ISDA Member Survey on AT1 Treatment in the IASB's Dynamic Risk Management Model

Global banking industry survey

Note: EY conducted a Survey on behalf of ISDA to perform an assessment on the current tentative decisions made by the IASB on the Dynamic Risk Management (DRM). In particular to understand the accounting and regulatory treatment by members of Alternative Tier 1 (AT1) financial instruments and to contribute with this information to discussions on the development of the IASB's DRM model. The Survey was carried out with the help of the *'Qualtrics Core XM' ("The Tool")*. All data collected by The Tool has been aggregated and anonymised for the purpose of this presentation. All information (including personal data) is confidential and will not be retained by "The Tool" after the 'retained period'.

September 2024

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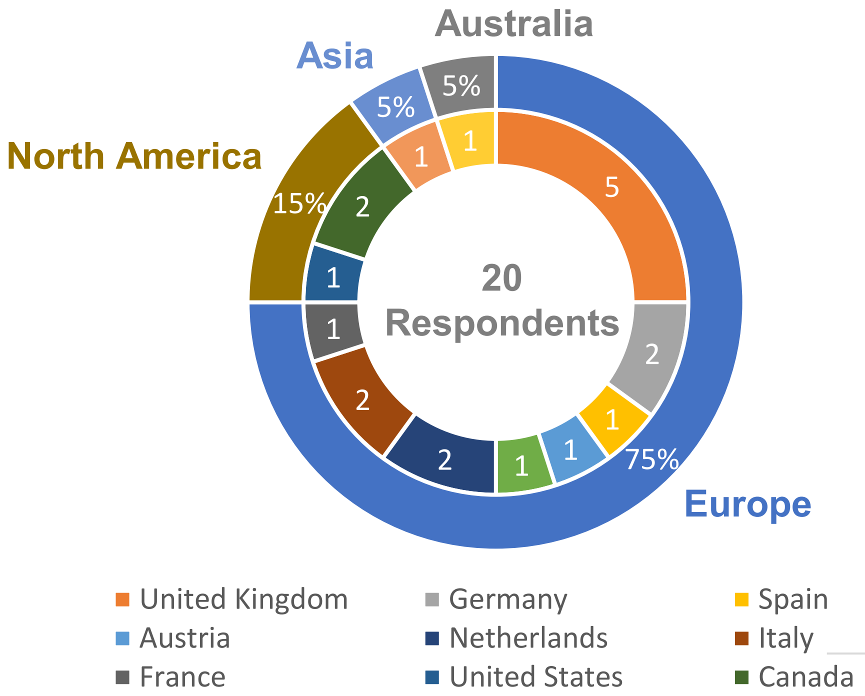
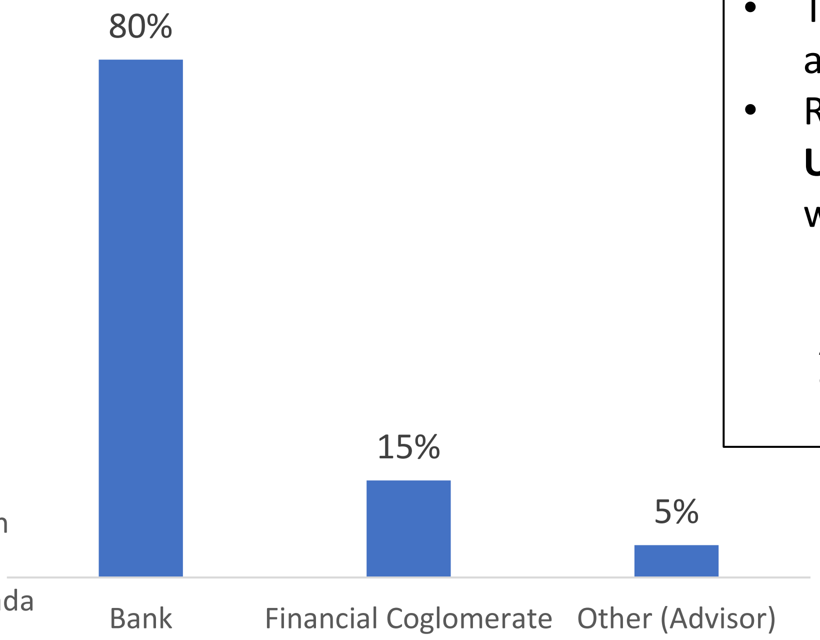
Respondent Profile:

- The results show a concentration of respondents in Europe (75%), followed by North America (15%), Asia (5%), and Australia (5%).
- In terms of organizational classification, 80% of respondents are banks, 15% are financial conglomerates, and 5% are classified as other.





