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Association for Financial Markets in Europe

# Consultation response

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

14 April 2014

The Association for Financial Markets in Europe (AFME) welcomes the opportunity to comment on **Discussion Paper on the impact on volatility of own funds of the revised IAS 19 and the deduction of defined benefit pension assets from own funds under Article 519 of the CRR ("the Discussion Paper")**. AFME represents a broad array of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks, brokers, law firms, investors and other financial market participants. We advocate stable, competitive, sustainable European financial markets that support economic growth and benefit society.

AFME is the European member of the Global Financial Markets Association (GFMA) a global alliance with the Securities Industry and Financial Markets Association (SIFMA) in the US, and the Asia Securities Industry and Financial Markets Association (ASIFMA) in Asia.

AFME is listed on the EU Register of Interest Representatives, registration number 65110063986-76.

We summarise below our high-level response to the Discussion Paper.

**Introduction**

AFME would like to reiterate its commitment to supporting the EBA in producing high quality analysis and credible technical advice for the European Commission. This is starting point for our following comments on the Discussion Paper.

Overall we believe that the methodology used to assess the volatility of own funds offers a reasonable basis to address the EBA's stated objectives. However, we think that the **scope** of the report should be widened and the **quantitative methodology** should be improved and to enhance its credibility. Moreover, we disagree with the **overall conclusion** of the paper which seems to downplay the potential impact from pensions on volatility of capital. We expand on these three points below.

***1. Scope of the Discussion Paper***

We suggest that the scope of the report is widened to consider the risk exposures that Defined Benefit Pension schemes represent to Institutions and ensuring that CET1 capital impact reflects the risk exposure.

The funding of Defined Benefit Pension schemes is a long term risk to Institutions, and employees cannot accelerate receipt of benefits. However under CRD IV significant short term volatility to CET1 capital is likely to be experienced by an Institution – this may require short-term capital raising actions

in response to adverse temporary movements in Defined Benefit Pension deficits, which are not reflective of the actual levels of risk to which the Institution is exposed.

The FSE exposure topic is also excluded from the scope of this report. The issue to what extent FSE exposure within pension assets has to be deducted from CET1 is explicitly removed from scope (paragraph 13). However the Discussion Paper seems to differentiate treatment between a pension fund which is "independent" from plan sponsor and one which is not. It is not clear why this unequal treatment has been introduced.

Finally, the paper seems to assume the absence of RWA being applied to pension assets. Whether to risk-weight pension assets is not addressed by CRR or similar pieces of regulation, but certain local regulators requires risk-weighting of pension assets. This unequal treatment does not only prevent a level playing field. Any risk-weighting of pension assets creates further volatility on the capital ratio and defines a natural dilemma – as any measures to match assets to the liability movements usually create RWA and hence lower the capital ratio.

***2. Quantitative methodology***

We believe that the methodology used to assess the volatility of own funds offers a reasonable basis to address the EBA's stated objectives. In particular we agree that actuarial gains and losses are expected to be the key driver of volatility in CET1 capital positions. However, we have identified some shortcomings with the methodology and scope adopted for the quantitative analysis performed:

- Data Used and Time Period: The analysis is restricted to 3 year-end positions (2010, 2011 and 2012) - a significantly longer dataset is required to provide robust analysis on the expected levels of volatility to Institutions CET1 capital levels under the CRD IV rules. Moreover, some Member States and International Jurisdictions require Defined Benefit Pension Scheme surplus / deficit assessments to be performed more frequently than once a year. It is therefore also important that analysis should be performed to consider the CET1 volatility over a shorter time horizon than one year which some Institutions could be subject to.

- Group Level Analysis: The analysis focuses on the impact to EU banking groups. Under CRD IV impact also can occur at a solo level (individual legal entity) where Competent Authorities require such capital ratios to be assessed - for such smaller entities where the levels of CET1 capital are lower and Defined Benefit Pension liabilities are much larger relative to the level of CET1 capital, the impact of the CRD IV Defined Benefit Pension Scheme treatment is likely to be much more severe than at EU banking group level.

- Netting: It is not clear if the EBA has applied full netting of all Defined Benefit Pension Scheme assets and liabilities for each institution when performing the analysis. In reality, Institutions may have a series of individual Defined Benefit Pension Schemes and may not be able to apply full netting across the individual assets and liabilities of each Scheme. This will increase the impact on CET1 capital; as such netting restrictions can increase the Defined Benefit Pension which have to be deducted under CRD IV.

