Watson Wyatt
Worldwide

26 September 2008

International Accounting Standards Board
30 Canon Street
London
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UK

Dear Sirs:

Watson Wyatt's response to IASB's discussion paper 'Preliminary Views on Amendments to IAS19 Employee Benefits'

Watson Wyatt is the trusted business partner to the world's leading organisations on people and financial issues. The firm's global services include: managing the cost and effectiveness of employee benefit programs; developing attraction, retention and reward strategies; advising pension plan sponsors and other institutions on optimal investment strategies; providing strategic and financial advice to insurance and financial services companies; and delivering related technology, outsourcing and data services. Watson Wyatt has over 7,000 associates in 32 countries and we provide actuarial consulting services to sponsors of over 2,000 defined benefit pension plans and other post retirement benefit plans.

We support the underlying objective of the consultation to improve the accounting for post-employment benefits in a timely manner. Our comments on the proposals can be summarised as follows:

1 Contribution–Based promises

The proposed introduction of the new classification of Contribution-Based (CB) promises is confusing and will not improve decision-usefulness. Apart from issues of consistency, the CB definition applies to many promises that we do not believe cause practical application problems at present. We believe the main problems of IAS19 (under the current measurement approach) can be better addressed through a combination of limited changes to the standard (e.g., so that the liability recognised reflects the accrued obligation according to the plan benefit formula) and more detailed guidance on the interpretation of specific parts of the standard.

The proposals related to CB promises appear to prejudge, to a significant degree, the outcome of a more comprehensive project. It is hard to see that if Phase I progresses in line with the consultation, Phase II would not extend the "fair value" attribute to defined benefit plans, leaving only the question of salary progression for debate. This gives the impression of introducing a fundamentally different measurement attribute through the back door. Measurement of all post-retirement benefit promises should be considered as part of a comprehensive project which applies a single measurement concept to all plans, or not at all. We would therefore suggest deferring decisions on the measurement issue of this project until key aspects of the comprehensive framework have been decided in general, and in particular the projects on the Conceptual Framework and Fair Value Measurement have concluded.

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That said, assuming that it remains consistent with other standards to allow for credit risk, we are unconvinced that any practical approach would be a significant improvement over the existing approach based on high quality corporate bonds.

In summary, considering the potential implications of a hasty decision now in view of work yet to be completed in the more comprehensive projects, we think the IASB should not seek to introduce an unnecessary accounting framework for the new category of CB promises. Instead, the IASB should focus on providing some guidance to narrow down the potential interpretations for plans whose accounting treatment is not currently clear under IAS19.

2 Recognition for Defined Benefit plans

We believe the proposal for immediate recognition needs to be considered alongside the recognition and presentation aspects of reporting gains and losses, since volatility of pension expense is the core issue here. At this stage, we would simply remark that it is imperative to segregate the various components of pension expense, such that financing aspects do not impact upon operating income, and market volatility is separately presented. We note that the comprehensive projects, which should drive the relevant decisions, are still in progress and therefore, we suggest retention of the SORIE approach for the time being. In addition, we believe that any removal of the deferred recognition approach should be accompanied by suitable transition arrangements.

Attached to this letter are responses to the consultation questions which explain our reasons for the above views. In addition, we have included appendices that further illustrate specific difficulties with certain aspects of the proposals.

Yours faithfully,

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Scope of the project

Question 1 (Chapter 1)

Given the objective of the IASB project to address specific issues in a limited time frame, are there additional issues which you think should be addressed by the Board as part of this project? If so, why do you regard these issues as a matter of priority?

The scope of the project is, in our view, poorly targeted. It is neither a comprehensive review nor is it narrowly focussed on areas of pressing difficulty. As such, it may be an impediment to any lasting outcome. Whilst we agree with the IASB's objectives of improving comparability, reducing complexity and increasing transparency, we perceive the following problems with the limited nature of this consultation:

1. There are major projects yet to be concluded on some of the fundamental aspects of accounting which could have implications on decisions taken under limited scope projects such as this one. In particular, preparers and users would be concerned if decisions taken now by considering certain aspects of pension accounting on a piece-meal basis were later changed for consistency with the more comprehensive projects on measurement, recognition and presentation, once they are concluded.

2. We agree with the IASB that users are concerned about risk (paragraph 1.2 of the consultation paper). We are surprised however that the Contribution-Based (CB) and Defined Benefit (DB) divide, as presented in this consultation paper, makes little attempt to address that; if anything, it introduces further confusion (see our response to Question 6).

3. The proposed division between DB and CB plans is highly problematic and does not improve decision-usefulness (which is stated as a scoping criteria in paragraph 1.6(c) of the consultation paper) due to the:

   - Artificial difference now created in the measurement of two identical annuity portfolios depending on their origin. This is a very real and significant problem for users of financial statements. It also goes against the IASB's objective of improving comparability in pensions accounting.

   - Potential inconsistencies and ambiguities in the implementation of the measurement requirements proposed for CB plans that also contradict the objective of improving comparability.

   - Disincentive for new introductions of risk sharing designs where the potential accounting treatment would appear unjustifiably harsh compared with other plans.

   Our responses to Questions 5 and 6 elaborate further on these points.

We would suggest that the fundamental principle should be 'one measurement concept for all plans'. This can be achieved if approached from the viewpoint of the risks carried by the reporting entity. After all, the primary users - defined as the capital providers under the 'Conceptual Framework' project - should have this attribute very high on their agenda of decision-useful information.

Therefore, we would suggest deferring decisions on the measurement issue of this project until key aspects of the comprehensive framework have been decided in general, and in particular the projects on the Conceptual Framework and Fair value Measurement have concluded.

In the meantime, we suggest providing some guidance clarifying how to handle plans whose accounting treatment is not currently clear under IAS19. In our response to Question 5 we have highlighted the type of plans that could benefit from such guidance, and in our response to Question 9(b) we have suggested a pragmatic approach consistent with the treatment of other plans under IAS19.

