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Berlin, 14. November 2019

Dear Jean-Paul,

EFRAG Discussion Paper *Accounting for Pension Plans with an Asset-Return Promise*

On behalf of the Accounting Standards Committee of Germany (ASCG) I am writing to comment on the Discussion Paper *Accounting for Pension Plans with an Asset-Return Promise* issued by EFRAG on 15 May 2019 (herein referred to as 'DP'). We welcome EFRAG's active role in the current discussions on pension accounting and appreciate the opportunity to comment on the DP.

In our view, EFRAG's DP is an additional valuable contribution to the ongoing debate on pension accounting. It addresses the important question, how pension accounting can be improved and should be developed further regarding pension plans that are linked to asset returns. The DP examines three alternative accounting approaches: (1) the Capped Asset Return approach, (2) the Fair Value-based approach and (3) the Fulfilment Value approach. It does not express an explicit preference for one of the approaches presented but encourages the Fair Value-based approach and the Fulfilment Value approach.

We concede that the Fair Value-based approach and, especially, the Fulfilment Value approach (being consistent with the latest IFRS developments and IFRS 17), may be more promising solutions from a purely conceptual point of view. However, considering the pension accounting discussions over the last years and the constraint not to rethink IAS 19's accounting and valuation approach fundamentally, we do not favour an introduction of any of these approaches. We believe that the Capped Asset Return approach better fits the current standard and represents a preferable solution in terms of costs and benefits.

Our view is in line with the feedback we received on our research performed together with Canada, Japan, the U.K. and the U.S. on hybrid pension plans (cf. https://www.ifrs.org/-/media/feature/meetings/2018/july/asaf/ap7-research-on-pensions-hybrid-plans.pdf). At the September 2017 IFASS meeting, IFASS members showed little support for the Fulfilment Value approach. Those who supported it did so as a longer-term solution, since it would require a complete rewrite of IAS 19, and it might be best to wait and see how the implementation of IFRS 17 *Insurance Contracts* proceeds and how the standard is perceived in practice.

In addition, we recommend to further develop the Capped Asset Return approach into a Fixed Asset Return approach, where the expected return is matched with the rate used to discount the liability. In many countries, including Germany, the reference assets often are not held as plan assets (i.e. the asset ceiling is not applicable). In such situations, the pension obligation would not be measured appropriately in cases where the expected return is lower than the discount rate.

Given that most reference assets are not held as plan assets, only a limited number of German pension plans fall within the scope of the DP. Therefore, we also recommend a scope extension. Pension plans where assets are recognised as other assets or are not held by the entity at all (notional assets) should also be covered. We consider the three approaches presented in the DP to be applicable to all these plans.

Finally, we believe that an alternative accounting method based on the IAS 19 model not to be a suitable solution for all types of hybrid pension plans. We do not encourage further consideration of these plans on a case-by-case basis and would like to emphasise that the development of any consistent solution would require a fundamental revision of IAS 19.

Our detailed comments in response to the ED questions are laid out in the appendix to this letter. If you would like to discuss our comments further, please do not hesitate to contact Kristina Schwedler (schwedler@drsc.de) or me.

Yours sincerely,

Andreas Barckow

President

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?

Yes, we believe that the approaches can equally applied to plans where the plan does not hold the reference asset.

Paragraph 2.7 of the DP states that there is a different risk exposure for the reporting entity in the case that (1) the plan holds the reference assets and (2) the plan does not hold the reference assets. In the first case the economic covariance between the pension obligation and plan assets is evident. In the second case, the entity is additionally exposed to the risk that the return earned on any alternative investment (positively or negatively) deviates from the return on the specified pool of reference assets.

In our view, the difference in the risk exposures is no reason for excluding plans that do not hold the reference assets. This view is based on the following reasons:

- The separate valuation of (plan) assets and the defined benefit obligation within the pension liability is an integral part of the fundamental concept of IAS 19 to measure an entity's pension obligation towards its beneficiaries.
- The adequate measurement of an asset-based pension promise should primarily be focussed on the adequate measurement of the defined benefit obligation, rather than on the measurement of the covering assets.
- The performance risk of assets other than the reference assets is reflected adequately by the overall IFRS-measurement objectives.

