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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the effect of the revised International Accounting Standard (IAS) 19 on the volatility of own funds of credit institutions and investment firms.

1. INTRODUCTION

According to Article 36(1)(e) of Regulation (EU) No 575/2013 ('CRR'), credit institutions and investment firms shall deduct defined benefit pension fund ('DBPF') assets on their balance sheet from Common Equity Tier 1 ('CET1') items.

The revision of International Accounting Standard 19 “employee benefits” ('IAS 19')[1] has led to changes in the valuation of DBPFs. Article 519 CRR contains a mandate for the Commission to prepare a report for the European Parliament and the Council on whether the revised IAS 19 in conjunction with the deduction of net pension assets as set out in Article 36(1)(e) would lead to undue volatility of institutions’ own funds.

The Commission has been asked to take into account the report prepared by the EBA on this issue in accordance with the mandate provided by the same Article. If appropriate, the Commission's report shall be accompanied by a legislative proposal to introduce a treatment which adjusts net DBPF assets or liabilities for the calculation of own funds.

The EBA submitted its report "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 EBA report")[2] on 24 June 2014.

This Commission report responds to a legal obligation to assess the effects of very specific changes in the calculation of Common Equity Tier 1 capital in credit institutions and investment firms due the adoption CRR and a new IAS 19.

2. MAIN ISSUES

2.1. Current treatment under the CRR

Article 36 CRR contains the requirement for banks to deduct DBPF assets from CET1. The rationale for this treatment is that the loss absorption capacity of these assets is doubtful from a prudential point of view. In the event that a bank would enter into bankruptcy or resolution, these assets would not be available to bear the losses.

It should be noted that Article 41 CRR contains an exemption from this general deduction rule in relation to assets in the DBPF which the institution has an unrestricted ability to use, subject to supervisory permission.

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[1] COMMISSION REGULATION (EU) No 475/2012 of 5 June 2012 amending Regulation (EC) No 1126/2008 adopting certain international accounting standards in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council as regards International Accounting Standard (IAS) 1 and International Accounting Standard (IAS) 19

[2] EBA (2014): Report. 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 report identifies the accounting and regulatory changes due the review of IAS 19 and analyses whether these changes might affect own funds. It includes a quantitative assessment of the impact of these changes on the volatility of own funds during a specific time period assuming full application of CRD IV/CRR and the revised IAS 19 requirements. Qualitative and quantitative information for a sample of EU institutions and Member States highlight the main effects of the prudential and accounting changes, their magnitude and what types of institutions are mainly affected. Finally, the report also looks at other variables which could have a direct impact on defined benefit pension funds and the volatility of own funds. The EBA report can be retrieved from: https://www.eba.europa.eu/documents/10180/534414/EBA+Report+on+the+impact+on+the+volatility+of+own+funds+from+defined+pension+plans.pdf

2.2. Changes due to revision of IAS 19

The revision in IAS 19 has led to changes in the valuation of DBPFs. The EBA has identified only two aspects of the revision of IAS 19 which may have an impact on the calculation of own funds:

1. **Immediate recognition of actuarial gains and losses**: Under the previous version of IAS 19, changes in the actuarial assumption did not have to be taken into account immediately as long as they remained within a certain corridor[3] (hence the so-called "corridor approach") and could be apportioned over several periods, whereas under the revised IAS 19, they will need to be immediately recognised.

2. **Immediate recognition of all past service costs:** Past service costs represent the change in the present value of the defined benefit obligation for employee services in prior periods, resulting from an amendment or a curtailment to the plan. Under the previous IAS 19, vested past service costs were recognised in the profit and loss account immediately, while unvested service costs were recognised over the average vesting period on a straight-line basis.

In this respect, it should be noted that CEBS as the predecessor of the EBA commented[4] on the previous version of IAS 19, raising concerns regarding the "corridor approach" and proposed abolishing it subject to transitional provisions. While IAS 19 has abolished the corridor approach on actuarial gains and losses, the CRR has provided transitional provisions to soften the impact on own funds.