Recognition and presentation of defined benefit promises

Question 2 (Chapter 2)

Are there factors that the Board has not considered in arriving at its preliminary views? If so, what are those factors? Do those factors provide sufficient reason for the Board to reconsider its preliminary views? If so, why?

Yes, the Board needs to fully consider the potential consequences of its proposals. Accounting standard setters have previously offered deferred recognition as a tool for managing volatility in pensions. Its removal requires consideration of whether the new recognition and presentation attributes will drive decisions which will be detrimental to pension plan members.

On another practical note, a switch from the present regime involving deferrals to one which does not would be regarded by most as a significant change, therefore we would expect such a change to be accompanied by suitable transition arrangements.

We note that the IASB has also reached a preliminary view that entities should not divide the return on assets between an expected return element and an actuarial gain or loss element. This view is driven by the IASB's concern that the subjectivity inherent in determining the expected return provides entities with an opportunity to choose a rate with a view to manipulating profit or loss (paragraph 2.15 of the consultation paper). We fail to understand the reason for this view. Apart from isolated cases in the past, we are not aware that this has been a problem in recent years and, in any case, the appropriate tools for dealing with potential abuse would be better policing and stronger guidance.

Considering the potential implications of a hasty decision now, in view of work yet to be completed (see below), we think the Board should retain the present approach for the time being. Amongst other things, this would allow the ultimate approach for recognising and presenting the return on assets in the pension plan to be decided in a consistent manner with similar items in other parts of the sponsor's business.

This view is supported by the results of a recent survey by Watson Wyatt to gauge the opinion of 131 finance and employee benefit directors across 17 countries. A majority (59%) of respondents did not consider change in this area to be necessary at the present time.

Question 3 (Chapter 3)

(a) Which approach to the presentation of changes in defined benefit costs provides the most useful information to users of financial statements? Why?

(b) In assessing the usefulness of information to users, what importance do you attach to each of the following factors, and why:

- ***Presentation of some components of defined benefit cost in other comprehensive income; and***
- ***Disaggregation of information about fair value?***

(c) What would be the difficulties in applying each of the presentation approaches?

Whilst the IASB is still considering the distinction between business and financing activities in the Financial Statement Presentation project, the task of discussing how to present amounts related to pensions within OCI is difficult. We note that the present SoRIE (now renamed OCI) approach has worked well but it would be a mistake to try to take this discussion to any conclusion without a clear understanding of the structure of the new income statement and how it would work in conjunction with OCI. At this stage, we would simply remark that it is imperative to segregate the various components of pension expense, such that financing aspects do not impact upon operating income, and market volatility is separately presented. This is important, not just to avoid market volatility items distorting headline profit figures, but also, to provide the level of transparency required for users with varied needs to understand the cost of pension plans and to adjust the income figures, if appropriate, to suit their purpose.

Provided the OCI (or similar) approach is also maintained and there are suitable transition measures, we would support the proposal to recognise changes in assets and liabilities immediately in the balance sheet. However, we believe it would be inappropriate for all experience items to be recognised through the income statement and consider it vital for market volatility to be distinguished from operational matters and recognised in a statement similar to OCI.

Amongst respondents to the survey referred to above, we found that whilst a small majority (56%) agreed with the removal of deferred recognition, the overwhelming majority (80%) said they would not support the proposal to recognise gains and losses immediately in the P&L.

The overriding difficulty with evaluating any of the proposed approaches, is not knowing how consistent they will be with the presentation framework that will emerge at the conclusion of the IASB's project on 'Presentation of Financial Statements'. Subject to this reservation, the practical problems with the 3 approaches presented by the Board are:

- Approach 1 fails to separate market volatility from operational matters. The preparer is currently able to separate the market and operational factors using flexibility within IAS19, but it is not clear if this flexibility will prevail once the Financial Statement Presentations project has concluded and the income statement takes a different format. As discussed above, we think it is imperative for this option to be considered in conjunction with changes in the structure of the financial statements. Any change towards recognising the actual return should, we believe, be accompanied by not just a separation of the financing items from the operating activities, but also by a presentation of the market volatility items outside the profit and loss account. Otherwise, there is the potential for the pension items to distort the sponsoring company's core financial results, and in many cases, due to the size of the pension scheme relative to the company, can swamp them in some instances.

- In Approaches 2 and 3 the effect of changes in long term inflation expectations are treated differently to the effect of changes in the discount rate. We believe they should be treated together. This is easily seen by considering a plan with indexed obligations invested in the matching assets of index linked bonds. Under proposed Approaches 2 and 3 a change in market inflation expectations (and hence nominal discount rate) would cause a P&L hit (increase in inflation) and an equal but opposite effect in OCI (increase in discount rate) despite the position being unaffected in real terms.
- Approach 3 requires a method of identifying interest income on plan assets.

Subject to the reservations above about the ultimate form of the income statement, we would say that Approach 3, with imputed interest based on the discount rate, and with changes in inflation expectations treated consistently with discount rate changes, would be the "least worse" of the 3 approaches presented.

Question 4 (Chapter 3)

How could the Board improve the approaches discussed in this paper to provide more useful information to users of financial statements?

Please explain any alternative approach to presentation that provides more useful information to users of financial statements. In what way does your approach provide more useful information to users of financial statements?

See our response to Q3 above.

Definition of contribution-based promises

Question 5 (Chapter 5)

Do you agree that the Board has identified the appropriate promises to be addressed in the scope of this project? If not, which promises should be included or excluded from the scope of the project, and why?

No. The distinction between CB and DB promises is artificial and the definition of CB has been extended to many promises that are not currently "troublesome" under IAS19. We believe the area where IAS19 is unclear is the extent to which measurement should be consistent with observable market inputs in plans where the benefits (which can also include pensions in payment) are linked to, but not necessarily equal to, the performance of specified investments or investment markets. Examples include

- Cash balance plans where the interest credit is linked to the performance of equity indices, possibly subject to caps and floors or fixed elements.
- Plans which largely are DC in nature, but where a guarantee applies either to a part of a fund accrued at a particular date, or to contributions invested after a particular date (the latter being a feature of Belgian plans following recent legislation).
- Career average plans where the interest credits and/or pension increases allocated are linked to the funding level at the time of allocation (and once allocated cannot be withdrawn). Such as typical Dutch plans.

