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European Banking Authority

Discussion paper on the impact on the volatility of own funds of the revised IAS 19

We appreciate the opportunity to comment on EBA's analysis related to article 519 of the CRR on the volatility of own funds of the revised IAS 19 and the deduction of defined pension assets from own funds.

EBA comments that the scope of the report is to assess whether the revised IAS 19 leads to undue volatility of institutions' own funds. EBA's focus in the report is mainly on the deduction of net defined benefit assets from CET1. However, we would point at the volatility related to the calculation of pension liabilities according to IAS 19 as a major problem. According to article 519 also aspects related to the calculation of pension liabilities should be covered by EBA's report as well as potential legislative proposal to introduce a treatment which adjusts defined net benefit pension fund assets or liabilities for the calculation of own funds. Below we will give a brief description of the problem primarily from a pension liability perspective. Thereafter, we will give answers to the questions raised in EBA's discussion paper.

Volatility in own funds due to IAS 19

The treatment of defined benefit pension schemes in CRR/CRD IV in combination with changes in IAS 19 has significantly increased the pro-cyclicality of capital requirements. The earlier corridor approach in IAS 19 and the prudential filters used in several Member States under Basel 2 had smoothing effects on the short term volatility caused by changes in market parameters of pension obligations. The revised IAS 19, which came into force from 1 January 2013, and the lack of filter in CRR/CRD IV took away these smoothing effects and fluctuations in net pension liabilities therefore fully impact institutions' CET1 capital. The result is a highly increased pro-cyclical volatility in capital levels, for institutions reporting net pension liabilities, and significantly increased needs for capital in such regulated entities in stressed scenarios, leading to a more pro-cyclical supply of credit under normal economic conditions. The effects are likely to be more pronounced in small Member States where there is no liquid market for corporate bonds and where the market for



long term government bonds is relatively thin. These problems could be reduced by introducing a prudential filter in CRR/CRD IV to dampen the pro-cyclical effects of IAS 19. Against this background we would like to express our concern that the problem needs to be highlighted in EBA's report on whether revised IAS 19 leads to undue volatility of institutions' own funds.

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 pro-cyclicality 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.

Pension risks in Pillar 2

We would also urge EBA to consider that volatility in capital requirements also will find its way via Pillar 2 assessments. With the amendments of the IAS 19 volatility now shows up in CET1 capital meaning that pension risk has become a significant part of the capital assessment under Pillar 2. Depending on methodology institutions might need to set aside significant amounts of capital under Pillar 2 to cater for future volatility, even if there is no capital deficit whatsoever in the pension fund even in a stressed scenario.

In UK the PRA has published a supervisory statement regarding pension obligation risks in the 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 P2PRC".

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



Answers to EBA's questions in discussion 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 CRR the EBA shall assess whether the revised IAS 19 in conjunction with the deduction of net pension assets and changes in the net pension liabilities lead to undue volatility of institutions' own funds. Still, the report focuses on the deduction of assets. We are of the opinion the EBA also should assess the impact when the firms starting point is a net pension liability (according to IAS 19) and hence whether changes in net liabilities lead to volatility in institutions' own funds.

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.

The EBA has collected quantitative information for a 3-year period, 2010-2012. The time period chosen represents a period with good years, just after the latest financial crisis. The outcome is also shaped by the fact that the selected banks have excess values in their pension systems and of the chosen time horizon.

In our opinion the focus in this kind of evaluation should be based on the risk for procyclicality. Therefore, we believe it would be more appropriate with a much longer time period, to represent both good and bad times. Also, it would be favourable to have theoretical example as base. 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 the EBA also should assess whether changes in net liabilities lead to volatility in institutions' own funds.

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)?

Drivers of changes in net pension assets or liabilities are all kinds of actuarial assumptions as well as changes in the actual terms and conditions of pension agreements as well as different kinds of market parameters.



That said we would not expect that in a going-concern assumption other parameters than market parameters should be the focus in an evaluation of the procyclicality of defined pension obligations.

