corridor, similar to the previous version of IAS19, should be subject of study, since we believe it actually reduces volatility on own funds.

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?

No. The end of the corridor method has an impact in countries that used mainly the deferred recognition "corridor approach".

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.

No. APB believes that the qualitative data should also take into account that in certain countries, e.g. Portugal, Financial Institutions' Defined Benefits Pension Plans are the First Pillar of Social Security for Bank's employees, and were mandatory by law for decades (they were not an option to Bank's management).

This means an uneven playing field exists for Portuguese banks, vis-a-vis their European peers, where Defined Benefits Pension Plans are a management option. Moreover, this difference in treatment is even more concerning if we consider that a full deduction of pension fund deficits will necessarily increase the pro-cyclicality and volatility of capital requirements. The different countries legal pension funds framework and funding requirements should be also considered.

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?

Please provide additional elements that need to be taken into account.

As mentioned in the previous answers, each European country have its own pension fund legal framework, namely with minimum funding requirements as, for instance, in Portugal. Therefore, other variables should be taken into consideration. For instance, deviations on expected return of plan assets. Other quantitative impacts can also be obtained by the new disclosures requirements of the revised IAS 19 (p.145).

The additional disclosure of sensitivity analysis of the main actuarial assumptions, for example, may be a potential source of volatility if seen in isolation of the institution's whole risk management strategy.

Furthermore, EBA takes the view that an almost full economic integration exists amongst Member States. Unfortunately, that is not currently the case, nor it should be taken for granted that the situation will be corrected anytime soon.

For instance, EBA focuses on the impact of an increase of the discount interest rate, arguing that (i) it is already low and (ii) an increase of the rate would be accompanied by the adjustment of other variables (salaries, etc) offsetting one another.

However, in Portugal, the discount rate is relatively high when compared to its European peers, but the other actuarial inputs are already leveled with inflation (as are in their European peers).

Therefore, if a decrease of the discount rate occurs in Portugal, impacts on pension fund liabilities could be larger than in other countries, as the other variables may not adjust in a proportional way.

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Overall conclusions

Given that the legislation that lays down the social welfare model for bank employees in the different Member States is not uniform, as it is also the case with the general welfare systems themselves, APB believes that some discretion needs to be assigned to national regulators in order to implement alternative measures that will allow to reduce the volatility and pro-cyclicality associated with the deficits of the pension funds of bank employees.

For all the reasons stated above, APB strongly believes that a prudential filter for Defined benefits Pension Funds Assets should continue to exist, at least for Banks with funds that correspond to the first pillar of Social Security that are/were mandatory by national law.

Such prudential filter could be a regulatory corridor, similar to the method defined by the previous IAS19 (10% of the Assets or from the Liabilities amount). This would reduce the volatility on own funds, a concern present in the article 519 of the CRR, and the purpose of the current EBA's DP.