- Plans where the level of pension increase in payment is linked to (but not necessarily equal to) the returns earned on the actual assets or on a notional portfolio (this is a legal requirement in Norway and similar plans also exist in the Netherlands).
- Swiss plans where crediting interest rates depend on decisions of a pension fund board, who will be mindful of the funding level.

We believe other plans are less of an issue, such as cash balance plans where the interest credit is set equal to the running yield available on an index (say a government bond index), rather than the total return on that index. There is a preponderance of such plans in the US.

Over the years, preparers and practitioners have developed techniques to deal with such issues and they have been subject to audit scrutiny, so we question if they are really as "troublesome" as the IASB believes. We do however accept that it is possible for them to be valued in a number of ways giving a range of results which might be regarded as wider than desirable. If the IASB has evidence that this is happening in practice to a significant extent then instead of a radical overhaul, we think that some application guidance would be the better route towards achieving some uniformity of practice.

Plans which we believe are inappropriately included in the wider definition of CB promises include career average, flat currency benefit and cash balance plans where benefits are fixed in monetary terms or are linked to non-investment market indices (for example National Average Earnings or inflation indices). Other than the question of whether a "project and prorate" approach is necessary, such plans give no particular difficulties to applying IAS19. We consider their inclusion in the CB definition to be inappropriate.

Further, the CB proposals appear to prejudge to a significant degree the outcome of a comprehensive project on Fair value Measurement – it is hard to see that if Phase I progresses, Phase II would not extend the "fair value" attribute to final salary plans, leaving only the question of salary progression for debate. This gives the impression of introducing a fundamentally different measurement attribute through the back door. Measurement of such promises should be considered as part of a comprehensive project which applies a single measurement concept to all plans, or not at all.

Question 6 (Chapter 5)

Would many promises be reclassified from defined benefit to contribution-based under the Board's proposals? What are the practical difficulties, if any, facing entities affected by these proposals?

Yes. We are aware of many promises which would be re-classified from Defined Benefit (DB) to Contribution-Based (CB). To pick just a few countries, career average, flat currency benefit and cash balance promises are prevalent in Italy, the Netherlands and Switzerland and common in Germany and the US and are becoming more common in the UK. While comprehensive statistics are not available, we believe that this proposal would impact more than half the plans in the US and all cash balance plans in Switzerland.

We foresee a number of practical difficulties if the Board's proposals are implemented:

First, there will be endless debate and discussion as to which category various promises lie, for example:

- Plans that used to have a salary risk but no longer do for some reason, for example because benefits have been frozen (by no means an unusual situation in the UK, and growing). Are these still DB plans under the Board's proposals?
- Final salary plans where pensionable pay is capped and a large proportion of members are earning in excess of the cap.
- Plans where benefits accrue under an individual level premium approach where allocations that are wholly defined at the end of each period in terms of current salary build up to provide a final salary benefit (for example, the prevalent ITP2 plan in Sweden). An example is given at Appendix A showing how the CB definition can be read to encompass a final salary plan like ITP2. Indeed we believe it can be read to encompass any final salary plan. This may be a question of inadequate wording of the current definition, but it underlines the difficulty of the distinction the IASB is seeking to make.
- Plans where it is no longer known how the benefit was defined at origin (e.g. pensioner portfolios acquired as a result of M&A activity).

Then, there will be difficulties stemming from the artificial divide between DB and CB, with implementation details for the latter open to a wide range of different judgements. The consequences can range from inconsistent implementation to behavioural actions driven purely by the accounting rules. Some examples are:

- There will be significant and unjustifiable measurement anomalies. For example, two pensioner portfolios which are otherwise identical except that they are classified as DB and CB respectively due to their different origins would be measured differently! In practice this anomaly would very often arise within the same plan.
- Similarly, a plan that averages salary over a whole career would, IASB staff have confirmed to us, be valued differently to one that averages it over all but the first year of service. There is no essential difference between such plans.
- Since the CB approach treats some pensions more harshly than others, one consequence is to penalise companies that currently offer or may consider offering CB promises.
- The proposals will encourage sub-optimality in investment decision making, and therefore poor allocation of capital. When setting investment strategy for pension plans, companies typically have regard to balance sheet and P&L risk under their accounting standard (as well as funding and cash-flow considerations) through ALM (asset-liability modelling). If, due to different accounting approaches, CB and DB benefits are measured and recognised differently in ALM studies, despite there being no difference between many CB and DB promises in terms of how investments may hedge the risks, the resulting investment strategies will be skewed and sub-optimal.
- There will be numerous difficulties with measurement and presentation of CB promises in commingled plans (where separate DB and CB sections share a single pool of assets). Such plans are not uncommon in the UK, and specific problems we have identified are

(see Q12(b) and Appendix B):

- Artificial assumptions are needed to disaggregate changes in plan assets and liabilities in order to accommodate the different presentation approaches for CB and DB
- In order to apply the credit risk adjustment to the measurement of the CB promise, it is necessary to first measure the DB liabilities at fair value despite the measurement of DB plans being outside the scope of the present consultation.

In addition, there are practical problems with benefits which the Board has excluded. Some of these excluded benefits can be significant proportion of the total obligation, and guidance on their recognition and measurement would be necessary. Examples are:

- The treatment of death and disability defined benefits in CB plans. In our experience, in relation to Swiss cash balance plans, between 10% and 30% of the DBO (as defined under IAS19) would relate to death and disability defined benefits.
- In Norwegian final salary plans and some Dutch insured plans there is a requirement to provide pension increases in line with the return on plan's investments less a fixed margin. We understand from the IASB staff that these plans would be categorised as DB and therefore outside the scope of the Board's current consultation. This is peculiar as the measurement issues arising from the pension in payment depending on asset returns are identical to the issues in plans where benefits in the accumulation phase are tied to asset returns. They are no more or no less "troublesome" than some of the plans included in the CB definition.