2.3. Transitional measures under CRR

The CRR sets out the following **transitional measures** to soften the impact of the changes in IAS 19 and the deduction of defined benefit pension fund assets in general:

1. General phasing-in of the deduction of DBPF assets from 2014 to 2017 enabled by Articles 469(1)(a) and Article 478 CRR.
2. Special phasing-in of the effect of the changes in IAS 19 from 2014 to 2018 under Article 473 CRR.
3. Phasing out of filters applied at national level from 2014 to 2018 under Article 481 CRR.

[3] See COMMISSION REGULATION (EC) No 1126/2008, Annex, IAS 19 Employee Benefits, paragraph 95

[4] CEBS Comment Letter on IASB ED/2010/3 Defined Benefit Plans – Proposed Amendments to IAS 19 on 6 September 2010.

3. ASSESSMENT OF THE POTENTIAL INTRODUCTION OF VOLATILITY DUE TO THE REVISION OF IAS 19

Based on the report provided by the EBA, the analysis of the effect of the revision of IAS 19 in conjunction with the deduction of DBPF assets according to Article 36(1)(e) CRR is assessed as follows[5]:

3.1. Impact depending on offsetting gains or losses

There will be no volatility of own funds where an institution reports a net DBPF asset on the balance sheet and there is an equal offsetting gain or loss. Only where the institution reports a net DBPF asset without a corresponding gain or loss can the deduction of the net DBPF asset result in volatility of own funds.

3.2. Impact at initial application of revised IAS 19

The impact of the deduction of the net DBPF assets from own funds upon initial application will be limited for most institutions due to the low levels of net DBPF assets[6] under both the previous and the revised IAS 19. In addition, for most institutions, the negative effect on CET1 will be further limited because the level of unrecognised actuarial losses compared to their capital position is small. Only a small[7] minority of institutions that have significant DBPF assets may be materially affected. In particular, the existence of substantial unrecognised actuarial losses might lead to a reduction in own funds.

3.3. General assessment of limited volatility introduced by revised IAS 19[8]

Based on the EBA's report, it can be concluded that, on average, there is limited volatility of own funds due to the accounting and prudential changes. For some institutions and in some countries the impact on the volatility of own funds could be higher, depending on the size and the performance of the DBPF relative to the capital position of the institution.

Furthermore, any change in the actuarial assumptions to be used can be viewed as an improvement in the alignment of the DBPF book values with the "real" exposure of the institution and the economics of the transaction.

Finally, any impact on own funds due to the first-time application of the revised IAS 19 can be softened by the specific transitional provision set out in Article 473 CRR or Article 481 CRR. The general application of these requirements for deducing DBPF assets can be phased-in subject to the provisions of Articles 469(1)(a) CRR in conjunction with Article 478 CRR.

[5] EBA has based its analysis on a sample composed of the 57 European institutions in 20 EEA countries used by the EBA for the KRI (Key Risk Indicators) analysis.

[6] See EBA report p. 25: "All institutions except three (38 institutions) had low levels of net defined benefit pension assets under the previous IAS 19, if any, in each of the years of the period assessed (up to 0.2% of RWA) and low levels, if any, of unrecognised actuarial gains in each of the years assessed (up to 0.4% of RWA)."

[7] According to the EBA report, none of the three institutions in the sample reviewed with relatively high defined benefit assets under the previous IAS 19 would be affected as they had significant unrecognised actuarial losses that would need to be immediately recognised against defined benefit assets.

[8] For an encompassing presentation of the quantitative evidence, readers are referred to the EBA report and especially the tables summarising the quantitative information on page 23 and page 31.

4. CONCLUSION

Taking into account the EBA's report, it is the Commission's assessment that the potential additional volatility of own funds introduced by the revision of IAS 19 will be limited and is justified by the arguments presented in this report. Furthermore, any impact due to the initial application has been mitigated by appropriate transitional provisions. Therefore, the Commission concludes that IAS 19, in conjunction with the deduction of DBPF assets set out in Article 36(1)(e) CRR and the changes in the net pension liabilities will not lead to undue volatility of institutions' own funds. Consequently, the Commission views the CRR treatment as it stands as appropriate and will not table a legislative proposal in conjunction with this report.