The reason for that is that most actuarial assumptions are long term estimates; i.e. estimates for the remaining time of service for the single employee, while market parameters are current parameters, not estimates.

Therefore we also question comments like "inflation assumption" would reduce the actuarial losses due to changes in the discount rate. The discount rate is a current rate while inflation is a long-term expectation that is not necessarily changed just because the discount rate has been changed.

However, other parameters than market parameters may be of interest in recovery or resolution scenarios, reason being that it may be probable that significant changes take place in the number of employees of an institutions or there may be renegotiations of the pension agreements in such scenarios. This kind of changes in the pension obligations are however "more in the hands of the management of the institutions" wherefore we do not believe that they should be simulated in a stress test.

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 report, point 38 on page 18, states that there is no expected impact on own funds from the changes discussed in point 38. We do not agree with this. All actuarial changes have impact on own funds. The changes made in IAS 19 also accelerates these other actuarial gains and losses and while therefore increase volatility in own funds. If they should be considered in a simulation is another question. See our answer to question 4, for more details.

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. See our answer to question 4 and 5.

That said, we again would like to stress the importance of:

- Stressing both net pension assets and net pension liabilities
- Stressing using long time series to capture possible procyclical behaviours of defined benefits schemes



- Stressing using a theoretical sample, else the outcome will be heavily dependent on the present financial position of the institutions covered by the stress test
- Stressing 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 the 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.

No. We consider the methodology chosen and the interpretation made to be of no relevance.

The EBA has collected quantitative information for a 3-year period, 2010-2012, just after the latest financial crisis. The outcome is shaped by the fact that the selected banks have excess values in their pension systems and of the chosen time horizon.

In our opinion the focus in this kind of evaluation should be based on the risk for procyclicality. Therefore, we believe it would be more appropriate with a much longer time period, to represent both good and bad times. Also, it would be appropriate to have theoretical example as base, with a neutral starting point; i.e. neither net pension assets or net pension liabilities. In 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.

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.

In appendix 1 you will find an alternative analysis made based on Swedish historical data.

The analysis highlights possible extreme volatility in the CET1 due, solely to changes in the discount rate. If possible volatility in plan assets due to changes in market values would have been included; the volatility would be significantly higher.



The analysis also highlights that high interest rate environments may cause higher volatility than low rate environment, but also shows that there still could be extreme volatilities in CET1 due to interest rate fluctuations even in low rate environments.

The analysis also highlights that severe negative value changes in pension liabilities may coincide with general stressed market conditions further highlighting the procyclical behaviour of IAS 19 without filtering mechanisms.

Finally the analysis highlight that a lot of the changes are very temporary in nature. Deferring those temporary changes could therefore significantly reduce procyclicality in the capital situation of banks.

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Appendix 1

In this analysis we have used an example bank with the following structure:

- CET 1 100,000
- Plan assets 20,000
- Defined pension liabilities 20,000
- Average remaining time of service: 20 years

The assumption made is that the bank continues to have the above structure throughout the whole stress periods. This makes it possible to isolate the effects due to changes in market parameters. However, that also means that it is the nominal pension obligation that is constant. Therefore, the size of the pension obligation will change when the discount rate changes. In practice, the deficits would need to be covered by the bank. However, disregarding that, the simulation avoids needing to include the sum of the negative effects on the bank's equity due to the cash flows to the pension system and the capital deficit in the pension system.

We have isolated the analysis to the volatility solely caused by changes in the discount rate (actual 10-year government bond rates in Sweden). If we had complemented the analysis with volatility caused by volatility in the plan assets, the aggregated net volatility would be even more significant. A contra argument could be that the interest rate risk could be eliminated if the plan assets were solely consistent of the same assets that represent the discount rate of the liabilities. However, this is not possible in a Swedish context. The reason for that is that even if there is a liquid market for assets representing the discount rate, the supply of such assets is not large enough and thin on maturities representing the maturity of the pension obligations.

