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International Accounting Standards Board
30 Cannon Street
LONDON EC4M 6XH
United Kingdom

Dear Sirs:

Re: Comments on the Preliminary Views on Amendments to IAS 19

In response to the invitation for comments about the March 2008 Discussion Paper on the Preliminary Views on Amendments to IAS 19 Employee Benefits, we are pleased to send our comments as attached.

If you have any questions regarding this submission, please do not hesitate to contact Ken Sugita at Ken_Sugita@chuomitsui.jp.

The opinions expressed or implied in this comment letter are solely those of us, Ken Sugita and Kozo Omori, and do not necessarily represent the views of the Chuo Mitsui Asset Trust and Banking Company, Limited.

Sincerely Yours



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Attachment

Commentary on the Preliminary Views on Amendments to IAS 19

We have four major issues with the Discussion Paper.

1. The boundary between “Contribution-based promises” and “Defined benefit promises” is not always clear, and there is no need to distinguish between the two, because of the availability of a consistent and comprehensive approach in the evaluation of pension liabilities by the use of the mark-to-market valuation method.
2. The use of “other comprehensive income” is indispensable in the evaluation of profit or loss, to be consistent with other accounts such as rent that are never measured by a change in market value. If some accounts are evaluated by accrual income, and other accounts are measured by a change in market value, the risk of the former accounts will be evaluated as smaller than the risk of the latter. Therefore, approach 2 or 3 should be applied not only to final-pay promises but also to other promises such as career average promises and cash balance promises.
3. Credit risk should not be considered in the evaluation of pension liabilities, to be consistent with other accounts such as bond and borrowing which is a debt item in the balance sheet.
4. We recommend the adoption of ABO instead of PBO for the measurement of pension liabilities as early as possible.

Our detailed comments on four of the questions in the Discussion Paper are set out below.

Responses to Questions

Question 3 (a) Which approach to the presentation of changes in defined benefit costs provides the most useful information to users of financial statements? Why?

Approach 2 or 3 is useful, but Approach 1 is misleading, because of the inconsistency with other accounts such as rent, caused by the inconsistency of pension accounting to report profit or loss as a change of market value, with accounts to recognize profit or

loss without the evaluation of underlying assets. The latter accounts are frequently used in business operation such as marketing and production.

We will give you an example. A stock price can be expressed as the present value of future dividends. If you immediately recognize changes in a stock portfolio in pension funds that means, logically, you are recognizing all future changes in dividends of stocks at one time. On the other hand, items such as rent are recognized only for one year regardless of any changes in the economic environment. To be consistent with approach 1 in the Discussion Paper, the sum of increase in future rent should be recognized at one time and should be expressed in the profit or loss, but no accountant or security analyst would ever do this. From the viewpoint of rent, the immediate recognition of the stock portfolio is a kind of overestimation.

Theoretically, there are two approaches to calculating periodic income. One is a method in which periodic income is defined as current earnings, that is the residual of revenues minus expenses in the period. We call this the “standard method”. The other one is a method in which the periodic income is defined as the sum of (i) current earnings and (ii) the difference between the present value of the future earnings or market value at former settlement date and those at current settlement date. We call this “present value (PV) method.” The present value method recognizes the periodic income earlier than the standard method, but the difference is only in the timing of recognition, and the total amount of periodic income is the same with both methods in the long run.

However the risk (variance of periodic income) is different, because the variance of sum of the stochastic variables is different from the sum of variance of each stochastic variable as long as there is a serial correlation among stochastic variables like periodic income, as illustrated in the Appendix.

If the periodic income of business operations is recognized in terms of the standard method, whereas the periodic income of pension is recognized in terms of the present value method, the risk of business operations is evaluated as smaller than that of pension management.

As a result, risk-averse managers want to diminish risks so they will invest more in safer assets, and the cost of the pension will increase. And some sponsoring company may abolish its corporate pension, or may impute the risk of pension asset management to ordinary employees for whom the investment is sometimes challenging. The abolition

of the defined benefit corporate pension may cause a decrease in the corporate value because the defined benefit plan has raised the corporate value by providing diligent employees with incentives for longer services. Moreover, there is a possibility that the employee's old age income will decrease because a sophisticated investment is sometimes challenging for ordinary employees and pensioners. Summing up, the inconsistency in the recognition of the periodic income decreases social welfare through the abolition of defined benefit corporate pensions, whose risk is overestimated. This decrease can be seen as inefficiency brought about by the inconsistency.

Because the accounts proposed to be measured by the standard method and present value method are different, directly comparing them is intractable and it is difficult to conclude which method is superior. But unlike financial commodities, it is difficult to apply the present value method to many accounts describing business operations, and applying different measurement techniques to each account will cause investors to make misjudgments. Thus, the use of other comprehensive income is inevitable. If recycling is necessary, the change of market value or present value should be divided in proportion for a suitable period. For instance, in the case of a bond with a three-year expiration, the value change may be divided by three. As for stocks, having no expiration date, the value change may be divided by the permanent present value of annuity of 1 discounted by the risk-free current yield. For example, if the market interest rate is a flat yield of 2 percent, the stock value change can be divided by $1/(1.02) + 1/(1.02)^2 + \dots = 1/0.02 = 50$

Furthermore, from a practical point of view, the stock price rally should cover the unsatisfactory business performance in marketing or manufacturing in a bull market, which also shows the misleading aspect of Approach 1.