- The total size of the AT1 market is approximately **USD 275 billion***.
- Respondents have approximately **USD 159 billion** AT1s in issue , which is **58% of the total**.

*Reuters 24 March 2023, Explainer: What are AT1 bonds and why are Credit Suisse's wiped out? LINK

- The 5 UK banks represent 25% of respondents. The 10 banks from Continental Europe represent a further 50% of respondents.

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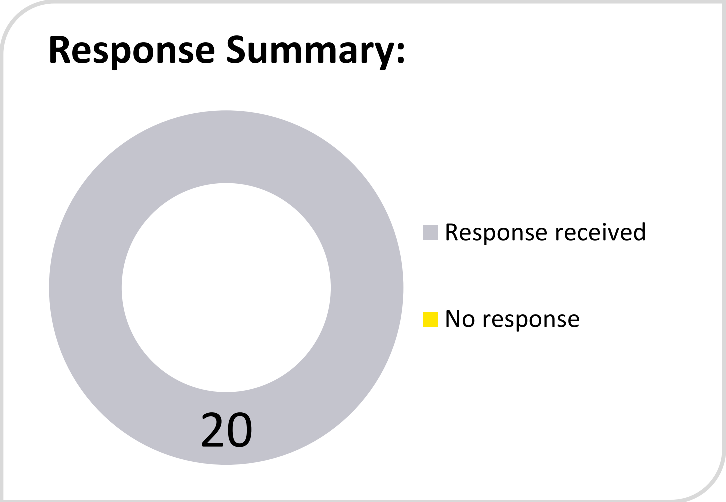
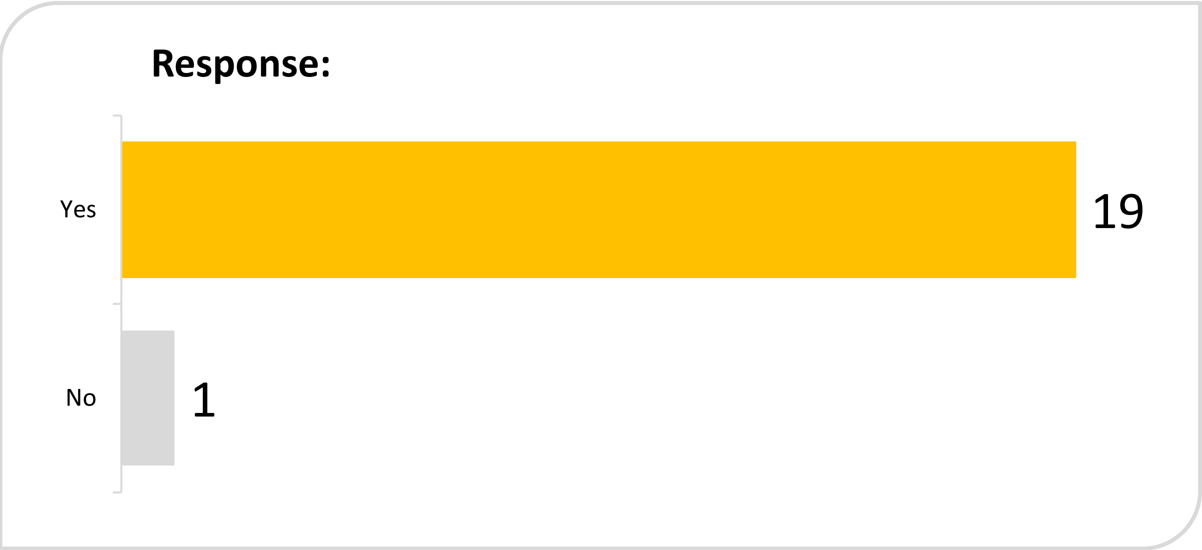
Executive Summary

