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Prepared for: EFRAG
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Comments on EFRAG Discussion Paper "Accounting for Pension Plans with an Asset-Return Promise".

Introduction

This paper is on behalf of Aon. We appreciate the opportunity to comment on the EFRAG Discussion Paper “Accounting for Pension Plans with an Asset-Return Promise“(the DP). We would be glad to provide additional information to EFRAG and would welcome the opportunity to discuss any issues with you.

About Aon

Aon is a leading global professional services firm providing advice and solutions in Risk, Retirement and Health at a time when those topics have never been more important to the global economy. Aon develops insights – driven by data and delivered by experts – that reduce the volatility out clients face and help them maximize their performance.

Aon 50,000 global employees in 120 countries consult to more than half of the Fortune 500™, more than one-third of the Global 500, three-quarters of the FTSE 100, and a host of other important organisations ranging from large NGOs to charities. Globally we provide compensation, benefits, and other forms of human resources consulting to major organisations across all industries.

Worldwide we provide actuarial services to hundreds of companies that sponsor Defined Benefit Plans, Defined Contribution plans as well as varying kinds of so-called Hybrid Plans, including plans with an Asset-Return Promise as defined in the DP.

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Summary

Our detailed responses to the questions raised by EFRAG are set out in the Appendix to this letter. Our key points are summarised below:

We agree that:

- Hybrid plans do not sit well within IAS 19 and while IAS 19 paragraph 29(b) clearly requires that the value of any guarantee be reflected in the IAS 19 accounting of such plans, inconsistencies regarding how this is achieved exist in practice and thus further guidance would be beneficial.
- The IASB has made it clear that there is no appetite currently to fundamentally review IAS 19, so any proposed amendment would need to fit into the current IAS 19 valuation approach without

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creating further inconsistencies between the accounting for various types of plans.

- The DP considers three approaches to value pension plans with an asset-return promise and while we see merits to all of them, we believe that the Capped Asset Return approach best fits the current standard, is easy to implement and is thus the preferable approach in terms of costs and benefits.

However, we believe that:

- The scope of the DP is very narrow and needs further clarification, without which we believe the DP might lead to more uncertainty as to the interpretation of which plans are intended to fall into its scope which could increase rather than reduce divergence in practice as compared to the current IAS 19 (for more details on this point see our answer to question 1 in the Appendix to this letter).

- The Fair Value based approach and the Fulfilment Value approach require complex modelling and valuations (e.g. Black/Scholes or extensive Monte Carlo simulations). We don't believe this added complexity and associated cost would be justified. Further, we believe these approaches would lead to greater divergence with U.S. GAAP. While U.S. GAAP does not provide specific guidance on accounting for pension plans with an asset return promise, it has been our experience that, where such plans exist, approaches not dissimilar to the Capped Asset Return approach have often been used under U.S. GAAP as well as IAS 19.

- The DP assumes that remeasurements under the Fair Value based approach and the Fulfilment Value approach are presented in profit and loss. This would be a significant deviation from the current IAS 19, which requires actuarial gains and losses to be recognised in other comprehensive income, and we feel strongly that this would introduce more inconsistencies in accounting treatment and less comparability in financial statements than exists currently and should therefore not be adopted.

Signed on behalf of Aon

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Appendix

Question 1 – Scope

The Discussion Paper addresses only those pension plans that have an asset-return based promise and hold the assets upon which the benefits are dependent. Do you think that the approaches could also be applied to those plans with an asset-return promise, where the plan does not hold the reference assets?

In our opinion the measurement of the obligation of pension plans should not depend on whether assets qualify as plan assets under IAS 19, are recognised as other assets or are not held at all (notional assets). We therefore believe that the approaches could and should also be applied to those plans with an asset-return promise, where the plan does not hold the reference assets to avoid creating further inconsistencies in accounting treatment.

As mentioned above we further believe that the scope of the DP, which appears rather narrow, needs further clarification. The DP defines an asset-return promise as “a post-employment benefit which amounts to the higher of the return on an identified item or group of items (e.g. a portfolio of equities) and a minimum, guaranteed return”. It further mentions that part of the actual asset returns may be used to cover administration costs related to the plan, so not all returns need to be transferred to the beneficiaries.

However, paragraph 2.4 of the discussion paper appears to say that if the asset returns to be included in the members’ benefit is at the discretion of the entity then a plan would not fall into the scope of the DP. If this is indeed the case we believe Swiss DC plans, which provide:

- An interest credit on members’ account balances that while linked to the actual asset returns is granted *at the discretion* of the Board of the Pension Fund each year (i.e. it could be higher or lower than the realized asset return in any given year); and

- A guaranteed return (between 1% and 0% depending on the other mandatory features of the plan)

would not be included in the scope of the DP. We wonder whether this is EFRAG’s intention?

