Commission de Surveillance du Secteur Financier

FAQ CSSF Regulation No 14-02 - Determination of distributable amounts of credit institutions using fair value in the statutory accounts

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Context

The below Questions & Answers have been prepared in order to assist banks in implementing the requirements of CSSF Regulation No 14-02 (thereafter "the Regulation") relating to the determination of distributable results and reserves of credit institutions applying the fair value measurement in their statutory accounts published either under IFRS or under the LUX GAAP mixed regime.

Preliminary observations

Tax effects

The Regulation clearly states that the amount to be regarded as unavailable / non-distributable must be assessed on a <u>net-of-tax basis</u> (i.e. by deducting current and/or deferred taxes charged on the unrealised gains allocated to the unavailable reserve).

Most of the answers in the below guidelines only focus on the determination of the <u>gross amount</u> of unrealised gains and omit the computation of the tax effect. That tax effect is however always supposed to be subsequently included in the computation (at a later stage).

The below section 6.2 includes a specific guidance concerning the use of a generic tax rate to measure the non-distributable amount.

Realised results recognised in other comprehensive income

IFRS may require or permit the recognition of certain unrealised gains and losses in revaluation reserves (through other comprehensive income).

When those gains and losses are subsequently realised, IFRS sometimes prohibit the recycling of those results in profit or loss[1]. Such results will thus remain in equity but can be transferred to other components of equity (e.g. to retained earnings).

The requirements of the Regulation only apply to <u>unrealised</u> gains and losses and not to realised results – even if an institution continues to recognise such realised results in a revaluation reserve.

In order to avoid the mix of realised and unrealised results in a revaluation reserve, the CSSF however encourages credit institutions to transfer realised results out of the revaluation reserves (e.g. to retained earnings) when gains and losses are realised (e.g. when the underlying instruments are derecognised).

[1] E.g. for investments in equity instruments measured at fair value through other comprehensive income or for tangible assets accounted for under the revaluation model.

Questions and answers

1. Is the scope of the Regulation limited to unrealised gains recognised in profit or loss? Or to unrealised gains recognised in equity?

No. The scope of the Regulation includes all unrealised gains, regardless of whether those gains have been recognised in profit or loss[2] or directly in equity through a revaluation reserve.

2. When applying the requirements of the Regulation to revaluation reserves recognised in equity, is it sufficient to consider the (net) balance of the reserve?

No. The Regulation specifically applies to unrealised gains and the netting of unrealised gains with unrealised losses will generally be inappropriate.

A limited number of exceptions however exist (as described below).

3. How shall amounts recognised in revaluation reserves (through other comprehensive income) be considered when calculating the distributable amount?

The computation of the distributable amount is a two-step process:

- The first step is to aggregate all revaluation reserves and to include this amount in the computation (i.e. in addition to the other reserves and to the profit or loss of the year).
- The second step is to determine the amount of unrealised gains to be considered non-distributable. This amount is to be deducted in the computation of the distributable amount.

The above process will ensure that, whenever applicable, unrealised losses will duly reduce the distributable amount.

As described below, the computation of the non-distributable amount will however differ according to the nature of the revaluation reserve considered (see section 4).

4. Are there specific rules to be applied for certain revaluation reserves recognised through other comprehensive income?

Yes. The application of the Regulation to revaluation reserves recognised in equity might raise implementation issues. The CSSF considers that the principles detailed below for each type of reserves are appropriate.

[2] For the avoidance of doubt, the cumulative unrealised gains which have been recognised in profit or loss in previous accounting exercises and which have then been transferred to retained earnings (or to another reserve in equity) are included in the scope of the Regulation until they are realised.

4.1. The revaluation reserve relating to investments in debt instruments measured at fair value through other comprehensive income

This paragraph relates to investments in debt instruments accounted for under IFRS 9.4.1.2A.

The amount to be considered non-distributable is the sum of unrealised gains recognised at the reporting date on all the instruments for which the individual revaluation result is positive. This computation thus prohibits any netting with unrealised losses recognised on other instruments.

The above principle implies that the non-distributable amount will generally exceed the net balance of the reserve (i.e. each time such a reserve will host at least one investment for which the individual revaluation result is negative).

Illustration

The bank holds two debt securities measured at fair value through other comprehensive income at the reporting date. The first one exhibits an unrealised loss of -100 and the other one exhibits an unrealised gain of +80. The balance of the reserve is therefore -20.

