

REQUEST FOR FEEDBACK – QUESTIONNAIRE

ACCOUNTING FOR PENSION PLANS WITH AN ASSET-RETURN PROMISE

QUESTIONS TO CONSTITUENTS

EFRAG invites comments on all matters in this Discussion Paper, particularly in relation to the questions set out below. Comments are more helpful if they:

- Address the question as stated;
- Indicate the specific paragraph reference to which the comments relate; and/or
- Describe any alternative approaches that should be considered. Comments should be received by 15 November 2019.

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?

We would like to limit the scope to pension plans that hold the assets upon which the benefits are dependent.

Since the computation of the fair value of assets and calculation of the promise are intertwined for plans that offer an asset-return promise, there is a fundamental difference between a plan that offers an asset-return promise on assets it actually holds and a plan that offers an asset-return promise on assets it does not hold. If we do not take into account the minimum guarantee, the first plan is riskless and the employer should not have any liability: the assets have covered for all liabilities, since the only promise is the asset-return. Plans that do not hold the assets of which they promise the return to their members are risky by design and should make proper estimations of the expected return on these assets.

For example:

- Plan A: offers the return on the assets in possession, which are all Belgian OLO's.
- Plan B: offers the return on Belgian OLO's, but invests all assets into cash.
- The fair value of the plan assets is for both plans 10 million euros.

Plan A is riskless and will always be capable of providing the benefits provided for by the plan. If it changes its asset allocation to 100% cash, the members will no longer be eligible to the guarantee of the Belgian OLO's. The liability for this plan should always be equal to the fair value of assets.

Plan B is riskier and will probably not be able to provide the benefits to which the plan's members are entitled unless the employer provides further financing of the past service rendered. The liability for this plan should therefore not be constantly equal to the fair value of assets. It could be higher or lower.

Since the fair value of assets for both plans is equal to 10 million euros, the liability should be measured otherwise.

Both plans should therefore be accounted for differently regardless of the minimum guarantee offered.

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 (=assessment of the approaches – see slide later on?)

Remark on the statement "*Is the information understandable?*": The Capped Asset Return Approach is at least as understandable as the other methods.

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?

The Fair Value Based approach and the Fulfilment Value approach are complex methods based on actuarial assumptions and computations (e.g. for the yearly option prices). These approaches are much more complex than the approaches which companies currently use for calculating their pension plans with an asset-return promise or a minimum guaranteed return (hybrid plans). By

contrast, the Capped Asset Return approach is less complex and is much more in line with the current calculation approaches for hybrid plans. Its implementation and application processes will be much less costly than those required for the Fair Value Based approach and the Fulfilment Value approach.

Clearly, after the operational changes to the processes and related software, the application processes of the Fair Value Based approach and the Fulfilment Value approach will remain costly. The required actuarial assumptions and computations are complex and will have to be reassessed every year, leading to higher human resources costs (or outsourcing costs). There are also practical implications. For instance, more variables enter into the calculation processes which require actuarial expertise and professional judgement, making the calculations less understandable for general accountants (not specialists), company management and other stakeholders. The increased complexity may lead to a lower transparency and risks to reduce the attractiveness of these pension plans.

Some companies, e.g. financial institutions, have the expertise and the resources to implement such complex accounting approaches. However, for the average employer this risks to be a very difficult and costly process. The Fulfilment Value approach is a method which is inspired by the accounting treatment under IFRS 17 'Insurance Contracts', one of the most complex IFRS standards. These calculation requirements have been developed for insurance and reinsurance companies having the expertise and resources to make complex actuarial calculations. It would not be appropriate to require each company, regardless of the sector in which it operates, to make comparable complex actuarial calculations for financial reporting purposes because it has introduced a hybrid pension plan for its employees.

If the challenges and costs of the financial reporting requirements for (hybrid) pension plans become excessive, this could act as a disincentive for employers to subscribe to such plans. This is especially true in the current low interest rate environment, where pension plans already have become very costly for employers. Rather than complicating the life of employers, the financial reporting requirements should be supportive so as to incentivize employers as much as possible to provide pension plans for their employees. This is in line with the political will at the European level to generalize the provision of supplementary pensions.

From this perspective it is more appropriate that the IFRS continue to allow for a principles-based approach to calculate hybrid pension plans. The Capped Asset Return approach represents a robust approach which seems to be appropriate for financial reporting purposes and acceptable in terms of costs and complexity for the average employer.

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 oppose to the Fair Value Based approach and the Fulfilment Value approach for the reasons explained in our response to question 3. We support the Capped Asset Return Approach for the reasons explained here below.

Firstly, several insurance undertakings in Belgium already apply this approach or a similar one. This approach being close to current IAS 19 requirements, its implementation costs would thus be low in comparison to the two other proposed approaches.