- For IFRS balance sheet classification, the majority of respondents classify their AT1s as equity.
- The majority of respondents include their AT1s for IRRBB as equivalent to financial liabilities. This reflects that for risk management purposes, AT1s are an integral part of respondents' interest rate risk exposure.
- Strong desire for the inclusion of AT1's in the CNOP since integral to the risk management strategy, with evidence from inclusion in IRRBB risk metrics (e.g. EVE) and actual banking risk management framework, indicating lack of inclusion, could cause conflict with DRM model objectives.
- For IRRBB purposes, AT1s are viewed by respondents as providing a material source of stable funding, which for the purposes of the DRM model should therefore be treated consistently with other financial liabilities seen as stable funding for risk management purposes.
- If the principle that the DRM model is aligned with risk management encompass allowing AT1s to be included in the CNOP, other equity instruments containing interest rate risk (e.g., fixed rate preference shares) may also be eligible for inclusion. This would make the DRM model relevant for non-banking entities that risk manage the interest rate exposure for their equity classified instruments.
- Irrespective of whether AT1s are included in IRRBB, the methodologies used to measure the risk associated with AT1s are aligned to the risk management view of those instruments for interest rate sensitivity, e.g., standardised time buckets, EVE, earnings-based sensitivity etc.
- Respondents noted the current issues in hedging resulting in proxy hedging and noted that this could become worse post FICE impacting liability classification of AT1, indicating that the size of the risk management issue is likely to increase, without actions in future accounting standards.
- Respondents express that whilst Loss-Absorption features would need to be dealt with in the lifecycle management of CNOP, these should not impact inclusion in DRM on going concern basis. These features are not a material consideration for risk management given the likelihood of these features being triggered being considered remote.

Section 1:
Survey responses on issuance of AT1 instruments

Does your firm issue AT1s?



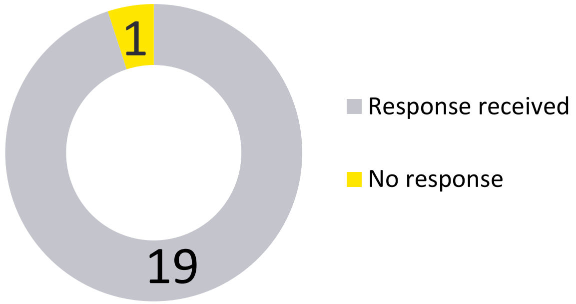


Further comments:

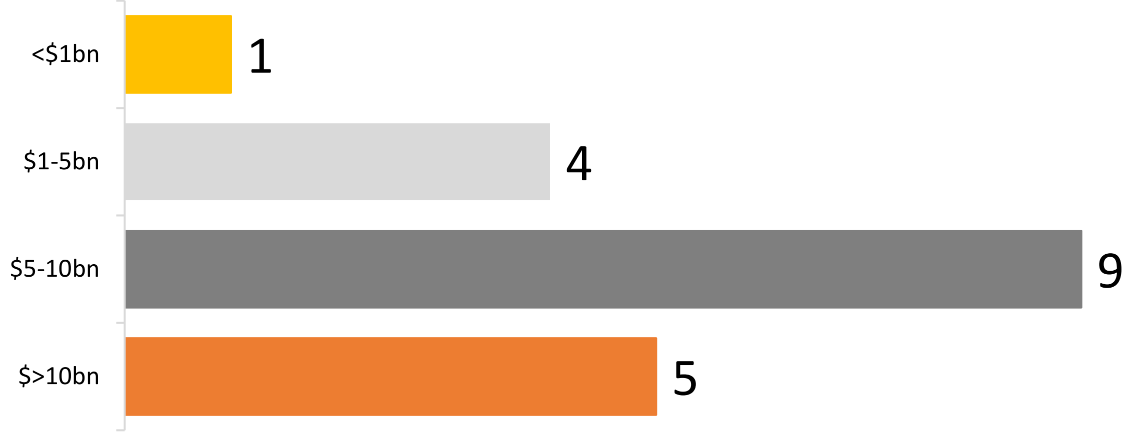
- All the banks and financial conglomerates that responded issue AT1 instruments, while the 1 advisor does not.

What is the size of total AT1 issuances outstanding in accordance with the latest published set of financial statements?