In a first step, the reserve of -20 is included in the computation of the distributable amount.

In a second step, the bank identifies the unrealised gain of +80 that is to be regarded as non-distributable and this amount is further deducted in the computation of the distributable amount.

Overall, the computation of the distributable amount will have been reduced by -100 (which, in substance, corresponds to the amount of the unrealised loss).

For the avoidance of doubt, the computation of the above individual gains and losses:

- ***Excludes*** changes in fair value recognised in profit or loss in accordance with IAS 39 / IFRS 9 fair value hedge accounting requirements.

- ***Includes*** the credit entry which relates to the recognition of expected credit losses (IFRS 9).

  Illustration

  A bond is acquired for an amount of 105 in July N (reimbursement value at maturity: 100). As of the December N+2 reporting date, the gross carrying amount of the bond (computed according to the effective interest rate) is 102; its fair value is estimated at 106 and the credit institution has recognised cumulative expected credit losses for that position for an amount of 1 in profit or loss.

  This bond will contribute to the revaluation reserve for an amount of +5 (being 106-102+1) at the reporting date. This is the amount to be regarded as non-distributable under the Regulation.

4.2. The revaluation reserve relating to investments in equity instruments measured at fair value through other comprehensive income

This paragraph refers to those investments in equity instruments that the credit institution has chosen to measure at fair value through other comprehensive income in accordance with IFRS 9.5.7.5.

The approach to be implemented for these items under the Regulation will differ depending on whether the instruments are designated as hedged items in <u>fair value hedges</u> or not.

Investments NOT designated as hedged items in fair value hedges

Principles detailed above for investments in debt instruments measured at fair value through other comprehensive income shall apply (see section 4.1).

Investments designated as hedged items in fair value hedges

When those instruments are designated as hedged items in fair value hedges, both changes in fair value of the hedged items and changes in fair value of the hedging instruments are recognised in other comprehensive income (cf. IFRS 9.6.5.8).

Since the instruments are designated in <u>fair value hedge</u> relationships, the derogation provided for in point a) of paragraph (3) of Article 3 of the Regulation shall be considered.

This derogation will be reflected in the computation of the non-distributable amount as follows:

- First step: the institution will assess the <u>net</u> unrealised result on each individual hedged position by aggregating changes in fair value of the hedged item and changes in fair value of the hedging instrument.
- Second step: the <u>net</u> individual amount computed under the first step for each individual hedging relationship will have to be processed according to the principles detailed in section 4.1.

4.3. The revaluation reserve relating to financial liabilities <u>designated</u> at fair value through profit or loss (own credit risk portion)

In accordance with IFRS 9.5.7.7, when a credit institution designates a financial liability at fair value through profit or loss, it might be required to recognise changes in fair value relating to changes in its own credit risk in a separate reserve in equity.

The computation of the non-distributable amount for unrealised gains recognised in that reserve shall follow the same principles as those detailed above for debt instruments measured at fair value through other comprehensive income (i.e. unrealised gains fully allocated to the non-distributable reserve without any netting with unrealised losses – see section 4.1).

The revaluation reserve addressed in this section only includes a portion of changes in fair value (the portion relating to changes in own credit risk) of the underlying financial liabilities designated at fair value through profit or loss. The other portion which relates to changes in fair value attributable to changes other than changes in own credit risk (e.g. changes in market interest rates) is recognised in profit or loss.

Under the Regulation, the identification of unrealised gains will also be required for that other portion of changes in fair value recognised in profit or loss (see section 5.2 below).

One could thus question whether the two components (i.e. the portion of the changes in fair value recognised in the revaluation reserve and the portion of the changes in fair value recognised in profit or loss) should be treated separately or whether an overall net approach at instrument level should be adopted.

The CSSF considers that both approaches are acceptable. The credit institution shall choose one methodology for all instruments and apply it consistently from one reporting period to the next.

Illustration

A fixed rate debt instrument issued by a credit institution has been designated at fair value through profit or loss. The fair valuation of the debt at the reporting date resulted in the recognition of an unrealised gain of +100 which was broken down as follows:

- *change in fair value relating to an increase in market interest rates: + 110 (recognised in profit or loss),*
- *change in fair value relating to a decrease of the institution's own credit risk: -10 (recognised in the revaluation reserve).*

If the overall net approach is adopted, the non-distributable amount will be measured at 100 (overall net unrealised gain on the debt).

