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– submitted only online via www.efrag.org –

Cologne, 14 November 2019

Comments of the IVS on EFRAG's Discussion Paper *Accounting for Pension Plans with an Asset-Return Promise*

Dear Sir or Madam,

The German Institute of Pension Actuaries (IVS – Institut der Versicherungsmathematischen Sachverständigen für Altersversorgung e. V.), a branch of the German Association of Actuaries (DAV), appreciates the opportunity to comment on the Discussion Paper "Accounting for Pension Plans with an Asset-Return Promise" issued by the European Financial Reporting Advisory Group (EFRAG) in May 2019.

Please find attached our comments and answers to the questions raised in the section 'Questions to constituents' of the Discussion Paper. We would appreciate if you would take them into account.

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

Yours sincerely,

Dr. Friedemann Lucius

Chairman of the Board

German Institute of Pension Actuaries (Institut der Versicherungsmathematischen Sachverständigen für Altersversorgung e. V.)

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Comments of the IVS on EFRAG's Discussion Paper *Accounting for Pension Plans with an Asset-Return Promise*

The German Institute of Pension Actuaries (IVS – Institut der Versicherungsmathematischen Sachverständigen für Altersversorgung e.V.), a branch of the German Association of Actuaries (DAV), appreciates the opportunity to comment on the Discussion Paper "Accounting for Pension Plans with an Asset-Return Promise" issued by the European Financial Reporting Advisory Group (EFRAG) in May 2019, particularly on the questions included in the section 'Questions to constituents' of the Discussion Paper.

First of all, we welcome EFRAG's participation as an important stakeholder in the IASB's discussion on asset-return based promises. We would first like to summarise our position on EFRAG's discussion paper and then discuss the questions in detail.

The discussion paper proposes three assessment approaches. Two of them, namely the fair value based approach and the fulfilment value approach, require complex simulations or valuations according to Black/Scholes. In contrast to stock option plans, such valuations in company pension plans may be very complex because the periods considered are very long and there is no single fixed due date. In Germany, for example, it is common for the plan also to provide benefits in the event of disability or death, which are often also linked to securities in these plans. Therefore, all possible events leading to benefits have to be taken into account by separate simulations or application of the Black/Scholes model. However, it is likely that the Black/Scholes approach will not applicable as the according valuations may be too complex or the interest environment may produce negative IAS 19 discount rates (very likely in the current market environment) which the Black/Scholes modell is incompatible with.[1] The only way to deal with these technical issues may be complex Monte Carlo simulations. Accordingly, we are of the opinion that the cost of such valuations is not reasonably proportional to the additional insights compared to simpler approaches, such as the capped asset return approach.

In addition, it has to be noted that the outcome of these calculations are in general to a high degree depending on the specific valuation parameters used, 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 parameters. In the case of the fair value based approach and the fulfilment value approach there would have to be clear guidance or principles about which values for volatility are acceptable as per a specific measurement date, because obviously the value of any guarantee incorporated in the plans in scope can be minimized by arbitrarily assuming a very low volatility.

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

The capped asset return approach, on the other hand, is certainly debatable. However, limiting the expected return to the technical interest rate used for discounting the liabilities does not solve the problem 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 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). Please compare IAS 19 BC 130 on this regard.

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 asset 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?

In our opinion, 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 not agree with all the assessments. We would make the following assessment.

QUALITATIVE CHARACTERISTICS		IAS 19	CAPPED ASSET RETURN APPROACH	FAIR VALUE BASED APPROACH	FULFILMENT VALUE APPROACH
Is the information relevant?					
• Does the approach reflect how the pension obligation will be settled?	*EFRAG assessment*	★	★	★	★★
	IVS assessment	★	★	★	★★
• Is the economic covariance between plan assets and pension obligation reflected?	*EFRAG assessment*		★	★★★	★★★
	IVS assessment		★★	★★★	★★★
• 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?	*EFRAG assessment*	★★	★★	★★★	★★★
	IVS assessment	★★	★★	★★★	★★★
• Does the calculation of current service cost result in a useful reflection of pension cost related to a particular period?	*EFRAG assessment*	★★	★★	★★★	★★★
	IVS assessment	★	★★★	★★	★★
• Is information about the value of the minimum return guarantee provided?	*EFRAG assessment*			★★★	★★★
	IVS assessment		★	★★★	★★★
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?	*EFRAG assessment*	★	★	★★★	★★★
	IVS assessment	★	★★	★★★	★★★
Can requirements be applied retrospectively?	*EFRAG assessment*	N/A	★★★	★★	★★
	IVS assessment	N/A	★★★	★	★
Is the obligation element related to the minimum guaranteed return accounted for similarly to plans under IAS 19?	*EFRAG assessment*	N/A	★★★	★	★
	IVS assessment	N/A	★★★		

QUALITATIVE CHARACTERISTICS		IAS 19	CAPPED ASSET RETURN APPROACH	FAIR VALUE BASED APPROACH	FULFILMENT VALUE APPROACH
Is the obligation related to the return on plan assets accounted for similarly to plans under IAS 19?	*EFRAG assessment*	N/A	★	★★★	★★★
	IVS assessment	N/A	★★		
Is the information understandable?	*EFRAG assessment*	★	★	★★	★★
	IVS assessment		★★	★★	★
Will the implementation of the approach be uncostly?	*EFRAG assessment*	N/A	★★	★	★
	IVS assessment	N/A	★★★	★	★

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 will lead to significantly higher valuation expenses in the long term. 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, in which the expected return included in the measurement of the obligation is replaced by the actuarial interest rate. 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.

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. The completely different approach proposed here would significantly reduce the comparability of the financial statements. The procedure for these two valuation approaches would also have to be such that interest expense would have to be determined (without the effects of a change in the actuarial interest rate) and the remaining change 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? 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 open up discretionary options for the reporting entity, which the IASB wanted to eliminate in 2011 by abolishing the expected return. In our opinion, such approaches are theoretical in nature and practically lead to annual financial statements that are no longer comparable.

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 borne in mind that in view of the complexity of the fair value based approach and the fulfilment value approach, it is no longer certain, even with the corresponding disclosures, that the reader of the financial statements will be able to correctly appraise the information on pensions. As valuation methods differ so much 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?

The plans discussed here have been around for many years, including Germany. Practical solutions have been developed. The economic content is likely to be adequately reflected in all the solutions chosen, 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 borne in mind 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.