Response Summary:



Response:



Further comments:

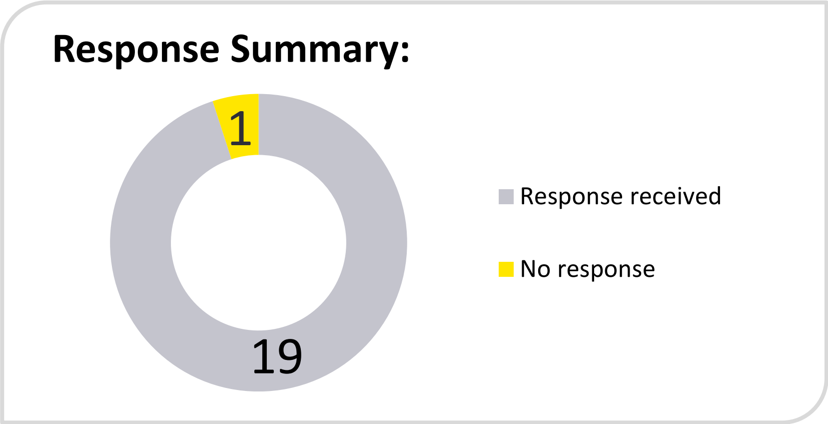
- Diverse AT1 issuance sizes among banks and financial conglomerates, with a clustering in the $5-$10 billion range.
- Five respondents report AT1 issuances over $10 billion, indicating substantial activity by larger institutions.
- A single respondent has an issuance under $1 billion, suggesting smaller issuances are less prevalent.

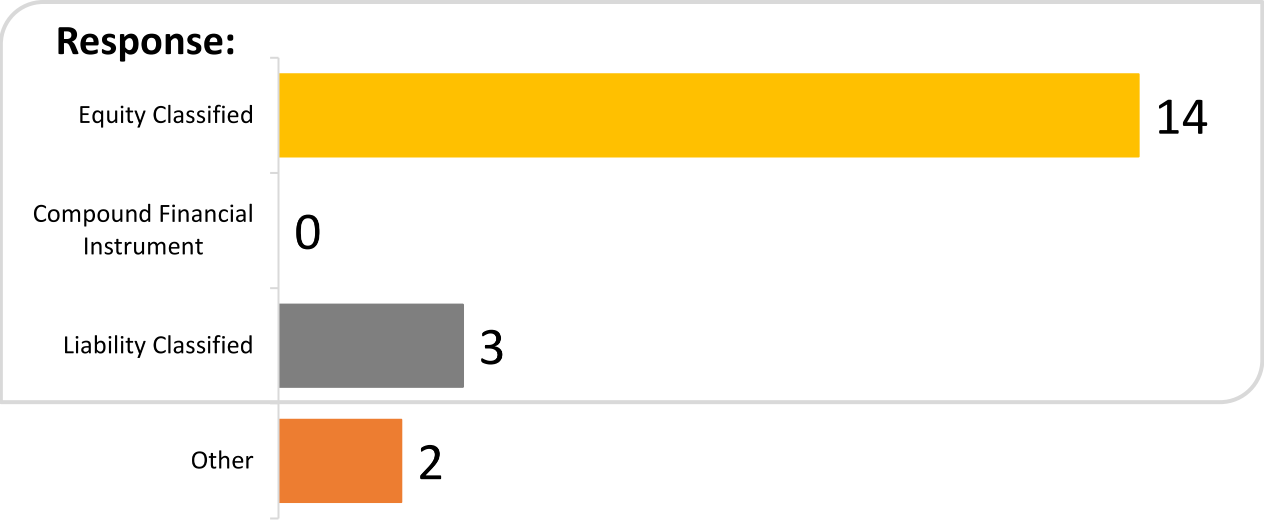
Observation:

- The combined total of AT1 issuances by respondents is USD 159 billion, representing 58% of total AT1s outstanding at 30 June 2024.

Section 2:
Survey responses on classification and measurement of AT1 instruments

What accounting classification is used for AT1 instruments?





Further comments :

- One respondent issues various AT1 types across different jurisdictions, resulting in a mix of equity, liability, and compound financial instrument classifications.
- Another's AT1s with write-down features are equity-classified but if they converted into variable number of shares, they may be compound instruments.
- A third respondent's perpetual AT1s include "must-pay" interest clauses, leading to liability classification. These would not be permitted under EU/UK regulations. Previously they were write-down notes but are now equity conversion instruments upon a CET1 trigger and / or regulator action.
- A fourth respondent noted that their AT1s are classified as liabilities, but the FICE amendments may change the classification to a compound instrument.
- A fifth respondent has AT1s that are compound instruments for which the non-viability trigger is remote, so the liability component is deemed immaterial.

Observation

- Classification of AT1s as equity or liability depends on local jurisdictional, regulatory and legislative factors, which affect the features AT1s must include.

