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aba Comment Letter

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EFRAG Discussion Paper

“Accounting for Pension Plans with an Asset-Return Promise“

The **aba Arbeitsgemeinschaft für betriebliche Altersversorgung e.V.** - is the German association representing all matters concerning occupational pensions in the private and public sector. The aba has 1,100 members including corporate sponsors of pension schemes, IORPs, actuaries and consulting firms, employer associations and unions, as well as insurance companies, banks and investment managers. According to our statutes, our mission is to represent existing schemes as well as to expand coverage of occupational pensions independent of vehicle. We are a member of the European Association [PensionsEurope](#).

Please do not hesitate to contact us if you have any questions:

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Comments regarding EFRAG's Discussion Paper "Accounting for Pension Plans with an Asset-Return Promise"

aba – Arbeitsgemeinschaft für betriebliche Altersversorgung e.V., a member organization of PensionsEurope and the representative of occupational (workplace) pensions in Germany appreciates the opportunity to comment on EFRAG's Discussion Paper "Accounting for Pension Plans with an Asset-Return Promise" (in the following: the "DP").

We will begin our comments with a summary of our view on the DP and the accounting of pension plans with asset-return based benefits. Then we will answer the questions raised in the discussion paper in more detail.

We appreciate EFRAG's DP as an important contribution to the ongoing discussion at the IASB and throughout the accounting community around a true and fair view on asset-return based pension promises with the overarching aim to improve the accounting for such plans.

The discussion paper focuses on three potential accounting approaches for asset-return based pension promises:

- (1) the Capped Asset Return Approach,
- (2) the Fair Value-based Approach and
- (3) the Fulfilment Value approach.

We understand that the Fair Value-based Approach and the Fulfilment Value Approach are derived from recent developments and considerations in other parts of the IFRS (especially e.g. IFRS 17). In our understanding especially the Fair Value-based Approach seems to be an attractive option from a conceptual point of view.

However, we also note that it is broad consensus within the accounting community and with the IASB that improvements to pensions accounting should not aim to rethink IAS 19 fundamentally, but instead should focus on fixes that seamlessly fit into the current IAS 19.

As we take the view that both the Fair Value-based Approach and the Fulfilment Value Approach are overly complex, costly in application and are not fitting well with the existing IAS 19 we do not favor them. The Capped Asset Return Approach on the contrary appeals to us as the preferable solution in terms of costs and benefits. In addition, it will also fit into today's IAS 19.

The Fair Value-based Approach and the Fulfilment Value Approach require complex modelling and valuations, e.g. Black/Scholes or extensive Monte Carlo simulations. While those models are well-known and well-introduced for (relatively simple) stock option plans, the application to company pension plans will in most cases be much more complex. This is due to the much longer time periods to be considered; additionally, there is no single fixed due date. In Germany, for example, it is common for pension plans to also grant benefits in case of disability or death in service. These benefits are often also linked to securities in these plans. Therefore, all possible events leading to benefits have to be taken into account by separate and extensive Monte Carlo simulations. This results in an overly complex and costly valuation exercise.

Furthermore, we are aware that the Black/Scholes model is incompatible with negative discount rates.¹ Please note that negative (pension) discount rates are already reality, e.g. in Switzerland for the 2019 Q3 accounting exercise, i.e. they cannot be ignored in the current market environment.

Accordingly, we view the additional efforts related to the Fair Value-based Approach and the Fulfilment Value Approach as not reasonably proportional to the additional insights provided – especially compared to simpler approaches, such as the Capped Asset Return Approach.

We also note that the outcome of such calculations / simulations is in particular very dependent on the specific valuation parameters (most prominently the assumed volatility of the underlying assets). As the asset allocation might change over time, sometimes in the discretion of the employee, so will the volatility and other valuation parameters. This would require a very clear guidance or clear principles for determining an acceptable volatility as per a specific measurement date. Otherwise comparability of financial statements could be impaired as obviously the value of any guarantee within the plans in scope can be minimized by arbitrarily assuming a very low volatility.