If the component approach is adopted, the non-distributable amount will be 110 (the entire unrealised gain recognised in profit or loss; the unrealised loss recognised in equity and relating to the own credit risk effect is ignored in the measurement of the unavailable reserve).

For the avoidance of doubt, the overall net approach described above allows to net changes in fair value recognised in profit or loss and in other comprehensive income only for a single / individual instrument designated at fair value (meaning at instrument level). It does not allow to net revaluation results of several separate instruments.

4.4. Cash flow hedge reserve and reserve for a hedge of a net investment in a foreign operation

The recognition principles relating to these hedging reserves are detailed under the paragraphs from 6.5.11 to 6.5.14 of IFRS 9.

In substance, different types of hedging relationships can be designated as cash flow hedges (e.g. hedges of an investment in a floating rate bond measured at fair value through other comprehensive income or at amortised cost; hedges of highly probable forecast transactions).

The CSSF notes that the derogation provided for in point a) of paragraph (3) of Article 3 of the Regulation specifically refers to fair value hedges (and the Comments on the articles relating to that paragraph confirm this statement).

It can therefore be concluded that the exemption granted to fair value hedges under the Regulation shall not be extended to the other types of hedges.

The CSSF is however of the opinion that the nature of the underlying transactions – which must meet certain specific qualifying criteria under IFRS – should warrant a distinctive treatment under the Regulation.

Consequently, the CSSF considers that the following approach is appropriate:

- If these reserves exhibit a net positive balance at the reporting date, this (net) amount is to be regarded as non-distributable under the Regulation.
- If these reserves exhibit a net negative balance at the reporting date, this (net) amount shall reduce the distributable amount. However, unlike the applicable approach to some other revaluation reserves (such as the revaluation reserve relating to investments in debt instruments measured at fair value through other comprehensive income), it is not required to further identify unrealised gains in those reserves in order to deduct the excess of such gains (over the net balance of the reserves) from other distributable amounts.

4.5. Actuarial gains and losses on defined benefit pension plans (IAS 19 reserve)

This reserve hosts certain amounts recognised for defined benefit pension plans accounted for under IAS 19 (revised).

It appears that this reserve might include unrealised gains and losses (amounts inherited from the fair valuation of plan assets at the reporting date), but also other amounts (e.g. realised results recognised from the management of plan assets, actuarial gains and losses stemming from changes in mortality tables).

It is also noteworthy that the amounts recognised in the reserve may be capped due to the application of the IAS 19 'asset ceiling' provisions.

The CSSF considers that the principles retained for the cash flow hedge reserve (see section 4.4 above) shall also apply for this reserve, namely:

- If the balance of the reserve is positive at the reporting date, that amount shall be regarded as non-distributable.
- If the balance is negative, the amount shall reduce the amount of the distributable reserves.

However, the identification of unrealised gains included in the reserve is not required.

4.6. The revaluation reserves relating to tangible and intangible assets

Those reserves relate to the remeasurement of tangible and intangible assets (including right-of-use assets under IFRS 16) when the institution has retained the revaluation model under either IAS 16 or IAS 38 (cf. IAS 16.31 and IAS 38.75).

Those reserves only include unrealised gains (but no unrealised losses). The balances of these reserves are to be regarded as non-distributable under the Regulation.

5. How to compute the non-distributable amount for unrealised gains recognised in profit or loss?

The provisions of the Regulation do apply to unrealised gains recognised in profit or loss, with a limited number of exceptions described below.

5.1. Unrealised gains recognised on assets and liabilities <u>held for trading</u>

Point a) of paragraph (3) of Article 3 of the Regulation includes a derogation to the general provisions prohibiting the distribution of unrealised gains for those "unrealised gains (…) related to financial instruments held as <u>trading book items</u> (…)".

The Comments on the articles which relate to that paragraph confirm that this derogation refers to those gains regarded as nearly realised (<u>short-term holdings</u>). The scope of the exemption thus appears to be <u>significantly narrower</u> than the scope of all unrealised results recognised on financial assets and liabilities classified as "Held for trading" under IFRS 9.