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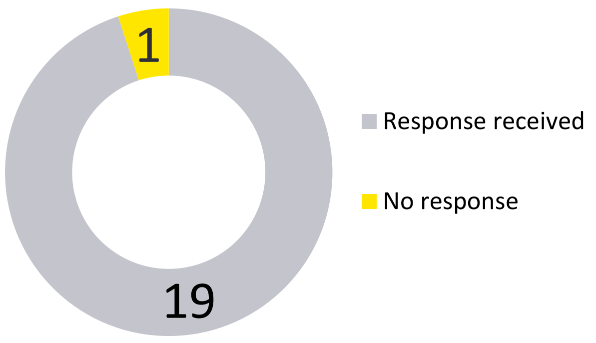
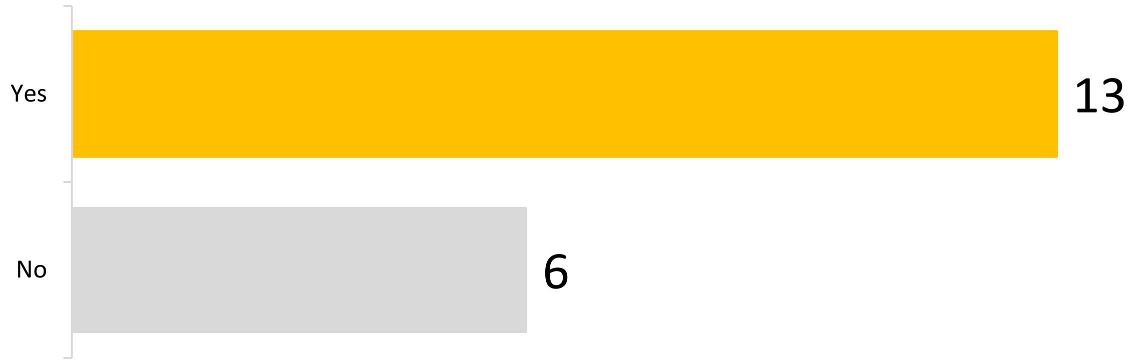
Section 3:
Survey responses on interest rate risk management

Are AT1s included in your Earnings Sensitivity metrics?

Response Summary:



Response:

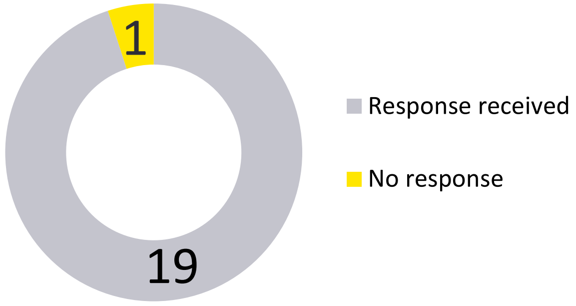


Further comments :

- 13 respondents include AT1s in earnings sensitivity metrics, while 6 do not, suggesting varied risk management practices (or the instrument being seen as fully discretionary and therefore part of the equity model book).

Does interest rate risk from AT1 issuances form part of banking book risk limit framework?

Response Summary:



Response:

Further comments :

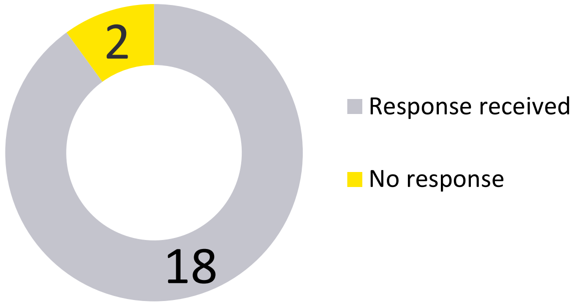
- The majority of respondents incorporate AT1 interest rate risk into their banking book risk frameworks.
- Of the 16 that responded 'Yes', 13 of them classify their AT1s as equity.
- For the three respondents that answered 'No', :
  - One clarified that equity classified AT1s are excluded but compound AT1s are included as a liability.
  - One noted that they are treated the same as any other group treasury issued debt instrument.
  - Another noted that AT1s excluded from IRBBB are mapped as a component of the equity model replicating portfolio, which stabilizes NII.

Observation:

- Whilst there is variation in the accounting classification as debt or equity, the vast majority of respondents include AT1s as part of the interest rate risk in the banking book for the purpose of setting risk limits, or otherwise consider them equivalent to liabilities.

How are AT1 issuances included in IRRBB in practice?