Finally, the Fair Value-based Approach and the Fulfilment Value Approach do not fit directly in IAS 19; instead both approaches would constitute a new category of plan types with a very different accounting treatment. The DP assumes that remeasurements under the Fair Value-based approach and the Fulfilment Value approach are presented in profit and loss. We strongly oppose to such an approach as it would be a significant deviation from the general approach of IAS 19, which requires actuarial gains and losses to be recognised in OCI. The comparability of the financial statements would deteriorate significantly.

The Capped Asset Return Approach, on the other hand, is certainly fitting into the current IAS 19. Moreover, we take the view that this approach could even be extended to a “Fixed Asset Return Approach”. Limiting the expected return to the technical interest rate used for discounting the liabilities will not necessarily solve the accounting mismatch in cases where the expected return is below the technical interest rate. If corresponding plan assets are available, the asset ceiling may become effective in these cases and prevent an accounting mismatch. In cases, however, where the underlying assets are not plan assets, the assets and liabilities continue to diverge. We therefore recommend to fully replace the expected return for the DBO calculation by the actuarial interest rate. This is also in line with the amendment to IAS 19 in 2011, which replaced the expected return in calculating expenses with the technical interest rate.

The discussion paper is limited to those cases in which plan assets corresponding to the pension promise exist. However, we do not consider this restriction to be necessary or appropriate. The measurement of obligations cannot depend on whether assets qualify as plan assets, are recognised as other assets or are not held at all (notional assets).²

Finally, however, we see only limited pressure to change the current accounting practice anyway. Pension plans with asset-return promises have been existing for many years, and practical solutions have been developed over time. In Germany, for example, there is a broad consensus of preparers, actuaries, auditors and enforcers on the valuation of such commitments. The result is relatively close to the Capped / Fixed Asset

¹ <https://www.bloomberg.com/news/articles/2019-09-30/how-negative-rates-broke-black-scholes-pillar-of-modern-finance>

² Cf. IAS 19 BC 130

Return Approach. We do not have the impression that there are serious discrepancies between different valuation approaches when evaluating such commitments. The comparability of the financial statements is not materially affected by these plans.

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?

As mentioned above we take the view that it should make no difference whether assets qualify as plan assets, are recognised as other assets or are not held at all (notional assets) when measuring the obligation. The alternative approaches discussed in the paper appear to be applicable in all these cases.

QUESTION 2 – ASSESSMENTS 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?

We do agree with some but not with all the assessments. Please find our assessment on each question below:

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

We do agree with the EFRAG assessment.

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

We do agree with the EFRAG assessment for the Fair Value-based Approach and the Fulfilment Value Approach (three stars each). However, in our view the Capped Asset Return Approach eliminates measurement inconsistencies of the current IAS 19 and thus the economic covariance would be better reflected by using that approach (two stars for the Capped Asset Return Approach).

- 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 do 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?

As mentioned under c) the Capped Asset Return Approach eliminates a related inconsistency and is thus appropriate in order to reflect the pension cost to a particular period (three stars). In addition, in our understanding the two other approaches cannot take a backload correction properly into account, though this appears to be mandatory under IAS 19 (two stars for the Fair Value-based Approach and the Fulfilment Value Approach).

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

We do agree with the EFRAG assessment for the Fair Value-based Approach and the Fulfilment Value Approach (three stars each). The Capped Asset Return Approach (as well as the current IAS 19) do include the guarantee element implicitly – as part of measuring the DBO – as well (one star for the Capped Asset Return Approach).

- 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 do agree with the EFRAG assessment for the Fair Value-based Approach and the Fulfilment Value Approach (three stars each). The current IAS 19 does not reflect the link between the DBO and the fair value of assets. The Capped Asset Return Approach however takes this into account. The approach also takes the employee's right to receive the higher of the return on (plan) assets and the minimum guaranteed return appropriately into account (two stars for the Capped Asset Return Approach).