Finally, if the Board proceeds we think it important that the Board should make clear that a financially immaterial plan feature should not drive its categorisation and presentation if it is considered more practical and materially accurate to account for the plan under the other classification.

Question 7 (Chapter 5)

Contribution-based promises, as defined in this paper, include promises that IAS19 classifies as defined contribution plans. The Board does not intend this proposal to lead to significant changes in the accounting for most promises that meet the definition of defined contribution plans in IAS19. Do the proposals achieve that goal? If not, why not?

The accounting treatment of pure DC plans (under the current definition of IAS 19) should be left unchanged.

Conceptually, we believe it may be simpler to think of a DC plan as one under which, once payment of the defined contribution has been made in the relevant accounting period, all obligations and opportunities have been settled or transferred to the employees within the accounting period.

Recognition issues related to contribution-based promises

Question 8 (Chapter 6)

Chapter 6 discusses recognition issues related to contribution-based promises. The Board's preliminary views are summarised in paragraphs PV9-PV11. Do you have any comments on those preliminary views? If so, what are they?

In our response to Question 6 we have highlighted many detailed recognition issues that will arise in practice because of the artificial dividing line between defined benefit and contribution based promises. At the very least, extensive guidance will be required, and during this process many of the preliminary views may have to be re-considered.

The recent survey, referred to above, revealed a desire for improvement / clarification around the treatment of such plans; this did not significantly differ between those plans whose benefits are tied to investments (82% desiring improvement) and those which are not (77% desiring improvement). In our experience, the most common issue affecting such plans, where change / clarification would be welcome, is the requirement to "project and prorate" set out in paragraph 67 of IAS19 (in the case that service in later years will lead to materially high levels of benefit.)

An example of this would be cash balance plans with age related contribution rates (a feature of most cash balance plans in Switzerland). On the one hand, it might be argued that the stepped contribution rates are a reflection of the age related element of the demographic risk, rather than expected salary patterns and therefore a uniform cost recognition method (such as project and pro-rate) might be applicable. On the other hand, it could be argued that the back loaded accruals (and cost) are a deliberate feature of benefit design and the application of a uniform cost recognition method would be inconsistent with the treatment of DC plans with stepped contribution rates.

Considering all plan types (including final salary), we believe that the project and pro-rate recognition method should not be applied to promises where benefits accrue as service is rendered. This methodology is really a smoothing mechanism which we believe is less relevant given the current thrust towards immediate recognition and it leads to anomalies in comparison to DC plans where there is no such requirement. Our suggestion would also remove an anomaly where accrued benefits are backed by insurance policies. So, we agree with conclusion PV10 but would extend it to all plan types (and would say that if it is implemented for CB but not for final salary plans that would introduce a further unwarranted difference in their treatment).

If the IASB does not wish to review paragraph 67 for all plan types now, we suggest it does at least make clear that projection and proration should not be required for plans with a uniform accrual rate where the only reason for an expectation of higher accrual in later years is that the assumed salary increases exceed the assumed crediting interest rate. We do not believe that the wording of IAS19 should require application of projection and proration in this situation, but we are aware that some auditing firms believe that it does, and an example in IFRIC exposure draft D9 indicated that it might be.

We do agree with PV11 that one should not recognise an additional amount to reflect any additional liability due to acceleration of benefit payment should members leave service immediately, as this is inconsistent with a "going concern" approach.

Measurement of contribution-based promises

Question 9 (Chapter 7)

(a) Are there alternative measurement approaches that better meet the measurement objectives described in this paper? Please describe the approaches and explain how they better meet the measurement objectives?

The measurement attribute for CB promises is vague and there will be many different ways to interpret it with widely differing outcomes. In our response to Question 6 we have highlighted some of the potential measurement and presentational difficulties, and provided a real life example in Appendix B of how widely differing valuations could result. An improvement in accounting will not be achieved if widely different interpretations are made, as there will be no consistency and comparability between companies. So, a pre-requisite for successfully implementing "fair value" as a principle would be that the IASB provides detailed, context-specific and country- specific applications guidance. We question if the IASB has the resources and inclination to do this. See further comments in our responses to Questions 9(b) and 10(b) and the example in Appendix B.

In principle, stochastic or option pricing techniques would be required to fully understand the value of some embedded guarantees, but that would bring considerable complexity, and so we think pragmatic alternatives need to be possible for less material plans and benefit features.

As discussed in our response to Question 1, we believe that an approach based on the principle of a single measurement concept for all plans and focussed on the underlying risks which the management of the entity is taking on behalf of its capital providers would meet the objectives of the primary users better. However, any discussion beyond the broad principle needs to await the conclusion of the Conceptual Framework and Fair Value Measurement projects.

(b) To what extent should the effect of risk be included as a component of the measurement approach at this stage of the Board's post-employment benefit promise project? How should this be done?

In general, we favour the allowance of risk in the measurement approach for pensions if that is consistent with other areas of accounting, and subject to some practical considerations.

We believe the UK's ASB is correct in the conclusion in its recent discussion paper that allowance for demographic risk is "too difficult". We do not believe that in most practical situations it could be discerned from observable market inputs. So any allowance would be highly subjective.

Ignoring the risk that the terms of the benefit promise may change results in double-counting. Possibilities of the sponsoring employer to change benefits that exist in some benefit plans reduce the value of such plans to members and should, all else being equal, mean employees demand separate compensation for that risk. The cost of that compensation will be accounted for elsewhere, and so to ignore the possibility of plan changes results in double counting.

We believe that where there is a credit risk associated with the payments being valued, then a valuation of that obligation should in principle allow for that risk. This is particularly true of pensions and so, ***provided that the overall approach to accounting is that credit risk should be allowed for[1],*** then the same principle should extend to pensions as well.