Response Summary:



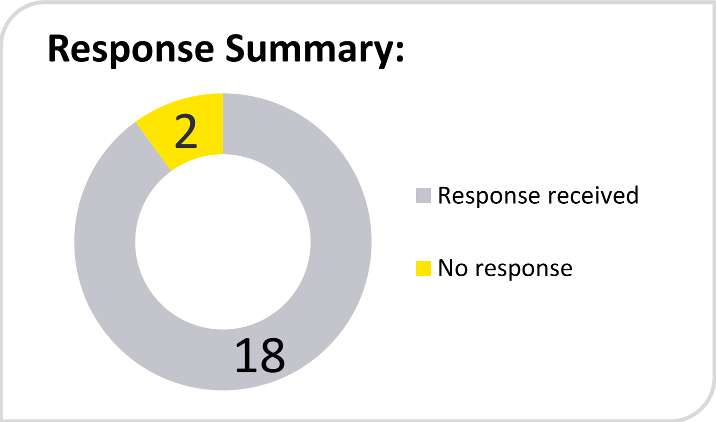
Response:

- AT1s are commonly managed as fixed rate liabilities within IRRBB metrics, up to the call date.
- Some equity-classified AT1s are excluded from IRRBB (because they are seen as fully discretionary and thus part of the equity model book / replicating portfolio) but most are included in IRRB as liabilities, while compound or liability-classified AT1s are included in IRRBB.
- One respondent that does not include interest rate risk from AT1s in IRRBB, noted that they treat those AT1s similarly to other debt instruments issued by the group treasury.
- Several respondents incorporate AT1s in EVE sensitivity and iCAAP calculations with some noting that it is not included in NII sensitivity and some noting that it is in NII sensitivity.
- The cash flow profile of AT1s up to the first call date is factored into IRRBB by the vast majority of respondents. Consistent with this, some respondents note that assumptions about AT1 maturity and interest rate components are used for IRRBB. Some respondents specifically noted that callability dates are included in EVE measures.
- One respondent noted that AT1s are often hedged using instruments classified as 'hold-to-collect' bonds and interest rate swaps until the next call date.

Observation:

- Whilst respondents' AT1s have different features, the treatment reflects that they are classified as an interest-bearing liability from which the risk management strategy follows.

Are AT1s included / profiled in the calculation of EVE?



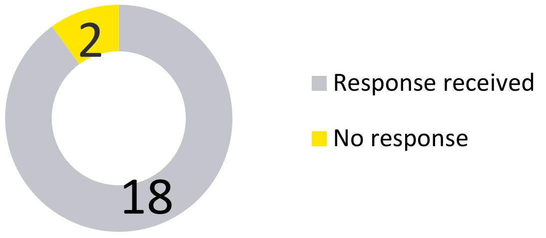
Further comments:

- The majority of respondents include AT1s in the calculation of EVE, indicating an industry standard approach to this calculation.
- One respondent excludes equity classified AT1s from EVE, including only compound or liability classified instruments as other regular financial liability.
- A couple of respondents specifically noted that AT1s are profiled in EVE calculations up to the callability date.

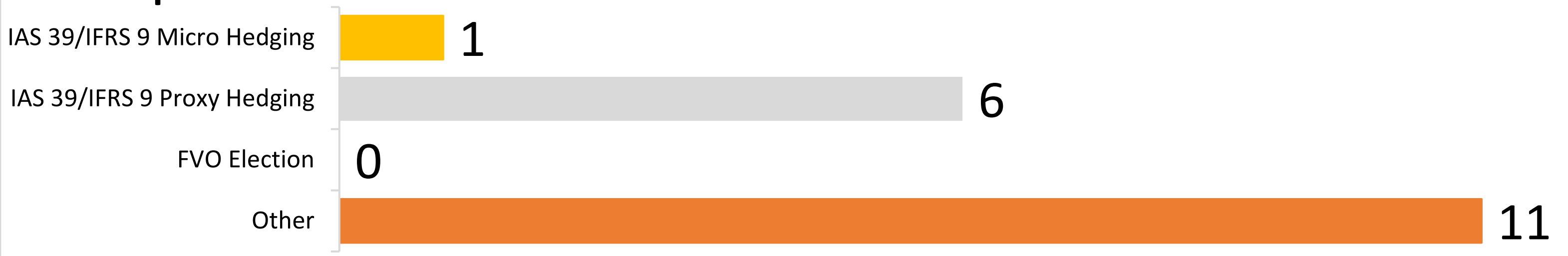
Section 4:
Survey responses on current hedge accounting strategies

Does your firm apply any hedge accounting strategies or accounting elections in relation AT1's?