- g) Can requirements be applied retrospectively?

We do agree with the EFRAG assessment for the Capped Asset Return Approach (three stars). However, the application of the two other approaches would in our understanding require additional and quite extensive research in order to also appropriately value the plan for previous periods, e.g. research on assumptions for volatility and markets (one star for the Fair Value-based Approach and the Fulfilment Value Approach).

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

We do agree with the EFRAG assessment for the Capped Asset Return Approach (three stars). The two other approaches, however, do differ fundamentally from the existing IAS 19 measurement and accounting approaches (no stars for both the Fair Value-based Approach and the Fulfilment Value Approach).

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

For the reasons as 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 (two stars) The Fulfilment Value Approach seems to be the most complicated and least understandable approach (one star only). The Capped asset return Approach is in our view in line with the current and well-established IAS 19 principles and valuation methods (three stars).

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

We do agree with the EFRAG assessment for the Fair Value-based Approach and the Fulfilment Value Approach (one star each). For the Capped Asset Return Approach, we do not foresee any additional costs (three stars).

QUESTION 3 - ASSESSMENT OF APPROACHES – ASSESSMENT OF 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?

Ongoing, the Fair Value-based Approach and the Fulfilment Value Approach will lead to significantly higher valuation expenses. The valuation would be completely different from the usual IAS 19 method; with the result that additional processes have to be carried out every year. 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 clearly prefer the Capped Asset Return Approach. However, it should be further developed into a Fixed Asset Return Approach as mentioned above. The expected return included in the measurement of the obligation should be replaced by the actuarial interest rate of IAS 19. This is in line with the amendment to IAS 19 in 2011, which eliminated the expected return from the expense calculation and replaced it with the discount rate. Another advantage of this further development would be that even in cases where the expected return is below the discount rate, the obligation would be valued appropriately without complex asset ceiling application.

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?

In our opinion, this approach would be a significant deviation from the general approach of IAS 19, which requires actuarial gains and losses to be recognised in OCI. Such a completely different approach would not fit well into IAS 19. In our view, it would also reduce the comparability of the financial statements significantly.

We take the view that for these two valuation approaches interest cost would need to be determined as well (net of any effects due to changes in the interest rate) while the remaining change in the DBO needs to 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? Which risks do you consider such an adjustment should cover?

We do not believe that such a risk adjustment, neither for non-financial risks nor for financial risks, is appropriate. These adjustments would invite a discretionary choice of adjustments by the reporting entity – similar to what IASB eliminated from IAS 19 in 2011 with the expected return rate assumption. In our opinion, such approaches are very theoretical in nature and will lead to annual financial statements lacking comparability.

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?

Apart from the suggestions in the discussion paper, we do not see any further requirements for disclosures in the notes. However, it should be noted that both the Fair Value-based Approach and the Fulfilment Value Approach are complex. Even with additional disclosures it is not certain that users of financial statements will be able to understand correctly the information on pensions. As valuation methods differ from those used for other plans (which may contain explicit or implicit guarantees in many forms other than asset-return promises), even actuaries will have difficulties to properly assess the risks on the basis of the information presented in the annual report.

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?

Plans with asset return-based components have been around for many years in many countries (including Germany). Practical solutions have been developed. The economic content is likely to be adequately reflected in all developed solutions, and large discrepancies between different valuation approaches are not to be expected. This raises the question whether an amendment to IAS 19 is necessary at all. It should also be noted that this topic has been discussed for many years now, with no one being able to develop solutions that can be applied in many different countries without creating discrepancies with existing plans, fundamentally changing the general valuation approach of IAS 19 or other unintended consequences.

We would be happy to discuss our views with you in more detail or answer any further questions you may have.

Yours sincerely,



Klaus Stieffermann
Secretary General / CEO