What about plans that provide a return based on inflation (or some other economic index) as well as a minimum guarantee? These appear to fall outside the scope of the DP despite the fact that they provide benefits which may be economically very similar to a plan that provides an asset-return promise.

We strongly believe that care needs to be taken to ensure that any definition of scope does not create a new form of accounting for certain plans that are only marginally different from plans that fall outside the scope thus creating new anomalies.

Furthermore, we note that the DP is silent on a major feature that is common in plans that appear to be asset-return promises. Many such plans have an established practice of (or more unusually a commitment to) allowing retiring members to convert their account balances into an annuity on off-market terms. We do not believe that the existence of this feature should exclude a plan from the scope of this DP but note that unless the additional obligation of this feature is expensed over service, a strain arises at retirement. Thus, any valuation approach adopted would need to take this into account.

Question 2 – Assessment of Approaches – Aspects to consider

Do you agree with the aspects of qualitative characteristics considered in the assessment of the various approaches in Chapter 5? If not, which aspects do you think should/should not have been considered? Do you agree with the assessments of the various approaches made in Chapter 5?

a) *Does the approach reflect how the pension obligation will be settled?*

   We agree with the EFRAG assessment.

b) *Is the economic covariance between plan assets and pension obligation reflected?*

   We agree with the EFRAG assessment for the Fair Value based approach and the Fulfilment Value approach. However, in our view the Capped Asset Return approach eliminates measurement inconsistencies of the current IAS 19 and we would thus give it two stars.

c) *Is a net pension liability recognised when the plan assets are expected to be insufficient to cover the portion of the final benefit entitlement for the service provided to date?*

   We agree with the EFRAG assessment.

d) *Does the calculation of current service cost result in a useful reflection of pension cost related to a particular period?*

   It is our understanding that the Fair Value based approach and the Fulfilment Value approach cannot take a backload correction into account. As this is a requirement under IAS 19 we would give these two approaches two stars each rather than three.

e) *Is information about the value of the minimum return guarantee provided?*

   We agree with the EFRAG assessment for the Fair Value based approach and the Fulfilment Value approach. The Capped Asset Return approach (as well as the current IAS 19) do include the guarantee element implicitly – as part of measurement of the DBO – so we would award them one star each.

f) *Is the employee's right to receive the higher of the return on plan assets and the minimum guaranteed return reflected in a complete manner?*

We agree with the EFRAG assessment.

g) *Can requirements be applied retrospectively?*

We agree with the EFRAG assessment for the Capped Asset Return approach. However, we would give one star to the Fair Value based approach and the Fulfilment Value approach as we believe that it may not be straightforward to gather sufficient information to apply the approach to prior periods.

h) *Is the obligation element related to the minimum guaranteed return accounted for similarly to plans under IAS 19?*

We agree with the EFRAG assessment for the Capped Asset Return approach. However, the two other approaches differ fundamentally from the existing IAS 19 measurement requirement, so we would not give them any star.

i) *Is the obligation related to the return on plan assets accounted for similarly to plans under IAS 19?*

For the reasons outlined under h) no star for both the Fair Value based approach and the Fulfilment Value approach; two stars for the Capped Asset Return approach.

j) *Is the information understandable?*

We do agree with the EFRAG assessment for the Fair Value based approach. The Capped Asset Return approach appears in line with the current well-established IAS 19 principles and valuation methods and we would therefore award it three stars. The Fulfilment Value approach seems to be the most complicated and least understandable approach, so we would give it one star only.

k) *Will the implementation of the approach be uncostly?*

We agree with the EFRAG assessment for the Fair Value based approach and the Fulfilment Value approach. For the Capped Asset Return approach, we do not foresee any additional costs and would therefore give it three stars.

Question 3 – Assessment of Approaches – Aspects to Complexity

The assessment in Chapter 5 of the costs related to the various approaches presented in this Discussion Paper, only considers implementation costs. Do you think that the complexity related to preparing financial information in accordance with the approaches would differ significantly? If yes, which approaches would be the most complex and least complex to apply?

The Fair Value-based approach and the Fulfilment Value approach, which both require complex valuation methods very different to the projected unit credit method otherwise used under IAS 19, will, in our opinion, lead to significantly higher valuation expenses on an ongoing basis. We believe that only the Capped Asset Return approach does not require much additional effort as compared to the current approach.

Question 4 – Choice of Approach

Which of the three alternative approaches, presented in this Discussion Paper, do you support? How should it be further developed?