Response Summary:



Response:



The majority of respondents apply proxy hedge accounting for their AT1s (6 in their primary response plus 6 that responded 'other' and explained their approach).

Other responses include:

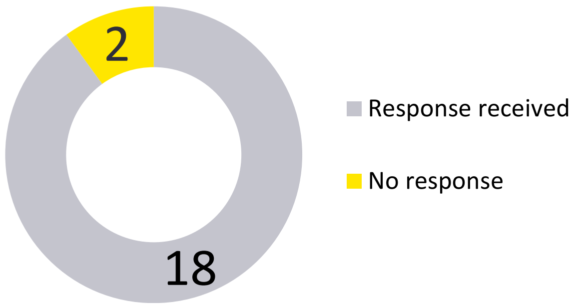
- Two respondents do not apply hedge accounting to their AT1s, attributing this to their equity classification.
- One respondent utilises interest rate swaps in their portfolio fair value hedge, with non-AT1 liabilities designated as proxy hedged items.
- Another respondent that classifies its AT1s as liabilities, uses micro hedge accounting for group treasury issued AT1s and for AT1s issued by their investment bank they apply the fair value option and so these are not subject to hedge accounting.

Observation

- AT1s are prevalent in structural hedges, for which the existing hedge accounting requirements are problematic, requiring the use of proxy hedging.

Can you describe the risk management objective for your AT1 Hedging?

Response Summary:



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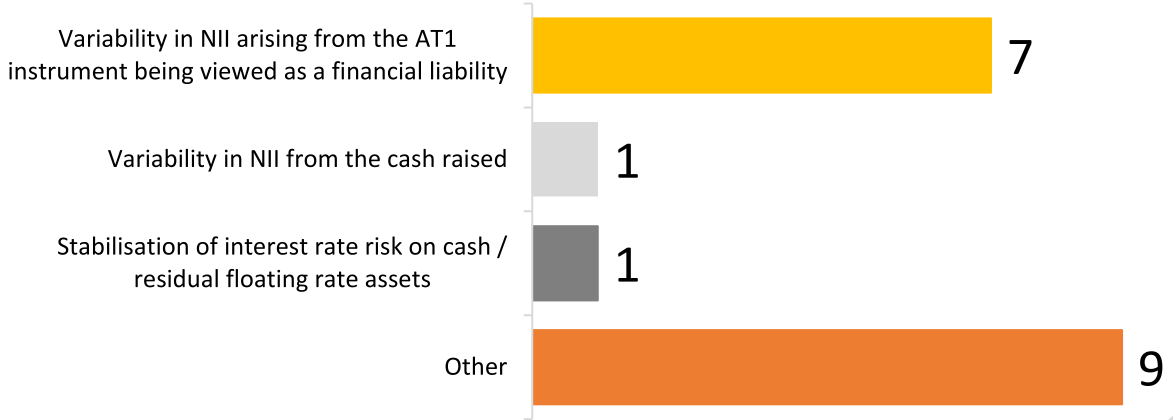


Other risk management objectives include:

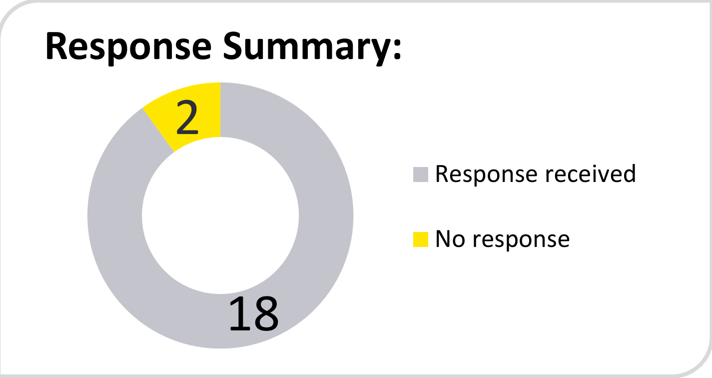
- One respondent that classifies its AT1s as equity noted they do not apply one-to-one AT1 hedging but they are included in IRRBB as financial liabilities.
- Active IRRBB management aimed at reducing NII volatility and maintaining EVE and NII exposure limits.
- Hedging long-term fixed rate AT1s with receive fixed instruments for EVE stabilisation.
- Stabilising NII by hedging the EVE sensitivity of fixed rate financial liabilities.
- Receiver interest rate swaps with maturity at AT1 call date to manage EVE sensitivity to fixed rate.
- One respondent that classifies its Ats as liabilities, uses fair value hedging to hedge changes in the fair value of the fixed rate issued liability.

