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10178 Berlin, den 26. September 2008
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Comments on the Discussion Paper "Preliminary Views on Amendments to IAS 19 Employee Benefits"

Dear Sir David,

Thank you for the opportunity to respond to the IASB's discussion paper "Preliminary Views on Amendments to IAS 19 Employee Benefits". The following comments focus on the implications of the proposed changes for the types of pension benefit promises most prevalent in Germany.

As we understand it, the plan is to consolidate the approaches to accounting for pension benefit promises in IAS 19 and US-GAAP into a single global standard. This is to be achieved in two phases. In the first phase, short-term improvements are to be made to the existing IAS 19 rules before subsequently, in a second phase, harmonising the European and US approaches and establishing a common standard. The discussion paper outlines the IASB's initial proposals for improving IAS 19. These proposals are also to be viewed in the context of two other ongoing projects by the IASB, namely the creation of a consistent fair value concept within the Framework and the project on financial statements presentation.

The plan to address changes to accounting for pension benefit promises in two phases and to take account of other IASB projects has our full support.

Unfortunately, however, we believe that the changes proposed in the discussion paper are fundamentally flawed. Before replying to the 15 questions posed in the paper, we would like to summarise our main criticisms as follows:

- Introduction of a new classification system unnecessary

The discussion paper proposes replacing the existing classification of benefit promises into “defined contribution plans” and “defined benefit plans” with the new terms “contribution-based promises” and “defined benefit promises”. The new contribution-based promise category is broader than the existing category covering defined contribution plans and, in particular, includes hybrid promises with a guaranteed return, which are currently classified as defined benefit plans. One of the declared objectives of the project’s first phase is to find an appropriate way of dealing with promises of this kind, for which IAS 19 currently offers no satisfactory solution.

We consider the new categories of benefit promises inappropriate and unnecessary to achieve the objectives of the first phase. It would be hugely onerous for employers to have to go through all existing benefit promises and allocate them to one of the new categories. We believe it would be sufficient in the first phase of the project to clarify the measurement rules for hybrid plans guaranteeing a fixed rate of interest.

- No need to dispense with the “corridor”

It is envisaged that the measurement of defined benefit promises will remain unchanged. Their presentation would change, however, in that the exact net obligation would have to be shown in the balance sheet with all changes either recognised in the profit and loss account or reported in OCI. The discussion paper proposes three approaches for reporting the changes in OCI. But unlike in FAS 158, for example, there is unfortunately no provision for recycling components from benefit obligations in OCI. As a result of these changes, the currently widespread corridor and SORIE methods would be eliminated or made much more difficult to apply.

Given the long-term nature of pension benefit promises, we do not consider it appropriate to require immediate recognition of short-term changes in the fair value of net benefit obligations (defined benefit obligation less plan assets) caused by changes in assumptions.

- Immediate recognition of past service cost inappropriate

We consider the present practice of distributing past service costs over the period in which the entitlement to increases in benefit promises is acquired to be more appropriate than immediate recognition at the time of a plan amendment, as envisaged in the discussion paper.

- Lack of clarity concerning fair value measurement of contribution-based promises

The discussion paper does not spell out explicit rules on measuring contribution-based promises but instead sets out abstract principles to be complied with. Among the most important are the fair value approach and the consideration of an entity's own credit risk when measuring benefit obligations.

The details of this approach are not sufficiently fleshed out, which throws up a number of practical questions concerning implementation. It would be desirable, in our view, to first await the findings of the parallel work which is being undertaken on creating a consistent fair value concept in the Framework.

- No suitable solution to the "higher-of" problem

If employees are promised the higher of a contribution-based promise or a defined benefit promise (higher-of option), entities currently use a mathematical formula to determine which is the higher. The discussion paper envisages no longer allowing this practice. Instead, defined benefit and contribution-based promises would be measured independently of one another, the latter using the new, undefined fair value approach. The balance sheet would show a provision for the defined benefit promise plus a separate additional provision to account for the contribution-based promise.

We consider the usual present method of measuring the higher-of option to be appropriate and believe that the proposed new method would complicate matters unnecessarily.