Therefore, we consider the three approaches presented in the DP to be applicable not only in cases where assets qualify as plan assets but also in cases where assets are recognised as other assets or are not held by the entity at all (notional assets). Also, we would like to point out that, in Germany, the reference assets are regularly not held as plan assets. Consequently, only a limited number of German pension plans would fall within the scope of the DP. Hence, the scope should be extended to have these plans captured as well.

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 not completely agree with the assessments made as detailed below.

The assessment criteria reflect the qualitative characteristics of useful financial information as set out in the Conceptual Framework as well as the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002. Accordingly, they form an appropriate foundation. However, the assessment made in the DP highlights specific aspects while other aspects remain unconsidered, e.g. verifiability and reliability. Both a comprehensive weighting of the assessment criteria and an overall assessment are missing in our view.

Regarding some assessment criteria and questions, we come to other conclusions than EFRAG, as detailed below:

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

We agree that the covariance between the plan assets and the pension obligation would be less clearly reflected under the Capped Asset Return approach.

However, the Capped Asset Return approach eliminates the measurement inconsistency – and, hence, the inconsistency in the estimation of the future cost incurred by paying the benefits – that arises because the variability (risk) of future asset returns is reflected only in the cash flows but not in the discount rate applied to those cash flows. As a result, the covariance between plan assets and pension obligation is reflected significantly better than under the current IAS 19 approach. Also, the DP correctly notes: *"[…] However, in cases in which an employee's service in later years will not lead to a materially higher level of benefit than in earlier years and the (uncapped) expected return rate is higher than the discount rate, the approach could appropriately reflect the covariances."* (cf. p. 42). We agree with this statement.

Furthermore, the DP's reasoning covers solely the Fair Value-based approach. It does not contain any explanatory remarks on the Fulfilment Value approach. (cf. p. 41-42)

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

Compared to the current IAS 19 approach, the Capped Asset Return approach better reflects the pension cost related to a particular period as it eliminates the measurement inconsistency as mentioned above. The assessment should reflect this.

Furthermore, we note that the Fair Value-based approach and the Fulfilment Value approach systematically do not take any backload correction into account (despite the fact that this is mandatory under by IAS 19). Hence, it is questionable whether these approaches better reflect the pension costs related to a particular period. In any case, the approaches are not comparable in this respect.

<u>Is information about the value of the minimum return guarantee provided?</u>

The DP's assessment considers only a separate measurement of the minimum return guarantee. However, both the current IAS 19 approach and the Capped Asset Return approach address the measurement of the guarantee element as well, although not separately but as part of measuring the DBO. Therefore, the two aforementioned approaches do also contain information about the value of the minimum return guarantee.

<u>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?</u>

We agree the employee's right to receive the higher of the return on plan assets and the minimum guaranteed return is better reflected under the Fair Value-based approach and the Fulfilment Value approach. However, the Capped Asset Return approach reflects this employee's right also more adequately than the current IAS 19 approach. The assessment should reflect this.

We further note that EFRAG's positive assessment of the Fair Value-based approach and the Fulfilment Value approach is based on a given VALUE of the minimum guarantee: *"[...] the Fair Value-based approach and the Fulfilment Value approach would reflect the value of the right to receive the higher of the two returns. It is therefore assessed that the two latter approaches provide more complete information on the right to receive the higher of the return on plan assets and the minimum guaranteed return."* (cf. p. 42-43) The previous question (Is information about the value of the minimum return guarantee provided?) refers to the same fact. In this respect, they overlap.

