# PensionsEurope comments on EFRAG Discussion Paper on accounting for pension plans with asset-return promise

January 2019

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## About PensionsEurope

**PensionsEurope** represents national associations of pension funds and similar institutions for workplace and other funded pensions. Some members operate purely individual pension schemes. PensionsEurope has **23 member associations** in 18 EU Member States and 3 other European countries[1].

PensionsEurope member organisations cover different types of workplace pensions for over **110 million people.** Through its Member Associations PensionsEurope represents more than **€ 4 trillion of assets** managed for future pension payments. In addition, many members of PensionsEurope also cover personal pensions, which are connected with an employment relation.

PensionsEurope also has **30 Corporate and Supporter Members** which are various service providers and stakeholders that work with IORPs.

PensionsEurope has established a **Central & Eastern European Countries Forum (CEEC Forum)** to discuss issues common to pension systems in that region.

PensionsEurope has established a **Multinational Advisory Group (MAG)** which delivers advice on pension issues to PensionsEurope. It provides a collective voice and information sharing for the expertise and opinions of multinationals.

## What PensionsEurope stands for

- A regulatory environment encouraging workplace pension membership;
- Ensure that more and more Europeans can benefit from an adequate income in retirement;
- Policies which will enable sufficient contributions and good returns;

## Our members offer

- Economies of scale in governance, administration and asset management;
- Risk pooling and often intergenerational risk-sharing;
- Often “not-for-profit” and some/all of the costs are borne by the employer;
- Members of workplace pension schemes often benefit from a contribution paid by the employer;
- Wide-scale coverage due to mandatory participation, sector-wide participation based on collective agreements and soft-compulsion elements such as auto-enrolment;
- Good governance and alignment of interest due to participation of the main stakeholders.

*Contact:*
***PensionsEurope***
*Koningsstraat 97, rue Royale – 1000 Brussels*
*Belgium*
*Tel: +32 (0)2 289 14 14 – Fax: +32 (0) 289 14 15*

[1] EU Member States: Austria, Belgium, Bulgaria, Croatia, Estonia, Finland, France, Germany, Hungary, Ireland, Italy, Luxembourg, Netherlands, Portugal, Romania, Spain, Sweden, UK. Non-EU Member States: Iceland, Norway, Switzerland.

## 1. Introduction and the scope of EFRAG Discussion Paper

PensionsEurope would like to thank EFRAG (European Financial Reporting Advisory Group) for the possibility to comment on EFRAG Discussion Paper on accounting for plans with asset-return promise. We welcome EFRAG's initiative to provide ideas and approaches for a more meaningful accounting of plans with asset-return promise (or so-called hybrid plans with features of both the DB and the DC world), as the usual IAS 19 accounting approach does not always support "a true and fair view" on plans' assets and liabilities. That leads to diversity in the accounting practice as preparers, auditors and actuaries tend to provide meaningful solutions to this dilemma on a country-by-country basis that not necessarily are completely consistent over the countries that feature such plans. We also welcome both the intend of EFRAG and the IASB (International Accounting Standards Board) to define more clearly what is meant by "pension benefits that depend on asset returns".

We see some pros and cons if the scope of the EFRAG project is aligned with the one that the IASB is considering for a limited project. We agree and hope that the EFRAG project may contribute in practical ways to the future standard-setting activities of the IASB, which is the main objective of EFRAG research activities. However, the IASB research project might not thoroughly consider all the alternatives before drawing the conclusions, and that the particular value of the EFRAG PAP (EFRAG Pension Plans Advisory Panel) work could be to explore a broader set of pension arrangements and a broader set of alternative accounting methods.

On the other hand, the IASB's more narrow approach (compared to EFRAG's broader analysis) could be concluded faster. In the past, some broad approaches, including IFRIC (International Financial Reporting Interpretations Committee) D9 and the 2006 Discussion Paper of the IASB, were very extensive and they did not come up with a solution (sometimes due to "unintended consequences"). As the IASB aims to analyse only one accounting approach ("Capped Asset Return Approach") which caps the expected return on any actual or notional (plan) assets of the plan at the IAS 19 discount rate, the "measurement mismatch" that may otherwise impact the true and fair view can be avoided.

## 2. PensionsEurope comments on EFRAG Discussion Paper on accounting for pension plans with asset-return promise

The EFRAG Discussion Paper analyses plans with a “minimum guaranteed return“ and it focusses also on two additional approaches beyond the “Traditional IAS 19 Approach“ and the “Capped Asset Return Approach“: (i) the “Fair Value Approach“, and (ii) the “Fulfilment Value Approach“ which uses concepts from IFRS 17.

Both of these approaches in the Draft EFRAG Discussion Paper have in common that the value of any guarantee is derived from an Option Pricing Model. We note that currently large insurance companies measure relevant parts of their insurance liabilities using Option Pricing Models (under IFRS4), and they will be required to do so also under IFRS17. Possibly this approach could also be applicable for instance for the Dutch Defined Ambition schemes as well.

The Discussion Paper features some calculation examples – however, in a very simplified way (only “one employee and one scenario“). A real-world valuation would be much more complex, for instance by considering disability, death-in-service, and retirement. Therefore, there is a significant risk that the examples of the EFRAG Discussion Paper do not reflect the obstacles associated with these approaches in a reality.