- Recycling of OCI sub-items unclear

It remains unclear whether and, if so, how OCI items arising from benefit obligations can be subsequently recognised in the profit and loss account (recycled).

Our replies to the 15 questions raised in the discussion paper are as follows:

Q1: 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?

- We find the proposed changes excessive. In our view, most of the current shortcomings could have been remedied simply by clarifying how to account for hybrid pension plans. Instead, the new definition of contribution-based promises not only fails to address this issue but, among other things, faces entities with considerable reclassification problems.

- There is no need, in our view, to address any additional issues in the first phase.

Q2: Are there factors that the Board has not considered in arriving at its preliminary views [on the recognition of defined benefit promises]? If so, what are those factors? Do those factors provide sufficient reason for the Board to reconsider its preliminary views? If so, why?

- We see no need to dispense with the corridor method. Entities take a long-term view of pension benefit promises so a short-term, volatile accounting approach does not properly reflect the economic substance of this type of obligation.

  One of the IASB's arguments for dropping the corridor method is its lack of transparency for users of financial statements. We would counter that the development of the obligation over the period is already perfectly transparent if the information in the notes is taken into account.

The third bullet point in paragraph 2.7 of the discussion paper implies that there is no place in the notes for “important information”. We do not share this view. We believe it is precisely the task of the notes to supply important (as opposed to unimportant) information about all items in the balance sheet and the profit and loss account. In our experience, the disclosures in the notes which have been required under IAS 19.120A since the standard was amended in 2004 are easily understandable and well received by interested users.

- As things stand, actual interest income from plan assets is divided into recognised, expected interest income and a residual amount, which is included in actuarial profit/loss. It makes good sense to retain this procedure, in our view, since more useful information is provided by recognising expected interest income in pension expense than by recognising the volatile actual interest income in a period. Furthermore, the question arises as to how “actual interest income” could be meaningfully defined.

- Immediate recognition of past service cost for forfeitable promises in the period of a plan amendment does not make good sense, in our opinion, because employees ultimately become entitled to promised increases in benefits only by virtue of their performance in future periods. The current method of distributing changes in the present value of the obligation arising from the plan amendment over these periods is therefore the more appropriate. In any event, there are inconsistencies between the proposed rules on forfeitable promises and corresponding existing rules in IFRS 2.

  If entities are no longer permitted to distribute past service costs over several periods, we also see a risk of them responding by splitting future plan improvements into a series of annual partial amendments.

Q3: (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:
(i) presentation of some components of defined benefit cost in other comprehensive income; and
(ii) disaggregation of information about fair value?

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

Q4: (a) How could the Board improve the approaches discussed in this paper to provide more useful information to users of financial statements?

(b) 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?

Our response to questions 3 and 4 is as follows:

- We consider the third approach to be the most appropriate of the three alternatives. As explained above, however, the expected interest income from plan assets and not the proposed actual interest income should be recognised.

- Recognising all income and costs in profit or loss as proposed in approach 1 would result in excessive volatility. In addition, it would no longer be possible to disaggregate personnel expense. Key indicators such as expense ratios would lose much of their information value.

- In Germany, pension benefit obligations worth around €250bn are financed exclusively through provisions. Interest income accrues in economic terms even in the absence of plan assets, however, since the pension provisions are covered in the balance sheet by assets other than the plan assets of the entity. Approach 2 would result in inconsistency between the interest income from these assets (which is not reported in OCI) and the interest cost associated with pension benefit obligations (which has to be reported in OCI).

- Furthermore, this inconsistency would make it more difficult to reclassify assets as plan assets (by means of trust instruments, for instance) because this would eliminate interest income and thus have an adverse effect on the profit and loss performance. Approach 2 consequently does not have a neutral impact on decisions concerning whether or not to create plan assets.

- When allocating components of pension benefit obligations and plan assets to OCI, the question arises as to whether and, if so, how these amounts can later be recycled (along the lines envisaged by FAS 158). The procedure proposed in the discussion paper could lead to situations in which certain residual items remain in OCI after pension benefit obligations cease.

- The selected approach should be consistent with the outcome of the IASB's parallel project on overall financial statement presentation. We therefore believe it would be desirable to first await this project's findings.

Q5: 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?

