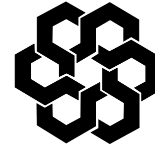

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International Accounting Standards Board

This document is provided as a convenience to observers at IASB meetings, to assist them in following the Board's discussion. It does not represent an official position of the IASB. Board positions are set out in Standards.
These notes are based on the staff papers prepared for the IASB. Paragraph numbers correspond to paragraph numbers used in the IASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

Board Meeting:	**16 October 2006, London**
Project:	**Post-employment benefits**
Subject:	**Intermediate Risk Plans – Education Session (Agenda Paper 3 - Appendix B)**

"Intermediate Risk" Pension Plans

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Introduction

- What is an intermediate risk plan?
- Types of risk and examples
- A discontinuity in plan valuations
- The “true nature” of plans

What is an intermediate risk plan?

Employer takes all

Employee takes all

The Risk Spectrum

Final Salary

Defined Contribution

What is an intermediate risk plan?

Employer takes all | **Employee takes all**

The Risk Spectrum

Final Salary	Career Average	Retirement Balance	Cash Balance	Defined Contribution

Types of risk

- Three key risks shared between employer and employee
  - Asset value risk
  - Interest rate risk
  - Mortality risk
  - “Salary” risk
- Note that a third party may also bear some of the risk
- Ask the questions:
  - What if asset values decline sharply?
  - What if interest rates rise sharply?
  - What if life expectancy dramatically increases?
  - What if employees receive unexpectedly high salary increases?

Types of risk : Examples

- Traditional DB final salary plan
  - A/I/M/S : all employer
- Traditional (UK-style) DC plan
  - A/I/M/S : all employee
- Final salary lump sum plan
  - A/S employer, M employee, I both
- Cash balance pension plan
  - A/M/I employer, S employee
- “DC” pension plan with investment guarantee and annuity purchase
  - A employer, M/S/I employee

Types of risk : How prevalent?

- Intermediate-risk (“hybrid”) plans in the UK
  - 10% (open plans for larger employers in 2004)
- Intermediate-risk plans in Belgium:
  - 100% of “DC” plans
    (as all “DC” plans must provide an investment guarantee)
- Intermediate-risk plans in Switzerland:
  - 100% of plans
    (as all “DC” plans must provide an investment guarantee,
    and all DB plans must provide a DC “underpin”)
  - BUT not all guarantees are underwritten by the employer
    (some guaranteed by insurance companies)

A discontinuity in plan valuations (1)

- **Example:**
  - Swiss “defined contribution” plan with 2.5% investment guarantee and annuity purchase on retirement
  - this is a common scenario in Switzerland and Belgium
- **Scenario 1: Guaranteed by investment manager**
  - no risk borne by employer, so account for as DC
- **Scenario 2: Guaranteed by employer**
  - risk borne by employer, so account for as DB
    - liabilities calculated on a DBO basis with discount rate (may be problematic)
    - assets valued at fair market value

A discontinuity in plan valuations (2)

- **Scenario 3: 2.25% guaranteed by investment manager**
  - risk borne by employer, so account for as DB
    - liabilities calculated on a DBO basis with discount rate
    - assets valued at fair market value
    (how to value the guarantee? Different from 2 above?)
- **Scenario 4: 2.499% guaranteed by investment manager**
  - should this be different from scenario 1?
- **What if the investment manager fails to meet their guarantee?**
  - is the employer faced with the remaining liability?
  - but in practice similar to risk of insolvency of insurer?

Types of risk : More examples

- Some intermediate-risk plans are "combination"
  - each member receives a DB and a DC component
  - e.g. in the Netherlands:
    - "career average earnings" on earnings up to €80,000
    - defined contribution plan on earnings over €80,000
- Some plans are "sequential"
  - members receive DC for some of their career and DB for the rest
  - e.g. in the UK, a "nursery plan"
    - DC up to age x
    - DB after age x

Separating the risk?

- Some intermediate-risk plans are "capped"
  - e.g. in France:
    - defined benefit plan
    - cost capped at x%
    - if cost exceeds x%, plan is "renegotiated" (i.e. benefits cut and/or contributions increased)
- What happens in the extreme scenario?

Separating the risk?

- Could we separate the "employee" risks from the "employer" risks?
  - simple, in the case of combination or sequential plans
  - more complex, in the case of the "Swiss" example
- Some analysis in the wake of D9 (using "Swiss" example)
  - DC liabilities equal to the assets ("2.25%")
  - plus option-priced valuation of the guarantee ("2.5%")
  - may be regarded as too complex

Separating the risk?

- Need a simple non-option-priced approach?
- Will different principles for DB and DC always lead to some form of discontinuity?
  - DB discounted at AA corporate bond yield
  - DC fair value