Assuming the Board agrees that some allowance should be made for credit risk, we would not suggest seeking a theoretically 'perfect' measurement attribute that accurately prices the specific credit risk of the plan and employer options. We believe theoretical perfection is impractical because:

- There is no single "magic number" that adequately captures the uncertainty in pension plans and so theoretical perfection is not just impracticable but it is unachievable. The case for this is made in the Cass Business school paper of January 2008 "An unreal number".
- Widely different viewpoints can be justified on credit risk adjustments (but importantly, the adjustment is not zero). This is because of the lack of any developed benchmark to assess credit risk for pensions.
- Additional issues arise from consideration of how collateralisation from the plan's assets should be taken into account. We have recently supplied the IASB staff with real life examples showing a wide range of possible answers under different approaches which could be argued as being reasonable, particularly in the case of a plan with both DB and CB elements (see appendix B).
- Also, post-retirement benefit obligations vary widely in their nature globally. It is very difficult to put a value on the employer's option to make plan changes that affect accrued benefits, and where such options exist, widely different values could reasonably be put on the option by different preparers.
- There is no universally agreed theoretical basis on which to base such a measurement – this is shown by the debate over what a "risk-free" discount rate might mean.

In view of these points, extensive guidance would be needed on how to apply a sophisticated measurement attribute, to avoid inconsistent application between companies and across different jurisdictions. We do not believe such detailed guidance is on the IASB's agenda and therefore we question the practicality of a sophisticated measurement attribute.

Additionally, there would be the need for a comprehensive set of disclosures to enable preparers to communicate essential information on the choices made or interpretations applied, and the IASB would need to consider the proportionality of this relative to all the other information that needs to be communicated in the report and accounts. (See our response to Question 14).

Therefore, on practical grounds, we argue for a simple benchmark that, whilst admittedly imperfect for any plan, is easily understood, is comparable between companies, and makes some allowance for credit risk and employer options. As any such approach involves artificial choices, we see no compelling case to change from the existing high quality corporate bond-based approach but

[1] The majority, 54% of respondents in the survey referred to, disagreed with making an allowance for credit risk for pensions. This may reflect a view that credit risk should not be allowed for in valuation of obligations generally or it could reflect the belief that reflecting a company specific credit risk is impractical; the survey does not consider such wider issues.

applied consistently across all countries. (The current approach where liabilities in some countries are discounted at a government bond rate and in other countries at a corporate bond rate is the result of an IFRIC decision on this point which was a narrow interpretation of IAS19's wording and as a simple matter of consistency we believe a broader interpretation should allow a credit risk adjustment in countries where there is no "deep" market in corporate bonds).

Consistent with this, our suggestion is that unless and until the IASB considers measurement comprehensively (and as made clear above we are unconvinced about finding any practical approach that is better than the one we have), plans with benefit amounts linked to investible assets should be valued by reference to the market value of those assets but then with a credit risk adjustment applied based on spreads between AA corporate and government bonds. We believe that this is a reasonable and pragmatic interpretation of IAS19. Coupled with the removal of projection and proration which we argue for in our response to Q8, simple guidance of this nature would be a pragmatic stop-gap that would lead to greater uniformity of practice around "troublesome" plans and avoid discontinuity of treatment to other non-settled plans. It will leave unanswered questions of application for some plans (Swiss plans in particular where benefit indexation decisions are in the hands of the plan's management, not the company), but many fewer than under the IASB's current proposals.

One objection to such an approach voiced to us by IASB staff is that "AA is obviously wrong for some plans". That is of course true, but it is no less true than for the case of DB pensions in payment from a fund that is heavily in surplus and backed by an AAA rated employer. An across the board AA adjustment in unlikely to be "right" for any plan, but it would be consistent with what is currently done for the vast majority of plans (both DB and CB). The IASB does not seem to consider a review of this to be a priority issue for DB plans.

One could also point to resulting discontinuity in valuation between "troublesome" plans valued using an AA corporate bond rate, and DC plans. However, there is a genuine distinction; DC plans are settled (no risk to the sponsor) whilst the plans in question are not settled (some risk). We believe this distinction is less artificial than the distinction proposed by the IASB between CB and DB plans, and our suggested approach is a more proportionate and "less worse" stop gap than what the IASB proposes.

Question 10 (Chapter 8)

(a) Do you agree that the liability for benefits in the payout and deferment phases should be measured in the same way as they are in the accumulation phase? If not, why?

We do not believe there should be a discontinuity at leaving employment any more than we believe there should be a discontinuity between identical or very similar plans. We strongly disagree with the IASB's proposal to introduce such discontinuities. After all, users are interested in understanding the liability, as evidenced by future cash outflows and the risks associated with them. In the payment phase, if the risk is the same for two sets of identical cash flows, then they should have the same value. The circumstances under which the liability arose should no longer be of concern.

The IASB's proposal is a disproportionate response to a limited problem and its partial nature will cause more problems than it will solve.

(b) What are the practical difficulties, if any, of measuring the liability for a contribution-based promise during the payout phase at fair value assuming the terms of the benefit promise do not change?

These are generally the same as in the accumulation phase, and unless the IASB provides detailed application guidance, different companies could value identical promises very differently. Additionally, determining fair value by reference to observable annuity prices may be misleading in markets, which are not 'deep' and liquid, or where the design and pricing of annuities is biased by regulations (for example, the US). In practice, there will be very different views on what constitutes a deep and representative market, thereby leading to inconsistency in application. It is not obvious to us that any of the world's annuity markets would be considered deep for this purpose.

Disaggregation, presentation and disclosure of contribution-based promises

Question 11 (Chapter 9)

(a) What level of disaggregation of information about changes in the liability for contribution-based promises is useful to users of financial statements? Why?

The same level as is considered useful for defined benefit plans, since many CB plans are indistinguishable from DB plans in any real way, and from a user's viewpoint the distinction between the two is artificial in any case.

(b) Do you agree that it is difficult to disaggregate changes in the contribution-based promise liability into components similar to those required for defined benefit promises? If no, why not?

It is no more difficult, once a method is agreed on how to calculate the discount rate and the expected return on assets. We would note that the fair value approach to CB plans does not remove the need to decide what the discount rate is, since a discount rate is implicit in any measurement method.

Question 12 (Chapter 9)

Should changes in the liability for contribution-based promises:

(a) be presented in profit or loss, along with all changes in the value of any plan assets? or

(b) mirror the presentation of changes in the liability for defined benefit promise (see Chapter 3)? Why?