We have chosen three different sample periods:

1. 1987 until today (starting 3-years before the Swedish financial crisis)
2. 2003 until today (as long as Sweden has had IAS 19 as an accounting standard for defined benefit pension obligations)
3. 2006 until today (to capture the latest financial crisis)

The advantages of the chosen time horizons are that:

- We capture a standardised time period for severe but not extreme stress tests (1 in 25 year event)
- We capture a time period in which IAS 19 has been in use and are able to separately follow the development during that short time period
- We isolate the volatility from the latest financial crisis
- We are able to identify the difference in volatility that occurs in a high rate environment contra a low rate environment. Today, all changes are underestimated because the discount rates are close to zero

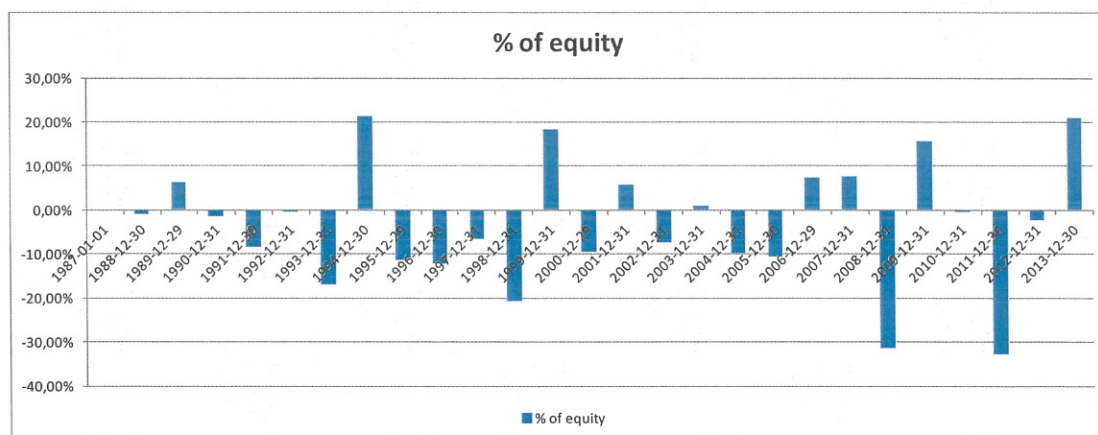


Another big advantage is that we can look at the theoretical outcome without any disturbing effects from different kinds of management actions that may have taken place when trying to use data from single institutions.

Stress of the discount rate

In these three scenarios we have evaluated the volatility in equity (CET1) caused by 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. The %-change in equity is expressed as a change compared to the year before to capture the yearly volatility.

1987--2013



During this time period the highest discount rate was 12.78% and the lowest was 1.52 %, i.e. an interval of 11.26 %-units. It speaks for itself that such possible volatility in the discount rate, for long dated liabilities causes an extreme volatility in the size of the pension obligations.

The graph shows the change in the pension liability one single year as a percentage of CET1. As shown the most extreme effect is that CET1 would have decreased by 32.78% in one single year just due to a change in the discount rate.

If studying the graph it worth noting that there are extreme movements during several periods in the sample period:

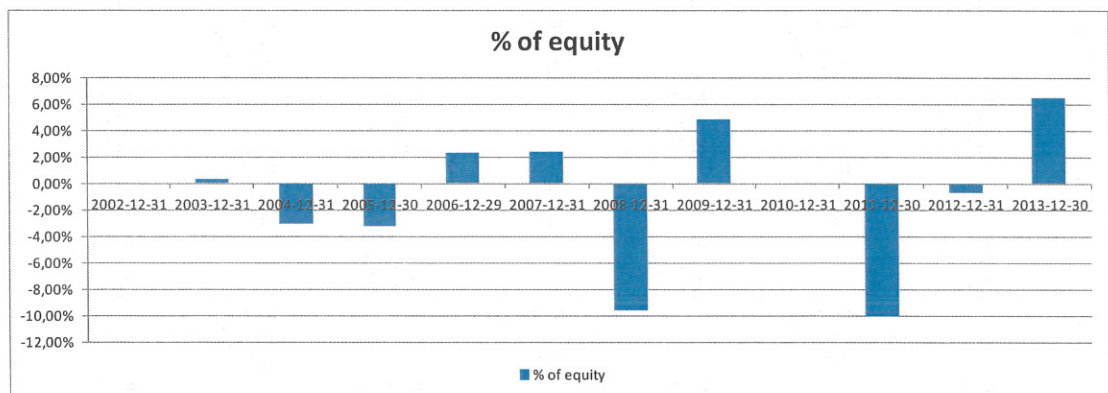
- 1991 a decrease of 8.34 % in CET1 in just one year. The first year of the Swedish financial crisis, a decrease the same year as the large credit losses started to occur
- 1993 One of the worst years in the Swedish financial crisis, a further decrease of 17.04 % in CET1 just due to a change in the discount rate
- 1995 – 1998 4 years in a row with significantly falling rates with a yearly decrease in CET1 between 6.56% to 20.75 %



