Comments

Discussion Paper 2014/01
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)

Register of Interest Representatives
Identification number in the register: 52646912360-95

Contact:
Dirk Peters
Telephone: +49 228 509- 438
Telefax: +49 228 509- 411
E-Mail: d.peters@bvr.de

Berlin, 14-04-14

*The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.*

Coordinator:
National Association of German
Cooperative Banks
Schellingstraße 4 | 10785 Berlin | Germany
Telephone: +49 30 2021-0
Telefax: +49 30 2021-1900
www.die-deutsche-kreditwirtschaft.de

Comments Discussion Paper 2014/01
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)

We appreciate the present opportunity to comment on the discussion paper. Please find our comments below.

General Comments

The EBA/DP/2014/01 investigates whether the revised IAS 19 (2011) in conjunction with the new rules on deduction of net pension assets and changes in the net pension liabilities may lead to undue volatility of own funds. This report is supposed to help the Commission prepare a legislative proposal for a potentially required adjustment of defined net benefit pension fund assets or liabilities for the calculation of own funds.

The regulatory deduction rule for net pension assets was already codified in the Basel III reform proposals submitted by the Bank for International Settlement's (BIS) Basel Committee (sections 76 - 77 (defined benefit pension fund assets and liabilities)) and it has been incorporated into the Capital Requirements Regulation (CRR) of 27 June 2013 (CRR, Article 36(1) (e) in conjunction with Article 4 (109). A regulatory deduction of the net pension assets from own funds would improve their quality (EBA/DP/2014/01, point 22). Furthermore, the discussion paper sets out that – given their dedicated earmarking - these assets shall only be available for the settlement of pension obligations and creditors of the bank will not have any access to such assets (EBA/DP/2014/01, point 12).

We doubt that a regulatory deduction of net pension assets from own funds will improve their quality. In our experience, in terms of the amounts involved, there is hardly ever a 1:1 correlation of changes in holdings of plan assets and defined benefit pension obligations. At various points, EBA/DP/2014/01 refers to the case of a 100% netting between changes to the regulatory deduction positions and changes in the plan assets and defined benefit pension obligations (which main value driver is the discount rate). In our view, this scenario only occurs in exceptional cases and is usually not the case. Changes to the net pension assets result from changes in holdings of plan assets and defined benefit pension obligations changes (both, recognised directly in equity and not recognised directly in equity). A comprehensive netting, however, would require changes in the holdings of both plan assets and also of defined benefit obligations to be exclusively recognised directly in equity.

However, the amount of the regulatory deduction position depends not only on changes to the relevant on-balance sheet item holdings that are recognised directly in equity but particularly also on changes thereto which are not recognised directly in equity. Hence, in our understanding own funds would be eliminated to a certain degree despite the fact that there was no prior equity allocation. We view this as an unjustified own funds cut; in our view, this fails to enhance the own funds quality.

The underlying rationale for earmarking plan assets consists in the protection of pensions. In our view, the regulatory deduction item would create an incentive to reduce the provision of surplus cover for pension funds to a minimum or even to tolerate a shortage of cover thus jeopardising pensions (cf. also

Comments Discussion Paper 2014/01
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)

ZKA comments on the 2010 BCBS Consultation Paper entitled "Strengthening the resilience in the banking sector", 2010, p. 20). From our point of view, the deduction thus gives rise to misguided incentives.

One alternative regulatory choice for a regulatory deduction position the BCBS might consider is described below. As we believe in the quality of our plan assets and the asset ceiling mechanism of IAS 19 we essentially endorse the [existing] supervisory rules which seek to ensure an appropriate own funds quality. Hence, we strongly object to a deduction of net pension assets from own funds.

For the purposes of a regulatory risk assessment we recommend keeping the (at least in Germany) existing policy of backing pension assets (gross amount) as risk weighted assets with equity. Furthermore, we ask the EBA to make sure that there is a level playing field in Europe in this regard.

The EBA/DP/2014/01 *inter alia* seeks to ensure identification of undue own funds volatility. In our view, any final assessment presupposes complete transparency of the underlying premises. At this juncture, we would like to differentiate between the following constellations:

a) Presence of a net pension asset and plan asset changes as well as defined benefit obligation changes that are recognised directly in equity

b) Presence of a net pension asset and plan asset changes as well as defined benefit obligation changes that are not recognised directly in equity

c) Presence of net pension asset and plan asset changes as well as defined benefit obligation changes that are not recognised directly in equity and that are recognised directly in equity.

Regarding the aforementioned scenarios, it is virtually impossible to forecast the volatility of own funds due to the following reasons:

Re. a)
At various points, the EBA/DP/2014/01 refers to the case of a 100% netting between changes to the regulatory deduction position and changes in the plan assets and defined benefit pension obligations. In our view, this scenario tends to be exceptional and is usually not the case (cf. also above).