Considering the above, the CSSF is of the opinion that the below treatments are appropriate:

- For <u>non-derivative</u> financial assets and liabilities: all unrealised gains are deemed to be included in the scope of the exemption of point a) of paragraph (3) of Article 3 (in other words, those unrealised gains can be distributed).
- For <u>derivative</u> instruments:
  - Results recognised on those derivatives which are concluded in a pure "back-to-back" activity[3] are qualified under the exemption (i.e. the related unrealised gains recognised on those positions need not to be retreated for the computation of the non-distributable amount and they may be fully included in the computation of the distributable amount).
  - All the other results recognised on derivatives are to be excluded from the scope of the exemption (e.g. economic hedges, pure discretionary trading positions) and must thus be processed under the general provisions of the Regulation (meaning that the sum of the related unrealised <u>gains</u> shall be fully considered non-distributable and that netting with unrealised losses is prohibited according to the principles laid down in section 4.1).

[3] For the avoidance of doubt, the exemption can only be applied to <u>perfectly matched</u> positions (the only acceptable difference between the position concluded with the client and the opposite position concluded with the market counterparty being the margin captured by the bank). Positions which are not perfectly symmetrical (e.g. in amounts or in maturity) shall be treated similarly as other trading derivatives (unrealised gains regarded as non-distributable).

5.2. Other unrealised gains recognised in profit or loss

Under IFRS, some transactions might result in the recognition of unrealised gains in profit or loss.

- Among those transactions, some relate to **items for which no exemption exists under the Regulation**.

  The related unrealised gains shall thus be considered non-distributable and netting with unrealised losses is prohibited according to the principles laid down in section 4.1. This notably concerns the following items:

  - Non-trading financial assets mandatorily at fair value through profit or loss,
  - Financial assets designated at fair value through profit or loss,
  - Investment properties (when the fair value measurement model has been retained),
  - Financial liabilities designated at fair value through profit or loss[4].

- Other transactions relate to **items for which a specific exemption is included in the Regulation** (point a) of paragraph (3) of Article 3 of the Regulation):

  - Changes in fair value relating to fair value hedges (hedged items and hedging instruments),
  - Changes related to currency fluctuations (foreign exchange differences).

  All results recognised under those headings will thus be fully included in the computation of the distributable amount.

6. Other specific topics

6.1. Shall unrealised gains be measured on a "clean price basis" or on a "dirty price basis"?

The CSSF considers that both approaches are acceptable under the Regulation. The credit institution shall choose one methodology and apply it consistently from one reporting period to the next.

6.2. How shall the tax effect be computed for unrealised gains to be regarded as non-distributable?

Paragraph (1) of Article 3 of the Regulation explicitly states that the amounts to be considered non-distributable shall be measured "net of related tax".

[4] For these liabilities, unrealised results recognised in profit or loss and in other comprehensive income (changes in fair value relating to changes in own credit risk) might be considered either on a separate basis or under the overall net approach (see section 4.3).

It is noteworthy that the amounts of tax to be deducted from the unrealised gains are those amounts which are to be recognised in the accounts for the related transactions in accordance with IAS 12 – and not an approximative estimate of such a tax effect (for instance, through the use of a generic tax rate in case such a use would prove to be inappropriate).

The use of a generic tax rate would – for instance – be inappropriate if a significant portion of unrealised gains to be considered non-distributable relates to the holding of participating interests for which no tax will be due on derecognition (and for which no deferred tax has been recognised in the accounts).

6.3. Are institutions expected to disclose in their financial statements the amount of results and reserves which cannot be distributed (undistributable reserves)?

Yes. The CSSF expects institutions to include in their financial statements information on the results and reserves which are regarded as 'non-distributable' at the reporting date.

Such a disclosure could be framed according to the following principles:

- A descriptive section: brief presentation of all types of unavailable reserves (e.g. legal reserve, statutory reserves, net wealth tax reserve, treasury shares (own shares) reserve, reserves relating to prudential provisions (cf. circular CSSF 14/599 – lump sum provision), reserves of unrealised gains from fair value measurement relating to the application of CSSF Regulation No 14-02).
- A quantitative section: disclosure (both individually for each type of reserves and in aggregate) of amounts that are non-distributable at the end of the financial year (including, where applicable, amounts recognised in other comprehensive income and in profit or loss).