Because we presume that the adoption of other comprehensive income would be inevitable, we think that Approach 2 or 3 should be applied not only to defined benefit promises but also to contribution-based promises.

Question 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?

The boundary between “Contribution-based promises” and “Defined benefit promises” is not always clear. For instance, according to section 5.39 and 5.40 of the Discussion Paper, IASB classifies lump sum benefit at retirement equal to 5 percent of the average of an employee’s final three years’ salary into defined benefit promises. But if a person retires from a company with career average plan after three years’ employment, his or her lump sum can be also classified into defined-contribution promises according to section 5.10.

The use of mark-to-market valuation consistent with financial economics makes it possible to measure any liabilities comprehensively and consistently, thus there is no need to distinguish between contribution-based promises and defined benefit promises.

What we call “mark-to-market valuation” of liabilities is the market price of the investment portfolio that generates congruent cash flows. The mark-to-market value of the benefit of a final pay promises or a career average promises is the ABO using the yield curve discount. According to this valuation, we discount cash flows after three years by a three-year yield, and we discount cash flows after five years by a five-year yield. The mark-to-market valuation is actually used in several large companies in North America and in Europe. For the cash balance promises whose benefit depends on stock indexes, or for the cash balance promises whose benefit depends on the average rate of bond yield for several years, the risk neutral valuation should be used, and it is generally difficult to derive a closed form formula, but the calculation is possible by using the Monte Carlo simulation which is widely used by investment bankers.

The advantage of mark-to-market valuation lies in its rigorous consistency with capital market valuation, thus evading arbitrage operations, and enabling pension accounting liabilities to be hedged with swaps. Therefore, mark-to-market valuation realizes a sophisticated risk management and efficient management of corporate pension plans.

The disadvantage of universally applying the mark-to-market valuation to all pensions is the complexity of its calculation, and we welcome any practical approximation, but the mark-to-market value should be primarily kept in mind to develop accounting standards.

It is worthwhile to develop a new concept “market related promises.” These are the promises whose benefit depends on the capital market. We classify cash balance plans

into this category. The aim to develop this concept is to rouse attention to model risk accompanying the risk neutral valuation of complicated pension plans, which need models for factors such as term structure movement.

Question 9(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.

We propose the exclusion of credit risk described in section 7.28, because of the consistency of the bond or borrowing account in the balance sheet.

Indeed credit risk may be considered in the valuation of pension liabilities because of the decrease of probability of payment when there is a drawdown in the rating of a sponsoring company, but consistency with debt accounts such as the bond and borrowing account should be considered for the purpose of accounting, because such debt accounts are unchanged even if the issuing company is given a lower rating. The reason for the difference between the valuation and the value in debt accounts lies in the nature of the accounts. Debt accounts can be said to be strike prices to evaluate debt value. They do not change according to credit risk, like the strike price of a stock option that is not changed according to a change in stock prices.

Because one of the purposes of the balance sheet is to judge the credit risk of a company the difference between valuation and the debt account caused by the exclusion of credit risk from the valuation of liabilities is compelling.

Question 15

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

We recommend the adoption of ABO instead of PBO for the measurement of pension liabilities as early as possible.

First, the evaluation of PBO includes the future unrealized salary increase, which does not exist in other accounts. Therefore some companies convert PBO to ABO by freezing the defined benefit pension plans. Thus the overestimation in accounting is canceled out. This can be seen to be a kind of arbitrage operation. We think the prevention of such arbitrage is the social responsibility of influential accountants.

Second, the salary increase considered by accountants is one of the “probable” factors considered by conservative accountants, and contains inflation. Many kinds of asset have the probability of inflationary appreciation, but this appreciation is usually not contemplated in other accounts except in inflationary accounting. Thus, pension plan liabilities are overestimated compared with other accounts.

Third, under the current global capitalism, M&As are frequently performed, and salary increases are more and more unstable, thus the degree of overestimation has been increased.

Appendix: Comparison of risk between two alternative methods to calculate period incomes

We illustrate the difference of the effect of these two methods, the standard method and present value (PV) method, by the use of a simple model. We assume three dates $t = 0, 1, 2$. From $t = 0$ to 2, a business project has been run by a risk-averse manager, whose utility function at t can be written as $U(e_t)$, where e_t denotes the period income of t . Its expected value can be represented as $E_t[U(e_t)] = E[e_t] - \lambda V_t[e_t]$, where $\lambda > 0$, and $E_t[\cdot]$ and $V_t[\cdot]$ denote the expected value and the variance conditional on information at date t respectively.

The characteristics of the project are as follows. The project generates earnings f_1 and f_2 , at date 1 and date 2 respectively. They are stochastic, and the expected values are both equal to f . The variance of f_1 is σ^2 .