<u>Is the obligation element related to the minimum guaranteed return accounted for similarly to plans under IAS 19? and Is the obligation related to the return on plan assets accounted for similarly to plans under IAS 19?</u>

These questions evaluate whether similar information will be accounted for similarly between plans within and outside the scope of the DP. In our view, the results are foreseeable and contain no additional advantage or evidence. This is because the contribution-based recognition of current service cost within the Fair Value-based approach and the Fulfilment Value approach is stressed again.

In our view, the Fair Value-based approach and the Fulfilment Value approach differ fundamentally from all other measurement approaches under IAS 19, including pension promises where benefits exactly match the proceeds from an underling qualifying insurance contract or reimbursement right, so that similar accounting treatments cannot be expected. Therefore, the Fair Value-based approach and the Fulfilment Value approach are assessed too positive, even with just one star. In our view, the introduction of the Fair Value-based approach and the Fulfilment Value approach would require a complete rewrite of IAS 19.

Is the information understandable?

Even after long and intensive discussions on the Fulfilment Value approach with our constituency, involving experts such as actuaries etc., we did not end up in a commonly agreed and comprehensive understanding of how this approach would work in detail and how it should be applied in practice. We therefore came to the conclusion that this approach is overly complex and hard to understand.

In contrast, the Capped Asset Return approach seems easy to understand, in particular as it is based on the existing principles of IAS 19 that preparers, auditors and actuaries as well as users are familiar with.

Will the implementation of the approach be uncostly?

For the Capped Asset Return approach, the implementation costs are assessed as negligible due to its similarity to the IAS 19 approach.

The Fulfilment Value approach is seen as more complex than the Fair Value-based approach (cf. previous question) resulting in higher implementation costs.

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?

We believe that the complexity involved in applying the approaches differ significantly, with the Capped Asset Return approach being the least complex and the other two being equally more complex to apply.

The complexity related to preparing financial information depends on the plan design. In the DP a variety of assumptions are made which keep the example simple. On the one hand, this allows to present certain interdependencies more clearly. On the other hand, this kind of simplification bears the risk that other relevant factors are not taken into account and that the overall complexity existing in reality is not being depicted appropriately.

For example, the DP does not describe how disability, death-in-service and longevity influence the measurement of the pension liability. Only one employee and one scenario are considered.

Therefore, the example is too simplistic and therefore does not properly reflect the prevailing measurement complexity and costs related to the various approaches.

The Fair Value-based approach and the Fulfilment Value approach require additional complex simulations and valuations. We are aware that Option Pricing Models are used under IFRS 4 and will be required under IFRS 17. However, the use of Option Pricing Models is challenging. We doubt that the additional benefit (if any) justifies the costs of such valuations and believe that one should wait and consider any experiences made with implementing IFRS 17 before applying such approaches to different fact pattern and all industries.

Especially under the Fulfilment Value approach, stochastic simulations become necessary (e.g. Monte Carlo Simulations). Such models are complex and sensitive to the various parameter constellations and would leave scope of discretion resulting in a potentially critical lack of comparability. Moreover, the results of such simulations may not be easily reproducible by a third party (such as an actuary or an auditor) and as a consequence, may lead to increased auditing requirements and procedures.

As a result, the Capped Asset Return approach is assumed to be less complex than the Fair Value-based approach and Fulfilment Value approach and would lead to lower valuation expenses.

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 support the Capped Asset Return approach and recommend it be further developed towards a Fixed Asset Return approach.

With reference to our answers to questions 2 and 3 and against the background that no fundamental rethinking of IAS 19 is intended, the Capped Asset Return approach is our preferred approach. It better fits into the standard and represents a preferable solution in terms of associated costs and benefits.

In addition, the Capped Asset Return approach should be further developed into a Fixed Asset Return approach, in which the expected return included in the valuation is matched with the rate used to discount the liability. Our reasoning is based on the following arguments:

- In cases where the expected return is lower than the discount rate, the Capped Asset Return approach will not properly reflect the economic circumstances. Although the asset ceiling might limit this problem, the asset ceiling only applies to plans with designated plan assets. Therefore, our aforementioned reservations hold true for the large number of plans without designated plan assets.