Secondly, the Capped Asset Return Approach takes into account the covariance between assets and liabilities, since the assets (§113, §115) or reimbursement rights (§119) are estimated as the present value of the expected future cash flows:

- 113 *The fair value of any plan assets is deducted from the present value of the defined benefit obligation in determining the deficit or surplus. When no market price is available, the fair value of plan assets is estimated, for example, by discounting expected future cash flows using a discount rate that reflects both the risk associated with the plan assets and the maturity or expected disposal date of those assets (or, if they have no maturity, the expected period until the settlement of the related obligation).*
- 115 *Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).*
- 119 *If the right to reimbursement arises under an insurance policy that exactly matches the amount and timing of some or all of the benefits payable under a defined benefit plan, the fair value of the reimbursement right is deemed to be the present value of the related obligation (subject to any reduction required if the reimbursement is not recoverable in full).*

Therefore, the fair value of assets and the defined benefit obligation are intertwined, and if the minimum guarantee should become negligible, the correlation between defined benefit obligation and the fair value of assets will become perfect. Hence, in this situation, the fair value of assets will exactly match the defined benefit obligation and the pension expense will exactly match the premium. In this case the Capped Asset Return Approach converges to plain DC-accounting, which is in our view the desired outcome.

The proposed actuarial valuation methods should in first place serve to calculate the liabilities of simple DC-plans as we have in Belgium. The Capped Asset Return Approach is thus a correct approach to measure these liabilities since it is already implemented in IAS 19 calculations.

With a unit linked product with guarantee, the Capped Asset Return Approach will exactly match the way the pension obligation is settled since the computation of the fair value of assets and the defined benefit obligation are intertwined. The predicted settlements are correct if all assumptions are correct (mortality, turn-over, salary increase, etc.), the predicted settlement will even be correctly calculated independently of the chosen discount rate.

The value of the minimum guarantee can be computed in a simple way using the Capped Asset Return Approach: the value would be equal to the difference between the computation done with and without the minimum guaranteed return.

Thirdly, the employee's right to receive the higher of the return on plan assets and the minimum guaranteed return is reflected correctly in the Capped Asset Return Approach: the cash flows

should be taken as the maximum of the two cash flows caused by the two different rates at each instance of the calculation.

You can find in Appendix A two examples of actual IAS 19 calculations using the Capped Asset Return Approach (which in our view correspond with IAS 19 AS IS).

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 agree with this approach of presenting remeasurements in profit or loss under the Fair Value Based approach and the Fulfilment Value approach.

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?

A risk adjustment for non-financial risks should be integrated in the calculations. It should reflect the uncertainty of the used estimations.

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?

The answer is positive in the case of the Fair Value Based approach and the Fulfilment Value approach. Some explanation is required about the used techniques and variables of the option prices used to express the minimum guarantee. The same reasoning applies if a risk adjustment is integrated in the model.

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?

No other approaches to account for pension plans within the scope of this Discussion Paper should have been considered.

* * *

Appendix A

Example 1:

- A unique premium of € 1.000 has been paid on 1/1/2010
- Guaranteed interest rate of 3.25%
- Minimum guarantee of 3.25%
- Discount rate of 1.00%
- No mortality
- No future contributions
- Evaluation on 1/1/2020
- One member, aged 40
- Retirement age = 65

$$\Rightarrow \text{FVA} = € 1.000 \times 1,0325^{10} \times 1,0325^{25} \times 1,01^{-25} = € 2.388,46$$

$$\begin{aligned} \Rightarrow \text{DBO} &= \max (\text{€ } 1.000 \times 1,0325^{10} \times 1,0325^{25}, \text{€ } 1.000 \times 1,0325^{10} \times 1,0325^{25}) \times 1,01^{-25} \\ &= \max (\text{€ } 1.000 \times 1,0325^{10} \times 1,0325^{25}, \text{FVA} \times 1,01^{25}) \times 1,01^{-25} \\ &= € 2.388,46 \end{aligned}$$

(The part in green reflects the minimum guaranteed return; the part in blue reflects the fair value of assets)

$$\Rightarrow \text{Liability in the balance sheet} = € 2.388,46 - € 2.388,46 = € 0,00$$

Example 2:

- A unique premium of € 1.000 has been paid on 1/1/2018
- Guaranteed interest rate of 0.75%
- Minimum guarantee of 1.75% for active employees
- Minimum guarantee of 0.00% for deferred vested
- Discount rate of 1.00%
- No mortality
- No future contributions
- Evaluation on 1/1/2020
- One member, aged 40, deferred vested since 1/1/2019
- Retirement age = 65
- Minimum guarantee at 1/1/2020 = € 1.017,50

$$\Rightarrow \text{FVA} = € 1.000 \times 1,0075^2 \times 1,0075^{25} \times 1,01^{-25} = € 954,07$$

$$\begin{aligned} \Rightarrow \text{DBO} &= \max (\text{€ } 1.000 \times 1,0175^1 \times 1,00^1 \times 1,00^{25}, \text{€ } 1.000 \times 1,0075^2 \times 1,0075^{25}) \times 1,01^{-25} \\ &= \max (\text{€ } 1.000 \times 1,0175^1 \times 1,00^1 \times 1,00^{25}, \text{FVA} \times 1,01^{25}) \times 1,01^{-25} \\ &= € 954,07 \end{aligned}$$

(The part in green reflects the minimum guaranteed return, the part in blue reflects the fair value of assets)

$$\Rightarrow \text{Liability in the balance sheet} = € 954,07 - € 954,07 = € 0,00$$