	Description		Q&A reference	Approach to be retained under the Regulation	IFRS reference
OCI	Revaluation reserve relating to investments in debt instruments measured at fair value through other comprehensive income		4.1	Unrealised gains and unrealised losses shall be treated separately : - the sum of unrealised gains shall be considered as non-distributable - the sum of unrealised losses shall reduce the amount of distributable reserves	IFRS 9.4.1.2A
	Revaluation reserve relating to investments in equity instruments measured at fair value through other comprehensive income	Equity instruments designated as hedged items in fair value hedges	4.2	Step 1 : Calculation of the cumulative net result of each (individual) hedging relationship (aggregation of the revaluation amounts relating to the hedged item and to the hedging instrument). Step 2 : Amounts computed under step 1 shall be subject to the same requirements as those retained for investments in debt instruments measured at fair value through other comprehensive income (see Q&A 4.1)	IFRS 9.5.7.5 IFRS 9.6.5.8
		Other equity instruments	4.2	Principles retained for investments in debt instruments measured at fair value through other comprehensive income (see Q&A 4.1) are applicable	IFRS 9.5.7.5
	Revaluation reserve relating to financial liabilities designated at fair value through profit or loss (own credit risk portion)		4.3	Principles retained for investments in debt instruments measured at fair value through other comprehensive income (see Q&A 4.1) are applicable Accounting policy choice : consider the amounts recognised in OCI and in P&L either separately or in combination ("overall net approach")	IFRS 9.4.2.2 IFRS 9.4.3.5 IFRS 9.5.7.7
	Revaluation reserves relating to cash flow hedges and to hedges of net investments in foreign operations		4.4	If the balance of the reserve is positive at the reporting date, this amount shall be regarded as non-distributable. If the balance of the reserve is negative at the reporting date, this amount shall reduce the amount of distributable reserves. (a separate assessment of the unrealised gains included in the balance of the reserve is not required)	IFRS 9.6.5.11 (IAS 39.95) IFRS 9.6.5.13 (IAS 39.102)
	Revaluation reserves relating to defined benefit pension plans		4.5	If the balance of the reserve is positive at the reporting date, this amount shall be regarded as non-distributable. If the balance of the reserve is negative at the reporting date, this amount shall reduce the amount of distributable reserves. (a separate assessment of the unrealised gains included in the measurement of plan assets is not required)	IAS 19.120
	Revaluation reserves relating to tangible and intangible assets		4.6	The reserves are non-distributable.	IAS 16.31 and IAS 38.75
P&L	Financial assets and financial liabilities classified in the "Held for Trading" category under IFRS	Non-derivative instruments	5.1	Unrealised revaluation result regarded as "nearly realised" / distributable [exemption provided for in Article 3(3)a) of the Regulation]	IFRS 9.4.1.4 IFRS 9.4.2.1
		Derivative instruments "Back-to-back" activity (perfectly symmetrical positions)	5.1	The exemption of Article 3(3)a) of the Regulation can be extended to perfectly symmetrical / pure "back-to-back" positions (both positions have opposite fair values / only acceptable differences relate to the bank's margin and to CVA/DVA adjustments)	IFRS 9.4.1.4 IFRS 9.4.2.1
		Other derivative instruments (imperfectly matched "back-to-back"positions, economic hedges, discretionary trading positions...)	5.1	Not included in the scope of the exemption of Article 3(3)a of the Regulation Unrealised gains shall be considered as non-distributable (netting with unrealised losses is prohibited)	IFRS 9.4.1.4 IFRS 9.4.2.1
	Other unrealised gains recognised in profit or loss	Non-trading financial assets mandatorily at fair value through profit or loss	5.2	Unrealised gains shall be considered as non-distributable (netting with unrealised losses is prohibited)	IFRS 9.4.1.4
		Financial assets designated at fair value through profit or loss	5.2	Unrealised gains shall be considered as non-distributable (netting with unrealised losses is prohibited)	IFRS 9.4.1.5
		Investment properties (fair value model)	5.2	Unrealised gains shall be considered as non-distributable (netting with unrealised losses is prohibited)	IAS 40.33
		Financial liabilities designated at fair value through profit or loss	5.2	Unrealised gains shall be considered as non-distributable (netting with unrealised losses is prohibited) Accounting policy choice : consider the amounts recognised in OCI and in P&L either separately or in combination ("overall net approach")	IFRS 9.4.2.2 IFRS 9.4.3.5 IFRS 9.5.7.7
		Changes in fair value relating to fair value hedges	5.2	Unrealised gains are exempted and considered as distributable [Exemption provided for in Article 3(3)a) of the Regulation]	IFRS 9.6.5.8
		Foreign exchange differences	5.2	Unrealised gains are exempted and considered as distributable [Exemption provided for in Article 3(3)a) of the Regulation]	IAS 21