- We consider the new classification system totally unnecessary. Given the tight time frame, it would have been sufficient to clarify the rules on accounting for hybrid promises, for which IAS 19 offers no satisfactory solution as things stand. Minor amendments to IAS 19.64, which now currently requires strict application of the projected unit credit method, would be enough to resolve the existing measurement difficulties in the first phase of this two-phase project.

- The new category of contribution-based promises is too broad, in our view. It covers promises which are currently classified as defined benefit plans and already accounted for in an appropriate manner. The dividing line between the two categories is not clear-cut, as is illustrated by average salary promises (which would be contribution-based under the new system) and final salary promises (which would remain defined benefit-based). If, for example, a final salary promise is calculated on the basis of the average salary over the last three years, it is not clear how the obligation should be accounted for in the final three years preceding retirement.

- What is more, the accounting treatment of some promises will pose problems which have not existed up to now. Take, for instance, the following irresolvable conflict: either a promise is measured consistently throughout its entire duration, that is to say using the same approach in the accumulation and payment phases, or the same measurement method is applied in the payment phase to the same benefits deriving from different promises. Both solutions result in inconsistency.

- The new categories may also give rise to practical problems because measuring a defined benefit promise in the payment phase will depend on information about the accumulation phase such as the precise development of the amount of the promise. But this information may not be readily available. This applies, among other things, to all current pension payments.

- The purpose of replacing the term “plan” with “promise” is not clear to us and is not explained in the discussion paper. We fear that preparers will need additional interpretation guidance.

Q6: 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?

- The working groups of pension actuaries in Germany estimate that around 70 % of all promises would be classified as contribution-based under the Board’s proposals as opposed to only 30 % at present. The promises which would have to be reclassified include average salary promises and promises in the form of contributions plus a guaranteed interest rate.

- One of the main practical difficulties would arise from the fact that the familiar, tried and tested expressions “defined contribution” and “defined benefit” have become established terms both within and beyond the accounting world. If the classification rules were changed, it would not only be the users of financial statements who would have to readjust. All those with benefit entitlements as well as all staff involved in administering pension plans would also need to be educated about and familiarised with the new system. We suggest exploring the idea of introducing grandfathering arrangements for the new classification of existing plans at least.

- We believe it is essential to retain defined contribution plans/promises as a (third) category in their own right because a key feature of these promises is that they are not reported in the balance sheet. Under the discussion paper’s proposals, however, they would in future be combined with promises reported on balance sheet.

Q7 to Q12: Measurement and accounting rules for contribution-based promises

- For the reasons outlined above, we have fundamental reservations about introducing the envisaged new category of contribution-based promises. Our consolidated response to the six questions on measuring and accounting for these promises is set out below.

- The discussion paper proposes that contribution-based promises should be measured at fair value but fails to provide sufficient detail about how this should be accomplished. This raises a number of practical implementation problems. We believe it would be desirable to first await the results of the parallel work on creating a consistent fair value concept in the Framework.

- As part of the fair value approach, the entity's own credit risk is to be taken into account when discounting future cash flows. We consider this practice questionable since it would result, among other things, in an entity reporting income if its credit standing deteriorated. This problem is nevertheless unlikely to be relevant in Germany since the vast majority of benefit promises are protected against insolvency by the German Pension Protection Fund (PSVaG). An entity's own credit risk should consequently play no role in the measurement process.

Q13 (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?

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

- We see practical difficulties in implementing the proposed treatment of plans under which employees receive the higher of either a contribution-based or a defined benefit promise (higher-of option). We consider the existing method of measuring the higher-of option perfectly appropriate and believe that the proposed new method would complicate matters unnecessarily.

- The proposed new contribution-based category would significantly increase the volume of higher-of options and would be impracticable to implement.

Q14: What disclosures should the Board consider as part of that review?

- It is virtually impossible to reply to the question at this stage since requirements concerning disclosures in the notes about pension benefit promises will depend on the precise nature of the amendments which are finally adopted.

Q15: Do you have any other comments on this paper? If so, what are they?

- No further comments.

Yours sincerely
on behalf of the Zentraler Kreditausschuss,
Bundesverband deutscher Banken

Dr. Hans-Joachim Massenberg Silvia Schütte