We can suppose that the realized f_1 has information about f_2 as a signal. For example, if the observed f_1 is larger than f , we would expect f_2 to also be larger than f in most cases. But it might be expected to be smaller if the total earnings of the project are supposed to be constant. Thus, we model the dynamics of f_2 as

$$f_2 = f + \rho(f_1 - f) + \varepsilon \quad (1)$$

where ε is the idiosyncratic risk of f_2 whose expectation is 0 and variance is σ_2^2 .

Then we get

$$E_0[f_2] = f,$$

$$V_0[f_2] = \rho^2 \sigma^2 + \sigma_2^2$$

The correlation coefficient of earnings is $\rho\sigma/(\rho^2\sigma^2 + \sigma_2^2)^{1/2}$

If $\sigma_2^2 = (1 - \rho^2) \sigma^2$, the variance of f_2 is σ^2 same as f_1 , and the coefficient is ρ .

For simplicity, the interest rate is assumed to be 0. The project is invested just before $t = 0$ and is depreciated immediately. The account is closed at $t = 0, 1$, and 2, and we get period incomes e_0, e_1 , and e_2 corresponding to each period respectively. We ignore tax. The project is assumed to terminate at date 2, whose liquidation value is 0. The market is assumed to be risk neutral, thus the present value of the project is the expected value of the sum of future earnings.

The manager is supposed to behave at $t = 0$ to maximize the expected discounted sum of utility at t . His subjective discount factor is 0, and e_0 is not stochastic at $t=0$, then he maximize $U = U(e_0) + E_0[U(e_1)] + E_0[U(e_2)]$.

Let us calculate period incomes with different accounting methods and analyze the manager's behavior.

In this case of standard method, period income is earnings.

Since $e_0 = 0$, $e_1 = f_1$, $e_2 = f_2$, we obtain,

$$\begin{aligned} U &= f - \lambda \sigma^2 + f - \lambda (\rho^2 \sigma^2 + \sigma_2^2) \\ &= 2f - \lambda ((1 + \rho^2) \sigma^2 + \sigma_2^2) \end{aligned} \quad (2)$$

In the case of present value method, period income is the difference of the present values of the project, thus

$$\begin{aligned} e_0 &= E_0[f_1] + E_0[f_2] - 0 = f + f = 2f \\ e_1 &= f_1 + E_1[f_2] - 2f \\ e_2 &= f_2 - E_1[f_2] \end{aligned}$$

From (1), we can calculate,

$$\begin{aligned} E_1[f_2] &= (1-\rho)f + \rho f_1, \quad V_1[f_2] = \sigma_2^2, \\ V_0[E_1[f_2]] &= \rho^2 \sigma^2, \\ \text{cov}[f_1, E_1[f_2]] &= \rho \sigma^2, \quad \text{cov}[f_2, E_1[f_2]] = \rho^2 \sigma^2, \end{aligned}$$

where $\text{cov}_t[,]$ denotes the covariance conditional on the information of date t . *Ex post* expectation of f_2 is stochastic from *ex ante* (that is, before the realization of f_1). The realized f_1 shifts the expectation of f_2 by $\rho(f_1 - f)$.

From these we obtained, using $E_0[E_1[f_2]] = E_0[f_2] = f$,

$$\begin{aligned} U &= 2f + 0 - \lambda(\sigma^2 + \rho^2 \sigma^2 + 2\rho \sigma^2) + 0 - \lambda(\rho^2 \sigma^2 + \sigma_2^2 + \rho^2 \sigma^2 - 2\rho^2 \sigma^2) \\ &= 2f - \lambda(1 + \rho^2 + 2\rho) \sigma^2 + \sigma_2^2 \end{aligned} \quad (3)$$

Since $\rho > 0$ in most cases, (3) shows that the variance of income in the PV method is bigger than the one in the standard method. Because each method measures a different object, different results would appear. Here in this paper, we approve standard method (2), assessing only the variance of earnings, σ^2 and $\rho^2 \sigma^2 + \sigma_2^2$.

Thus, PV method (3) is overvaluing the risk of the project. If the manager can choose the risk of the project and related profitability, he would decide to reduce the risk with the PV method. Then the profitability would decrease.

The overestimated portion of variance is $\text{cov}_0[f_1, E_1[f_2]]$. When f_1 and f_2 are evaluated

separately, the serial correlation of f_1 and f_2 does not affect the risk of income. But if they are valued as a whole, the correlation increases the risk.

For example, let us assume $\sigma = \rho = \sigma_2 = 1$, the variance of earning in standard method is 1 at date 1 and 2 at date 2. With the PV method, on the other hand, the variance of the income is 4 at date 1, because the income e_1 at date 1 is $2(f_1 - f)$, added the change of the expectation of f_2 . The variance of e_2 is 1, which is smaller than the standard method variance, but the total variance with the PV method is larger than the one with the standard method. They are equivalent if and only if $\rho = 0$, which means that supposing the independent earning each year, the PV method does not distort the risk, because the variance of the PV method of sum of earnings equals the sum of variance of standard period earnings. The difference between the two alternative methods is just the timing. The PV method estimates variance earlier than the standard method, but the earlier estimation is offset by the decrease of variance of future incomes.