We think the same presentation approach should apply for all plans, and that it is vital to split out operational from market aspects. We note that Approach 1, amongst the Board's presentation options, does not meet this criterion (see our responses to Questions 3(b) and 11)

Further, the proposals for different treatment are unworkable in the - frequent - case of a plan with both CB and DB benefits with a common pool of assets, or a "better of" plan. Consider these issues:

- How does one split the assets for reporting?
- Even harder, how does one split the actual return on the assets? Should one assume that the different types of promise are backed by a pro-rata share of assets or by different

asset classes reflecting different investment strategies which, in turn, reflect the different duration and nature of the benefits? The investment strategy will typically have been determined with regard to the overall mix of liabilities; it is not the sum of two separate strategies for two sets of (artificially split) liabilities.

Benefit promises with a 'higher of' option

Question 13 (Chapter 10)

(a) What are the practical difficulties, if any, in identifying and measuring the 'higher of' option that an entity recognises separately from a host defined benefit promise?

Running stochastic or other option-pricing models to do such calculations means more complex and costly actuarial valuations than those with deterministic scenarios. But, if the options in the plan are material, it is necessary to understand them. We believe it important for the Board to make clear that materiality considerations may permit less sophisticated techniques.

On another practical point, we do not think that the host benefit should always be the DB promise. Sometimes it would be much easier to value the CB promise as the host, with the DB on top. In general, we would suggest that where there are two competing formulae for all employees, the host plan should be the one that is expected to prevail most of the time. But, of course this distinction only matters if there are different measurement attributes for different types of plan – we do not believe there should be. A common measurement attribute will ensure the same valuation regardless of which benefit is regarded as "host".

(b) Do you have any other comments on the proposals for benefit promises with 'higher of option? If so, what are they?

The IASB seems not to have considered the parallels between "greater of" plans and the asset ceiling and whether the resulting inconsistencies of treatment are acceptable. For example, consider the following two pension plans, each with one member:

- Plan A: DB benefit of 50% of salary at retirement. Company is required to contribute at 5% of pay no matter what the funding level, and cannot get any surplus back.
- Plan B: DC plan with contribution 5% of pay but with underpin benefit of 50% of salary.

These plans are identical in their financial effect on the company and we suggest, therefore, that they should be accounted for in the same way. However, under the IASB's proposals, we believe plan A would be considered a DB plan and the asset ceiling / IFRIC 14 would limit recognition of surplus but assessed on a deterministic approach. Meanwhile, we believe Plan B would be considered a "better of" plan with any benefit in excess of the 50% underpin being treated as CB and valued at fair value, with option pricing techniques being used to anticipate the possibility of the CB promise being non zero, even if it is currently "out of the money". Presumably this could give different answers to applying IFRIC 14.

We presume the IASB would not wish to revisit the asset ceiling and IFRIC 14 at this time and so it is hard to see how these anomalies can be prevented if the IASB proceeds with its proposals for "better off" plans. Any revisiting of the asset ceiling to address this issue would, we suggest, only be tenable in the context of a comprehensive project since it immediately impacts on the question of how DB plans are measured.

Other matters

Question 14

What disclosures should the Board consider as part of that review?

We suggest it would be helpful to reinforce that longevity is often a material assumption by requiring it to be disclosed.

Mandatory disclosure of sensitivity to key assumptions and some information regarding expected cash flows would mitigate limitations in the broad-brush approach to measurement that we advocate, with far less cost, disruption and scope for variation in practice than the IASB's current proposals.

If the IASB's proposals for CB promises proceed, we foresee a need for increased disclosure about the value judgements made in assessing fair value. Such disclosures could incorporate a description of the methodology underlying fair value, as well as specifics of the collateral and credit risk allowed for (plan sponsor or parent company, and what about joint ventures?). We note that this would be cumbersome. However, without comprehensive disclosures to compensate for the vague measurement concept, it will be impossible for users to judge the reasonableness of the value put on the obligations.

Question 15

Do you have any other comments on this paper? If so, what are they?

The proposed terminology of "contribution-based" and "defined benefit" is highly confusing and we have seen examples of such confusion when discussing the Board's proposals with clients.

- If the IASB pursues a category of plans that is narrower than the ordinary sense of the words "defined benefit" then, it should find a different phrase.
- We are aware that the distinction between "contribution-based" and "defined contribution" may be lost on translation to other languages and a more distinctive terminology is necessary.

Such problems are not merely semantic; they will cause real difficulties to multinationals seeking to explain the requirements to their operations around the world to enable proper production of accounts.

We would expect comprehensive field testing and cost benefit analyses to be carried out before any final decisions are taken, particularly since we believe the number of pension plans affected by the proposed contribution-based measurement attribute may be very significant.

The existing IAS19 standard is widely credited with improving the quality of pension disclosure, with increasing consistency of treatment between companies, and with raising pensions to a deserved level of attention. The proposed measurement change to a wide range of plans would bring no further advantages in these respects. Rather, we think attention should be focussed on recognition aspects, (but only once the Financial Statements Presentation project is complete) on further improvements to disclosure and sensitivity analysis, on the question of projection and proration, and on some simple guidance around "troublesome" plans which will have a much higher benefit to cost ratio than a change in measurement attribute.

Finally, we would emphasise again the danger of addressing many of the fundamental and inter-related issues piece-meal (see our response to Question 1) by using pensions as a test bed. We believe the interests of financial statement preparers, as well as users, would be better served through a more cohesive approach, which gives priority to settling first the principles governing the conceptual framework of accounts, fair value measurement, and cost recognition. A consistent application of the resulting principles to pensions and other areas of accounting should then follow more logically. If pensions are treated more harshly or leniently than other aspects of a company's accounts then sub-optimal decisions will be made.

Example of how a final salary plan appears to meet the definition of "Contribution-Based"

Introduction

1.1 The ITP plan is the prevalent white collar industry wide pension plan in Sweden with some 700,000 active members. ITP2, the defined benefit section of the plan may be financed in one of three ways (at each employer's choice): though purchase of with profit insurance from Alecta (a mutual insurer), by making unfunded balance sheet provisions, or via a pension foundation.