In practice, this could lead to underestimating the efforts necessary to make such valuation models readily available on a broad scale. There are good reasons why some accounting standards, such as IFRS 17, have taken more than one and a half decades to be developed, only to be once more postponed recently for mandatory application to 2022 (and there are issues raised in connection with IFRS 17 by EFRAG itself in the direction of the IASB).

Additionally, also the Option Pricing Model may be challenged. It generally assumes a log normal distribution of discount rate changes. However, some argue that this does not necessarily reflect reality (due to mean reversion). Another possible deficit of Option Pricing Models is that most of them assume a constant volatility, although it can regularly be observed that volatility varies both with the time to maturity of the option as well as the relation of the strike price to the price of the underlying asset (“volatility smile”). Finally, the complexity of the Option Pricing Model include the situation in which both the interaction with the IAS19 requirement of straight lining of the effect of future salary and pension accrual increase.

Stochastic simulations (considering many economical scenarios) could be a solution to this – however, that does not seem to be considered or tackled by the EFRAG paper (yet). Nevertheless, such models are on the other hand very sensitive to the considered scenarios which would leave preparers, auditors and actuaries with a lot of reasonable choices that may also lead to divergence in practice.

We would also like to comment on the views shown in the below table (from paragraph 5.1 of the EFRAG Discussion Paper).

| Qualitative characteristics | IAS 19 | Capped Asset Return approach | Fair Value approach | Fulfilment Value approach |
|---|---|---|---|---|
| The information is relevant: | | | | |
| • The approach always reflects how the pension obligation will be settled | ✗ | ✗ | ◔ | ✗ |
| • The economic covariance between plan assets and pension obligation is reflected | ✗ | ◔ | ✓ | ✓ |
| • Inadequate funding is reflected | ✗ | ✗ | ✓ | ✓ |
| • Information is relevant for assessing stewardship | ✗ | ◔ | ✓ | ✓ |
| The information is a faithful representation | ✓ | ✓ | ◔ | ✓ |
| Requirements can be applied retrospectively | N/A | ✓ | ◔ | ◔ |
| Similar elements of pension plans are accounted for similarly to plans under IAS 19 | N/A | ✓ | ✗ | ✗ |
| The information is easy to understand | ✗ | ✗ | ✓ | ✗ |
| Information will not be costly to provide | ✗ | ✗ | ✗ | ✗ |

| Symbol | Explanation |
|---|---|
| ✗ | The approach does not reflect the qualitative characteristic. |
| ✓ | The approach reflects the qualitative characteristic. |
| ◔ | The approach reflects to some extent the qualitative characteristic / whether the approach reflects the qualitative characteristic depends on the circumstances. |
| N/A | The effect is not relevant to consider for the approach. |

The comparison of the four distinctive valuation approaches could be viewed as to favour both the “Fair Value Approach“ and the “Fulfilment Value Approach“ while the much simpler and more pragmatic “Capped Asset Return Approach“ could be viewed as suboptimal. However, we take the view that this may not be completely accurate, e.g.:

- Criterion 2: The “Capped Asset Return Approach“ in our view also reflects the “economic covariance between plan assets and pension obligation“. As long as the “option” is “in the money” the value of the promise should be equal to the fair value of assets – which is reasonable.

- Criterion 8: In our view the “Capped Asset Return Approach“ fulfils the criterion “The information is easy to understand“. We do not agree with EFRAG’s view in 5.19 b) that the “Capped Asset Return Approach“ cannot “be explained by other means than how it is ‚computed‘“. As the “Capped Asset Return Approach“ avoids the aforementioned “measurement mismatch“ and – in cases in which the minimum guarantee is not applicable – measures the DBO at the fair value of assets which is very straight forward and easy to explain and to understand.
- Criterion 9: It seems unrealistic that all valuation approaches are viewed as completely equivalent in terms of cost (“Information will not be costly to provide“) – we recommend a further analysis.

Finally, we would also like to comment on some other, more technical issues:

- In our view paragraph 1.20 is not true in each and every case – pure defined benefit plans for example in Germany may be designed without any consideration of (actual or notional) contributions (e.g. fixed amount promises and final salary promises). Furthermore, there is no funding requirement in Germany and respectively in many cases no payments during the accrual phase.
- The statistics on pages 15 and 16 do not seem very comprehensive and in our view are at least partly unclear – e.g. what exactly is meant with the 42% ratio for Germany in paragraph 1.29 and how are this number and the other numbers interpreted?
- The graphs in chapter 3 and 4 should be scaled consistently to allow for a better comparison – e.g. the graphs in 3.25 and in 4.5 are not easy to compare although that could be useful.
- If one would like to compare all approaches discussed in more detail it would be useful to provide more sample calculations – on the one hand some more elaborate ones (bigger population, more scenarios) but on the other hand also some very basic cases (actual return equals expected return etc.).
- Regarding the question in 4.67 we take the view that – independent of the chosen valuation approach – that NOT “all interest rate movements for the net pension obligation should recognized in profit or loss“. In our view this would not be consistent to other requirements by IAS 19 (i.e. changes in assets and obligations induced by the changes in interest rates in the market are to be recognized in OCI).

## 3. Final remarks

No matter what the scope of the EFRAG project will finally be, we support and encourage EFRAG and IASB to finalise their projects within a reasonable time frame in order to solve the current challenges with accounting for hybrid plans.

We would be happy to complement our remarks above and answer to any possible questions, if needed. We are looking forward to continuing constructive dialogue with EFRAG on pension accounting.