IASB's project on Pension Benefits that depend on asset returns Issues Paper

Objective and introduction

1 The objective of this session is to obtain feedback from EFRAG TEG and EFRAG CFSS members regarding the IASB's research project on *Pension Benefits that Depend on Asset Returns*.

2 This IASB project became active in September 2018 and the IASB staff are exploring whether to cap asset returns used in estimates of pension benefits that depend on asset returns. Below is a summary of the IASB staff's paper and an EFRAG Secretariat analysis.

Agenda Papers

3 In addition to this paper, agenda paper 12-02 – *IASB's ASAF paper on Pension Benefits that Depend on Asset Returns* – has been provided for the session for background only.

Summary of the IASB's approach regarding pension benefits that depend on asset returns

Scope of the IASB's research project

4 The IASB intends the project to be a narrow-scope one which focusses only on some types of pension benefits that depend, wholly or partly, on asset returns. The assets could be held (by the plan or employer) or could also be used as a reference point to compute the pension benefits.

5 The scope of the project is based on the type of pension benefit rather than the type of pension plan. The project will not investigate other aspects of the benefits e.g. an employee being guaranteed the higher of actual return on plan assets and the guarantee.

Current application under IAS 19

6 In accordance with IAS 19, the ultimate cost of the benefits to be paid is estimated using the projected unit credit method and the discount rates used to determine the present value of the defined benefit obligation ('DBO') is based on high quality corporate bonds ('HQCB'). A measurement inconsistency arises because the rate of return used to estimate the benefits to be paid is often higher that the HQCB rate used to discount the pension benefits to present value.

7 For example, if the expected rate of return of assets is 5% and the HQCB rate applying IAS 19 is 3%, an entity would measure the DBO by projecting the cash outflows using 5% but then discounting those cash flows to present value using 3%.

8 This measurement inconsistency arises regardless of whether the specified assets are actually held by the plan (or by the employer). However, the measurement

inconsistency is made worse if those assets are held by the plan (or by the employer itself and measured at fair value). In such cases, the assets would be measured at fair value, but the obligation to pay benefits that depend on returns from the assets would be measured at a different (higher) amount.

IASB's approach

9 The IASB intends to assess whether it would be feasible to address this measurement inconsistency by capping the asset returns without changing other elements of IAS 19.

10 In other words, using the same example in paragraph 7 above, an entity would project the cash outflows using 3% (instead of 5%) and then discount those cash flows to present value using 3%.

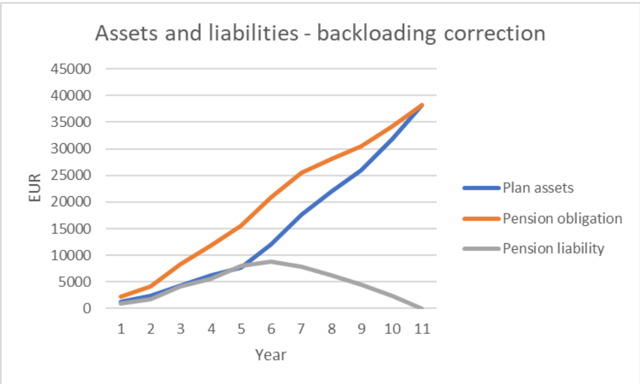
11 The IASB staff consider this approach to be relatively simple to develop and to give a cost-beneficial short-term solution for the plans in scope because it would not need an arbitrary scope to be set and it would not change the fundamental concepts of a DBO under IAS 19.

12 Note that the IASB staff has not yet explored the approach in detail and they intend to perform further analysis and outreach to assess whether it can be further developed.

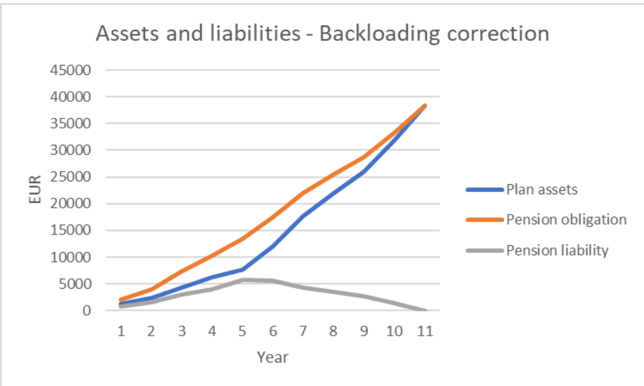
Illustration of the IASB's approach

13 The graphs below illustrate the effect of the IASB's approach. The graphs illustrate the effect of applying the approach to a pension plan promising the higher of a minimum guaranteed return and the actual return on contributions. In the example, the employee's service in later years will lead to a materially higher level of benefit than in earlier years. The entity has therefore attributed benefits on a straight-line basis (backload correction).

Effects under the current requirements in IAS 19:



Effects under the IASB's proposed approach:



14 As it appears from the graphs, the IASB's approach, in the example, results in a closer alignment of the plan assets and the pension obligation. However, even when the minimum guaranteed return is not relevant, the pension obligation will still be measured at a higher amount than the plan assets (on which the pension benefits will be determined) because of the backload correction.

EFRAG Secretariat analysis

15 The EFRAG Secretariat expects that only defined benefit plans that depend on asset returns are in scope of the IASB's project.

16 The EFRAG Secretariat observes that the IASB's approach will not completely reflect the economic linkage between assets held by an entity and any benefits depending on these assets (see paragraph 8 above) as the defined benefit obligation and the assets will be measured on a different basis. However, the EFRAG Secretariat acknowledges that this IASB's approach is relatively simple and could be a short-term solution.

17 The EFRAG Secretariat also observes that the IASB staff paper refers to *capping* the expected return rate because in their example, this rate exceeds the HQCB rate. It is unclear if, in the IASB's explored approach, the expected return rate would also be adjusted when it is lower than the HQCB rate. While this occurrence would likely be infrequent, the EFRAG Secretariat would encourage the IASB to clarify this aspect.

18 EFRAG has a research project also relating to asset-return based pension plans. The EFRAG Secretariat is in the process of developing a Discussion Paper, which is expected to be published in Q1 2019. In this Discussion Paper, three approaches are being considered, namely, a fair value approach, a fulfilment value approach (which takes some concepts from IFRS 17 *Insurance Contracts*) and a capped asset return approach (which is similar to the approach considered in the IASB's research project).

Questions for EFRAG TEG and EFRAG CFSS members

19 Do EFRAG TEG and EFRAG CFSS members have any comments on the IASB's approach?

20 Do EFRAG TEG and EFRAG CFSS members consider that this IASB's approach would help to address the measurement inconsistency?

21 Do EFRAG TEG and EFRAG CFSS members consider that this IASB's approach would have any unintended consequences?