- And as shown, these severe yearly effects continued to occur the years thereafter as well

To summaries; the analysis shows that a move from a high rate environment to a low rate environment could cause extreme stress on the capital situation of a bank if the effects of changes in pension liabilities are not deferred. The significant negative impact may occur in the same periods in which there already is significant stress on the banks due to increased loan losses.

2003—2013



Studying the time period in which IAS 19 has been used in Sweden also shows a significant implication on the volatility in CET1 given that no deferral is made of actuarial gains and losses.

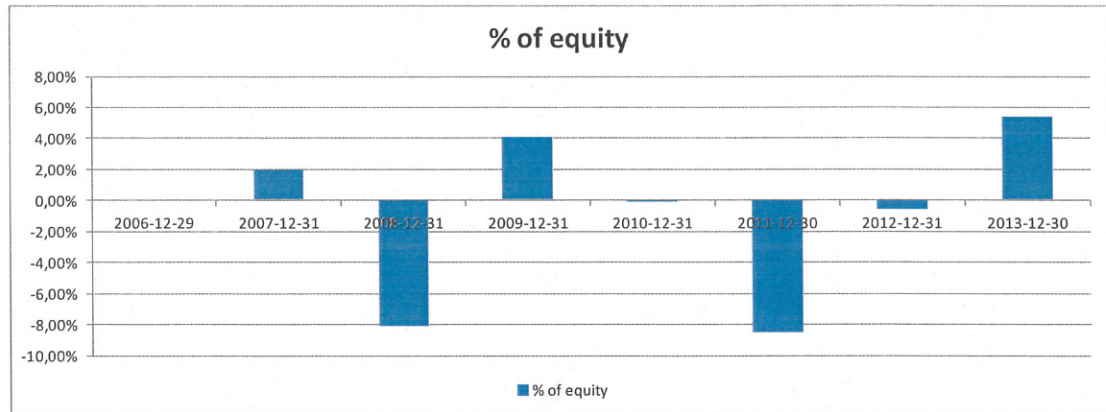
In 2004 and in 2005 there was a yearly reduction in CET1 of 3.05 % respectively 3.24 %, i.e. 6.29 % reduction in CET1 just in a two year scenario due to changes in the discount rate.

That later was followed up in 2008 with a reduction of 9.64 % followed by a reduction of 10.08 % in 2011.

The simulation shows that just in a 12 year period there was more than 4 years with a yearly reduction in CET1 in excess of 3 % just due to fluctuations in the discount rate. Worth noting is also that this significant volatility could occur even though the discount rate at the beginning of the sample period was as low as 4.71 %.



2006--2013



This sample period covers the latest financial crisis including the EBA sample period.

Worth observing is that this stress period shows two extreme decreases in CET1, only due to changes in the discount rate (8.11 % respectively 8.48 %). One of the changes is also well correlated with the bottom of the crisis, highlighting the procyclical behaviour of IAS 19. The short sample period also shows that an averaging of the volatility just during this short sample period would significantly decrease the volatility since the increase in the liability during the 7-year period is 5.8% in total, i.e. 0.8 % in average every year compared to the single year volatility in the sample period of maximum 8.48 % of CET1.