1.2 In outline, on retirement at age 65, after a full career of 30 or more years, ITP provides the following annual pensions, as a percentage of Pensionable Salary at retirement.

Pensionable Earnings band (Base Amounts)	Member's pension
0 – 7.5	10%
7.5 – 20	65%
20 – 30	32.5%

The base amount is currently SEK 48,000 and increases in each year in line with average earnings.

Pensionable earnings includes bonus. There are some restrictions on the size of pensionable earnings increase after age 60; the plan is therefore a final salary plan, albeit with, effectively, some averaging of final salaries.

Individual level premium method

1.3 The approach used to determine the accrual of benefits from year to year can be described as an individual level premium method. It is easiest first to describe the build up in the case that the benefits are insured with Alecta.

1.4 Consider an individual who enters the system. Based on his current Pensionable Earnings, the pension that will be payable from age 65 is calculated according to the formula in paragraph 1.2 ***(Future increases in earnings and base amount are not anticipated).*** A deferred annuity for the amount of this pension payable from age 65 is purchased from Alecta. Alecta calculate a level monthly premium, and guarantee that if this premium is paid through to age 65, they will pay the member's pension benefit.

1.5 After one year, the position is reassessed. Typically, Pensionable Earnings and the Base Amount, and with them the pension payable from age 65, will have increased. Alecta calculate the additional premium which if paid through to age 65 will provide the additional required retirement pension.

1.6 These premiums paid are accumulated by Alecta with interest from year to year, also the accumulation is increased with the bonus level declared by Alecta.

1.7 At any time the pension purchased to date from Alecta is the pension that equates in value to the accumulated premiums. That is the benefit the member receives as a vested deferred pension payable from 65 should he leave the ITP system.

1.8 In the case that the benefits are not insured with Alecta, (i.e., the book reserve or foundation approach is selected) a shadow calculation is made of the notional premiums Alecta would have charged and also of the accumulation of those, from which is derived the amount of pension which would have been purchased to date. This means the member's accrued benefit is identical whether or not the plan is insured with Alecta or one of the other to financing methods is used.

1.9 Therefore at any time, the pension earned by the member can be expressed in terms of notional contributions that are known at the end of the period and a future return on those, and most importantly, is independent of any future salary changes. There is no other attribution of the earning of pension that is implied by the system. The 30 year minimum requirement for the full pension does not in our view imply any attribution: the pension paid at 65 for a member with 35 years service is the same as that for a member with 30 years service. Should a member who joined at 30 leave at 60 they do not receive the full accrual as a deferred pension, nor 30/35ths of it, but the amount of pension defined by the individual level premium approach.

1.10 It therefore appears to us that the system meets the definition of a Contribution-Based promise as set out in the paper para 5.3. The point is that contributions that meet this definition can build up to a final salary benefit. All that is necessary is that the contribution known at the end of the period is a function of the ***change*** in salary over the period and not just of the salary during that period.

Conclusion

- We question whether the IASB would intend that ITP2 would be categorised as Contribution–Based: this for a plan which has always been regarded as a final (average) salary plan in the ordinary sense of the words. It has always been practice to value ITP2 when financed under the book reserve or foundation methods as a final salary plan with normal IAS19 defined benefit accounting. (In the case of ITP2 insured with Alecta, it is practice to treat the plan as if it were defined contribution, due to some multi-employer features. This distinction is not relevant to the point at issue.)
- The most material benefits provided by pension plans are those on retirement and it would be odd if two plans with identical final salary retirement benefits are categorised and measured differently because the – less financially significant – leaving service benefits build up in different ways.
- Lest it be though that this is an issue unique to ITP, some Danish plans use the same Individual Level Premium approach and it used to be the approach used in Norway.
- There may well be other examples, and indeed it would not be difficult, albeit less natural, to present a typical final salary plan (for example, a typical UK plan with a 60ths accrual rate) in a way that fell within the IASB's CB definition in para 5.3 of the discussion paper.

Our conclusion is therefore that the IASB's proposed definition does not adequately make the distinction that the IASB is seeking.

Difficulties in interpreting "fair value" measurement of CB plan, particularly when it is commingled with a DB plan

Introduction

1.1 This note contains a brief description of the XYZ pension plan, which has separate defined benefit (DB) and cash balance (CB) sections but sharing a single pool of assets. The purpose of this appendix is to provide a brief description of the CB Section, and to explore the uncertainties in valuing it under the IASB Phase 1 proposals. The note is based on a real plan; non-essential details have been removed in the interests of clarity and highlighting the key points at issue, and the figures quoted are illustrative.

Summary of the cash balance element of CB Section

1.2 The plan is summarised as follows:

- Each member has a cash balance account which receives a credit of a fixed % of salary each month.
- The account balance is then re-valued in line with price inflation to a maximum of 5% pa (the maximum applies each year). Further increases of up to 2% pa may be granted depending on the returns on an equity index relative to price inflation.
- At retirement, the account balance is available to purchase an annuity on the open market.
- The assets held in respect of the cash balance section are part of the general pool of assets backing XYZ's defined benefit liabilities. There is no segregation of the assets from other defined benefit assets.
- On leaving service, the account balance attributed to the member continues to receive revaluation and is then applied to produce a pension from retirement age.

How might one value the CB plan if the IASB's proposals are implemented?

1.3 We believe that under the IASB proposal, the CB Section will need to be valued under the accrued benefit method rather than a project and prorate method; however the basis of valuing the accrued liabilities is less clear.

1.4 As a basis of illustration of the uncertainties the table below sets out specimen liabilities on some possible alternatives. It should be noted that the proposal currently does not suggest a change to the method of valuing the final salary liabilities; however these are shown as the overall level of asset coverage (collateral) may well impact on the value placed on the CB Section.