We would support the Capped Asset Return approach. We note that in countries where asset return promises are prevalent practical solutions have been developed to value these plans that are not dissimilar to the Capped Asset Return approach.

For example, in Germany where we observe a growing number of these plans the prevalent consensus by preparers, actuaries, auditors and enforcers on the valuation of such pension commitments is effectively very similar to the Capped Asset Return approach. Interestingly, the broad accounting consensus in Germany for this kind of benefits applies not only to plans that fall into the narrow scope of the DP but also to plan designs in which the related assets do not qualify as plan assets or plans that are unfunded (i.e. where there exists only a notional link to assets).

In Belgium employers are required to provide a minimum return on the contributions for defined contribution plans. Overall, we observe consensus between actuarial consultants to project the past and current contributions with the minimum return and to actualise with the discount rate as defined under IAS19. For insured plans with individual accounts, the maximum of the projected minimum return and the projected account balance is considered at every instance of the projection loop for each beneficiary. This methodology does not take into account the maximum between the projections based on the minimum return and on the capped asset return.

Unfortunately, the major audit firms have all defined their own specific methodology which leads to divergence and inconsistency on the market. Differences usually relate to the way the fair value of plan assets are determined, the way current shortfalls are treated (which may disappear in the future), but also on whether only past and current or future contributions should be included in the measurement of the liability.

As mentioned above we believe that the approach ought to be developed further to consider member options such as conversion of the account balances into annuities at off market rates, the measurement of plan assets for insured plans and the treatment of current shortfalls.

We further believe that the scope needs to be carefully considered and clarified to ensure plans that provide economically similar benefits will be valued consistently.

Finally, further developing the Capped Asset Return approach into a Fixed Asset Return approach, i.e. replacing the expected return included in the measurement of the obligation by the IAS 19 discount rate could be considered. This would be in line with the amendment to IAS 19 in 2011, which eliminated the expected return on asset assumption from the expense calculation and replaced it with the discount rate. This would also have the advantage that in cases where the expected return is below the discount rate, the obligation would be valued appropriately without complex asset ceiling applications.

Question 5 – Presentation of Remeasurements under the Fair Value Based Approach and the Fulfilment Value Approach

This Discussion Paper assumes that remeasurements under the Fair Value Based approach and the Fulfilment Value approach are presented in profit or loss. Do you agree with this approach? If not, how would you present components of defined benefit costs other than service costs?

We do not agree with the suggestion to recognise remeasurements under the Fair Value Based approach and the Fulfilment Value approach in profit and loss (P&L), as this would be a significant deviation from the general approach of IAS 19, which requires actuarial gains and losses to be recognised in other comprehensive income (OCI).

For pure DC plans where member benefits are linked to the actual assets, the issue does not arise as liability gains/losses will be exactly balanced by equal and opposite asset gains/losses. There is therefore no implication in IAS 19 that "DC" type benefits require recognition of gains/losses in P&L. We therefore see no reason why asset return promises should be required to recognise remeasurements in P&L whereas more traditional defined benefit plans recognise remeasurements in OCI.

In our opinion, this would introduce inconsistencies in accounting treatment and reduce the comparability of financial statements significantly.

We believe if either of these two valuation approaches were to be adopted, despite its complexities, an interest cost on the DBO would need to be determined (net of any effects due to changes in the discount rate). Any remaining changes in the DBO would then be recorded in OCI.

Question 6 – Risk Adjustment for Fulfilment Value Approach

As stated in paragraphs 4.56 to 4.57, this Discussion Paper proposes that a risk adjustment for non-financial risks is made when discounting the pension obligation under the Fulfilment Value approach. Do you agree?

The modelling of the Fulfilment Value approach would need to include the usual actuarial assumptions such as mortality/longevity and attrition rates as well as assumed retirement age.

However, we do not believe that further risk adjustments are appropriate. Such adjustments would invite a discretionary choice by the reporting entity and would therefore significantly reduce the comparability of financial statements.

Question 7 – Disclosure

Do you think that additional disclosure requirements about pension plans, included in scope of this Discussion Paper, should be added to the requirements of IAS 19?

We agree with the conclusion in the DP that the application of alternative accounting approaches would lead to additional disclosure requirements. The Capped Asset Return approach would require the least amount of additional disclosures while the complexities of the Fair Value Based approach and the Fulfilment Value approach would require significant additional disclosures which may not fit well into the current IAS 19 disclosure requirements.

Question 8 – Alternative Approaches

Do you think there are other approaches to account for the pension plans within the scope of this Discussion Paper that should have been considered? If so, which approaches?

We have no further comments that have not already been raised in the answers to the questions above.