- The situation that the expected return is lower than the discount rate might have been a more theoretical case in the past. However, in light of the current low-interest environment it has become more likely.
- In addition, we think a further development of the Capped Asset Return approach into a Fixed Asset Return approach is consistent with the amendments to IAS 19 in 2011 (Elimination of the expected return from the expense calculation and replacement by the discount rate).

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. As no fundamental revision of IAS 19 is intended, the presentation should be in line with the existing IAS 19 approach, i.e. remeasurements should be presented in OCI.

The assumption that remeasurements under the Fair Value-based approach and the Fulfilment Value approach are presented in profit or loss does not correspond with IAS 19. IAS 19 requires the recognition of interest expense on a defined benefit plan and also the recognition of interest income, if the reporting entity accounts for plan assets with regard to that plan in profit and loss whereas remeasurements are recognized in other comprehensive income. While the Capped Asset Return approach is consistent and in line with that principle, both the Fair Value-based approach and the Fulfilment Value approach are not. Not recognising interest expenses (accrued interest of DBO) or fictious interest expense that is independent from the discount rate are generally viewed as giving rise to a mismatch with interest income on the asset side. As a result, the comparability of financial data for different pension plans is limited.

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?

Taking into account the constraint not to rethink IAS 19's accounting and valuation approach fundamentally, we doubt that the introduction of risk adjustments for non-financial risks as well as for financial risks within the discount rate should be considered.

In our view, sensitivity analyses do fit better with the existing IAS 19 concept. Further, we believe that an introduction of risk adjustments for non-financial risk as well as for financial risk within the discount rate requires a fundamental revision of IAS 19. Otherwise, a consistent accounting for pension plans might be jeopardised. This is e.g. shown by the fact that the introduction of risk adjustments within the discount rate is not in line with the 2011 amendments of IAS 19. (cf. Basis for Conclusion par. 129 et sec.)

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 that the application of alternative accounting approaches call for additional disclosure requirements. Furthermore, how much more or less disclosure requirements are deemed complex depends on the complexity of the accounting method.

However, it is not only the complexity of the approach that determines the complexity of the disclosure requirements. The parallel use of different accounting approaches requires more disaggregated and differentiated data to be disclosed in order to enable users to better understand the effects presented on the face of the balance sheet and/or statement of income. The greater the conceptual differences between the accounting approaches used, the stronger this effect will be.

Any new accounting approach will lead to additional disclosures. Due to the higher complexity of the Fair Value-based approach, and especially of the Fulfilment Value approach, we expect the disclosures to be more complex and more difficult to understand. Both approaches leave considerable scope for discretion. Therefore, detailed disclosures would be required on the assumptions applied.

Since the Fair Value-based approach and the Fulfilment Value approach significantly differ from the current accounting concept, it is also likely that information on these approaches cannot be combined with existing notes. This means that not only the complexity of the Fair Value-based approach and the Fulfilment Value approach will cause the complexity of the disclosure requirements to increase. The application of different accounting approaches also requires a more disaggregated and differentiated presentation of data which additionally increases complexity.

As IAS 19 already requires extensive disclosures in relation to defined benefit plans, we welcome the IASB's decision to select IAS 19 as one of the IFRSs for its Standard-level review of existing disclosures.

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?

Considering the pension accounting discussions over the last years and the IASB's research project on *Pension Benefits that Depend on Assets Returns*, we favour focussing on the Capped Asset Return approach. In addition, we recommend to further develop the Capped Asset Return approach towards a Fixed Asset Return approach.

As stated in our answer to question 4, we recommend to further develop the Capped Asset Return approach into a Fixed Asset Return approach, in which the expected return rate is matched with the rate used to discount the liability. In many countries, including Germany, the reference assets are regularly not held as plan assets (i.e. the asset ceiling is not applicable). In such situations, the pension obligation would not be measured appropriately in cases where the expected return is lower than the discount rate.