Discount rate	Cash balance liability Based on accrued benefits not project and prorate	Final salary liability excluding CB Section No allowance for salary projection	Total defined benefit assets	Overall funding level
AA Corporate bonds (5.82%)	2,950	6,323	10,000	107.8%
Gilts (4.54%)	3,900	7,902	10,000	84.7%
AA Corporate bonds +2% (7.82%) – Proxy for Plan sponsor's own risk	2,000	4,416	10,000	155.9%

Crediting interest rate:

1.5 Stochastic modelling/option pricing techniques are necessary in principle to assess an appropriate assumption as to the crediting interest rate, but in practice, the narrow range between the floor and ceiling on increase, dependant on equity returns, means the range of possible assumptions relative to long term inflation is small. Therefore, no major difficulties arise in setting an assumption.

Demographic uncertainty fluctuations:

1.6 The big demographic uncertainty (post-retirement longevity) is not there for the CB Section (as the plan does not guarantee any rate of conversion of accumulated balance to pension at retirement), so we believe these should be small and we leave them to the side for now.

Risk free discount rate:

1.7 It is not clear whether this should be based on government bonds, swaps or something else.

Credit risk in a standalone plan:

1.8 Credit risk is the big uncertainty we have identified in the assessment of fair value for the CB Section and we have identified several questions/difficulties.

1.9 According to the IASB's consultation paper, credit risk should take into account both the entity risk and the degree of collateralisation (funding). We therefore hypothesise that if the plan's assets exceed the liabilities assessed on a risk free discount rate, then little or no credit adjustment should be made (in principle there is still some risk, for example, if asset values decline). This suggests that a practical approach would be to make the credit risk adjustment only on the excess of liabilities over assets, which in turn raises questions about how the liabilities would be measured for this purpose. For example, would we use a risk free discount rate, a risk free rate plus an uncertainty allowance (and how would the latter be determined?) or a settlement cost?

1.10 Additionally, it is not clear what adjustment should apply to the excess for credit quality? This should be specific to the pension situation. Credit ratings/pricings of an entity's bonds may be a poor indication of credit risk applying to pensions, given different priorities and approach to building up the funding level and so changing the degree of collateralisation. But they may be the best indication available.

Complications to credit risk when looking at part of a bigger plan with commingled assets:

1.11 Since the CB Section is part of a bigger plan, presumably it is necessary to allow for this in assessing which part of the liabilities is funded. Several issues arise because there is no segregation of assets in the plan:

a. Priority issues: which liabilities are assumed to be covered by the assets? This is important as a credit-risk adjusted discount rate impacts very differently on benefits paid later than on those paid sooner.

- Those paid first?
- According to plan termination priority rules?
- The same proportion of each benefit payment?

b. Is it necessary to allow for salary projection on main plan benefits in doing this, or are the relevant benefits for this purpose the accrued/termination benefits?

c. Is it necessary to allow for a demographic risk uncertainty allowance on the DB benefits plan in assessing degree of asset coverage? This could be a factor due to longevity risk, which does affect the final salary DB pension plan even if it does not affect the CB section. The IASB paper suggests that annuity pricing would be used to do this and the IASB staff have indicated to us that this would be the case if the annuity market is considered "deep and liquid". Would the UK market be considered "deep and liquid"? Evidence of major changes in market pricing caused by new entrants could be read either way. Could any market in the world be considered deep enough?

Two possible "strawmen" valuations

1.12 The following calculations outline two different valuations emanating from different, but not unreasonable, answers to the above questions.

Strawman Valuation 1 of CB Section

- Assume assets collateralise an equal proportion of each benefit.
- Don't allow for a mortality fluctuation reserve on final salary benefits.
- Don't allow for salary projection in final salary benefits.
- Risk free rate taken as government bonds.
- Assess credit risk on unfunded benefits based AA index yields, which are lower than the yield on the sponsor's own bonds; hypothesise that the pension funding regime will force collateralisation to increase in the future, so the yield on the Sponsor's own bonds is not an appropriate measure.
- 84.7% of benefits are deemed to be collateralised.
- Valuation 3,900 x 84.7% + (1 – 84.7%) x 2,950 = 3,755

Strawman Valuation 2 of CB Section

- Assume assets collateralise those benefits that are paid first.
- Those will be the final salary benefits as it is the older part of the plan.
- Allow for a mortality fluctuation reserve on final salary benefits – assume 10%.
- Allow for salary projection on final salary benefits – assume 5%.
- Risk free rate taken as swaps – assume 0.2% above government bonds.
- Assess credit risk on unfunded benefits at the sponsor's own bond rating.
- Final salary benefits "face value" would be:

  $7{,}902 \times (1-0.002)^{15\text{say}} \times 1.1 \times 1.05 = 8{,}857$
  (making adjustments for swaps, mortality uncertainty, and salary to the gilts liability.)

- Assets available to collateralise CB Section are:

  $10{,}000 - 8{,}857 = 1{,}143$

- Take 1,143 of the liabilities measured on swaps as needing no credit risk adjustment, this suggests a valuation of:

  $1{,}143 + (3{,}900 \times (1-0.002)^{25\text{say}} - 1{,}143) \times 2{,}000/3{,}900 = 2{,}459$

  The adjustment to the 3,900 is to move from gilts to swaps and the ratio of 2000/3900 is to apply the sponsor's credit risk based on its own bond rating relative to gilts.

  But this valuation of 2,459 is overstated. The credit adjustment needs to be applied to those CB benefits paid last (as we are assuming it is those paid earliest that are collateralised) so the adjustment will be greater than 2,000/3,900.

  Allowing for this could bring the valuation down to about 2,300.

Conclusion

1.13 On the basis of these two interpretations we have valuations of the CB benefits ranging from 2,300 to 3,755 – a range of 63%. Many other valuations in the range are possible, as are others outside the range – for example we have not looked at annuity buyout cost to get the mortality fluctuation reserve adjustment.

1.14 Absent detailed guidance from the IASB, we expect that companies may come to many different legitimate conclusions.

1.15 Finally, the example shows that ***in order to make the valuation of the CB section it is necessary to effectively decide how fair value should be applied to the final salary section***, including such questions as allowance for salary progression.