Observation:

- The responses suggest that AT1s should be included in the CNOP, if the AT1 is managed as a liability for risk management purposes. As a result, it would be most beneficial to the overall relevance and effectiveness of the model if the boundaries of the CNOP are principles based and linked to risk management.

Section 5:
Survey responses on DRM model

Do you think interest rate risk from AT1s should form part of the DRM model?



Reasons provided for inclusion of interest rate risk include:

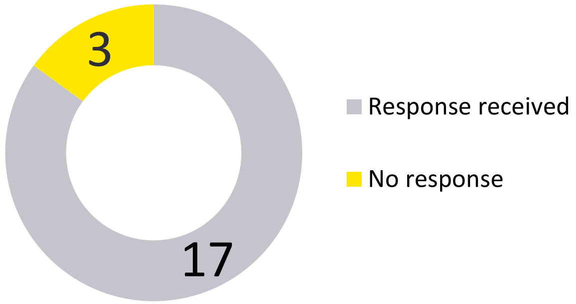
- AT1s generate fixed payments against floating rate receipts, impacting macro risk management.
- Standard AT1s with call dates are already considered in EVE sensitivity and should be mirrored in DRM.
- AT1s, similar to issued fixed rate bonds until the call date. They exhibit interest rate risk akin to financial liabilities.
- Excluding AT1s from DRM would misalign with Risk Management models and practices.
- The DRM project's goal to better represent the effects of risk management activities in financial statements. The risk management view supports including AT1s to align with IRRBB.
- EBA Guidelines and EBF positions advocate for AT1 inclusion in DRM as financial liabilities, especially when instruments have call dates and are included in IRRBB.

Observation

- If AT1s could be included in the CNOP, the inclusion should be principles based, which would potentially allow the inclusion of other equity instruments.

What is your expectation of the accounting treatment in the event the loss absorption feature of an AT1, which is part of the DRM adjustment, is triggered? Is this a material item for consideration as part of ongoing interest rate risk management?

Response Summary:

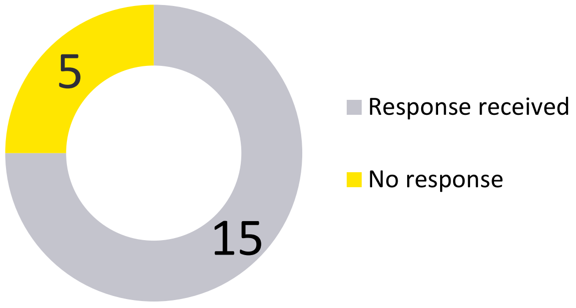


Response:

- Some respondents mention that DRM adjustments should not change if the risk and hedging requirements remain the same post-conversion to equity (for loss absorption purposes), particularly if the AT1 is already included in CNOP.
- A few responses suggest that the loss absorption feature of AT1s should be treated like features of core demand deposits within the DRM model, while others consider it immaterial due to the very low likelihood of being triggered.
- There is a view that AT1 write-downs should be recognized in P&L upon loss absorption, with no need for further interest rate risk management actions.
- Several respondents emphasize that hedging strategies and risk management are conducted on a going concern basis, suggesting that AT1s should be excluded from CNOP in the event of a credit event.
- Some respondents note that the specific accounting for an AT1 conversion event will depend on the facts and circumstances, and if conversion affects the economic hedging position, DRM adjustments may be warranted. If loss absorption triggers conversion to CET1 shares, this could lead to a change in the open position and potential DRM adjustment release.

When considering capital stock more broadly, do you think that there are other financial instruments that would benefit from a principle-based approach as part of the DRM model, similar to AT1 issuances, for example equity accounted preference shares?

Response Summary:



Response:

- Some respondents suggest including equity accounted preference shares and similar perpetual instruments in DRM, akin to AT1s.
- A number of respondents call for a broader principle-based approach in DRM, consistent with IRRBB, to encompass all capital stock with interest rate risk characteristics, including equity and preference shares.
- Certain respondents identify specific instruments like NVCC non-cumulative redeemable preference shares and limited recourse capital notes as candidates for DRM inclusion.
- One respondent prefers a simple capital structure but supports including equity portfolios and deposits in DRM.
- Some respondents commented that they had no instruments other than AT1s within their capital stock that needed to be specifically considered.