Re. b)
The setting up or the transfer to a Contractual Trust Agreement (CTA) by means of an entry of "per plan assets to cash assets" changes the amount of the plan assets in a manner that is not recognised directly in equity thus also changing the amount of the regulatory deduction item. The own funds volatility results from the change in the regulatory deduction position.

Comments Discussion Paper 2014/01
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)

The pension obligations' funding status has a major impact on the creation of a net defined benefit pension fund asset. The rationale for this is described below:

External funding of pension obligations through plan assets is not a mandatory requirement under the provisions of IAS 19. The investment into plan assets is left at the discretion of the company. The company shall be free to transfer assets to an external fund at any time. In terms of the balance sheet this constitutes an exchange of long positions which is neutral in its effects on profits. If and when the requirements with regard to a plan asset are met, the pension obligation shall be reduced by the fair value of the plan assets and the balance will be recognised as a pension provision (reduction in total assets). If the plan assets' fair value exceeds the value of the pension obligation, this will be accounted for as an asset (provided the company has obtained an economic benefit from the excess allocation of funds [to plan assets], for instance in the form of lower payments to the pension fund). Whilst the investment into the plan assets does not have any effect on IFRS own funds, subsequent changes may indeed impact IFRS own funds.

As a result, also an increase of the funding status through the fund allocation to plan assets (by virtue of the pension provisions' fair value) leads to an increase in the defined benefit pension fund assets in the absence of any effect on the IFRS own funds. In this case, we hold the view that a deduction from own funds would be inappropriate. Hence, we suggest reconsidering the rules on the capital deduction for defined benefit pension fund assets and suggest a recognition of these effects in the RWA calculation for the assets.

Re. c)
That proportion of holding changes which is recognised directly in equity will be eligible for the comprehensive netting of the changes to the regulatory deduction position with the changes in the plan assets and the defined benefit obligations described at various junctures under EBA/DP/2014/01. For the proportion of changes in the holdings which are not recognised directly in equity, the change in the regulatory deduction position results in the own funds volatility.

The revised IAS 19 (2011) as well as the potential impact on regulatory own funds were discussed under section 4.3.2. and 4.5. EBA/DP/2014/01. However, the analysis of the own funds' volatility was made without any reference to the aforementioned scenarios; hence, we are of the opinion that this analysis is incomplete. The heterogeneous nature of possible scenarios illustrates the fact that generalisations are virtually impossible.

Based on the above reason, we advocate against the prudential filter as regards the accounting treatment of defined benefit pension funds set out under IAS 19 (2011). In this context, the only viable approach consists in an unfiltered incorporation of the rules concerning the reporting, recognition and valuation under the IAS/IFRS.

Comments Discussion Paper 2014/01
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)

Detailed comments

1. Is the scope of the report appropriate? Are there additional elements to in-clude in the scope of the report based on this mandate?

We recommend a harmonisation of the following definitions (page 4) or, moreover, a clearer definition: "net pension assets, net pension liabilities", "net benefit pension fund assets or liabilities" as well as "defined benefit pension funds".

Furthermore, due to the fact that the rationale for certain conclusions will be difficult to comprehend otherwise, we recommend a more detailed elaboration of the individual scenarios, e.g. the scenario featuring a regulatory deduction position/net pension asset or the scenario without a regulatory deduction position/net pension liability or defined benefit pension obligations which are not funded through plan assets.

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.

Basically, we agree with the proposed methodology/approach (qualitative, quantitative, additional considerations).

However, in our preliminary understanding there is no recommended course of action for the legislative process.

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?

We have strong doubts over the fitness for purpose of a regulatory deduction position (cf. our general comments above). Particularly the fact that the allocation of plan assets shall not be recognised directly in equity for accounting purposes (per plan assets to cash assets) speaks against a deduction of an asset surplus.

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

No, we do not agree (cf. our general comments, scenarios, b) and our response to Q3).

Comments Discussion Paper 2014/01
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)

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 sub- sequent periods under the scope of the report.

From the point of view of a company which previously applied the corridor method this is likely to be the case (cf. our general comments on possible constellations). „Defined benefit pension fund" in EBA/DP/2014/01 point 34: cf. our response under Q1.

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?

The analysis of the revised IAS 19 (2011) appears to be complete. However, this analysis was divorced from the potential scenarios (c.f. General Comments above); In our view, it is incomplete or, moreover, not sufficiently clear.

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 are unfamiliar with the data on which the analysis is based. Hence, any assessment thereof would be premature.

8. Do you agree with the elements included in the additional qualitative as-sessment 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 previ-ous IAS 19? Please provide additional elements that need to be taken into ac-count.

n/a

Yours sincerely,
on behalf of the German Banking Industry Committee
National Association of German cooperative banks

Gerhard Hofmann Dirk Peters