***3. Overall conclusion of the Discussion Paper***

With regards to the conclusion of the EBA analysis, we consider that the outcome of average volatility on an annual basis around 20 bps is significant in magnitude compared with the volatility of the total ratio. Therefore an additional 20 bps volatility introduced by pension obligations valuation would be a significant part of the capital fluctuations if not filtered or reduced via the adoption of an alternative CET1 capital treatment for Defined Benefit Pension schemes.

We also would highlight that there is a significant range across Institutions in the results achieved by the EBA for CET1 volatility impact and this needs to be considered when assessing significance to Institutions. For institutions with pension schemes which are partially funded or unfunded, the actuarial gain/loss is not compensated by a parallel move in the value of pension assets which would generate significant CET1 volatility under CRD IV.

Another conclusion of the EBA analysis is that - if banks fund their plans so the IFRS funding levels are above 100% - there is no impact because surplus assets are deducted from CET1 capital. There can be a buffer effect, but several other factors also come into play. Most notably, if an Institution contributes into an overfunded plan, it weakens its capital position at the outset - for the sole benefit of having perhaps less volatility at this lower capital position. Further, a bank is often not free to unilaterally set the level of contributions into a pension fund - there may be minimum funding requirements or a negotiating process with Trustees.

As recognised in the EBA's qualitative volatility analysis, the IAS 19 valuation of Defined Benefit Pension scheme obligations is very sensitive to both discount rates and inflation. As the duration of commitments is generally very long, a 50 bps variation can lead to wide fluctuations on the total value of commitments (between 5% and 10%). This can lead to significant CET1 volatility of an Institution under CRD IV.

Moreover, it should be noted that external Defined Benefit pension schemes invest in a diversified portfolio (equity, fixed income, sovereigns, real estate etc.) while the discount rate is defined on the corporate interest rate curve. These assets and the discount rate are therefore not correlated, introducing IAS 19 valuation volatility. It is important to note that discount rate movements, particularly in the Eurozone, are erratic and cannot be replicated by investing in purely in fixed income securities to mitigate significant CET1 volatility. The main reason for this shortcoming is the fact that the bond universe on which the discount rate is based is limited to (in many instances, illiquid) AA rated bonds which cannot be bought in the market. We think the IFRS Board should consider including other high quality investment grade bonds to ensure replicability, which would limit CET1 volatility, and we seek EU policy makers' support in this respect.

Also, for Defined Benefit Pension schemes which are partially funded, the changes in the IAS 19 present value of gains or losses can differ significantly from the increase or decrease in the value of the pension assets simply due to differences in the magnitude of assets and liabilities.

As noted above, one of the key drivers of Defined Benefit Pension scheme deficits is the discount rate applied to projected defined benefit commitments. In times of economic stress, recent event have shown that the expected monetary policy response is the reduction of interest rates – such actions are likely to adversely impact IAS 19-based surpluses / deficits in pension schemes through reductions to discount rates. In addition, in such periods asset values are also likely to be adversely affected. Under CRD IV / Basel 3 this dynamic has the potential to be a significant source of pro-cyclicality to Institutions levels of CET1 capital, and from a prudential standpoint mechanisms to reduce such pro-cyclicality should be considered.

**Conclusion**

To conclude, we believe that that the CRD IV treatment of Defined Benefit Pension schemes can lead to undue volatility in the level of CET1 capital to Institutions, causing adverse impacts to Institution's capital planning and introducing another source of pro-cyclicality to Institutions' capital positions. With smoothing taken out of IAS19, there is an argument for reintroducing smoothing mechanisms when assessing the CET1 adjustment for pensions. EBA and European Commission should consider such mechanisms to reduce the short term volatility to Institutions' CET1 capital that the CRD IV rules, in their current form, introduce.

We are ultimately of the view that, as CRD IV and the IAS19 change happened independently of each other, there has been a greater tightening of the capital regime for pension obligations than was originally envisaged. It needs to be widely recognised that under the current CRD IV rules pension volatility could delay banks achieving the desired increases in capital ratios, and that if this were to occur it should be regarded as a less "serious" breach than failure to meet capital requirements for other reasons.

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