STAFF PAPER

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IASB Meeting

Project	IAS 19 *Employee Benefits*		
Paper topic	Discount rate		
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Introduction

1. This paper is to ask for IASB members' views on an issue related to IAS 19 *Employee Benefits* (2011).

2. In October 2012, the IFRS Interpretations Committee (the Interpretations Committee) received a request for guidance on the determination of the rate used to discount post-employment obligations. In particular, the submitter asked the Interpretations Committee whether corporate bonds with an internationally recognised rating lower than 'AA' can be considered to be high quality corporate bonds (HQCB).

3. In its November 2012 meeting, the Interpretations Committee noted that:

   (a) the predominant past practice has been to consider corporate bonds to be high quality if they receive one of the two highest ratings given by an internationally recognised rating agency (i.e. 'AAA' and 'AA').

   (b) IAS 19 does not specify how to determine the market yields on HQCB, and in particular it does not specify what grade of bonds should be designated as high quality.

   (c) an entity shall apply judgement in determining what the current market yields on HQCB are, taking into account the guidance in paragraphs 84 and 85 of IAS 19; and

(d) an entity's policy for determining the discount rate should be applied consistently over time.

4. In its January 2013[1] meeting, the Interpretations Committee:

(a) expressed support for the June 2005 Interpretations Committee agenda decision that, in determining the discount rate, an entity shall include HQCB issued by entities operating in other countries, provided that these bonds are issued in the currency in which the benefits are to be paid. A consequence of this view is that for a liability expressed in euros, the deepness of the market of HQCB should be assessed at the Eurozone level; and

(b) requested the staff to consult with the IASB:

(i) to confirm that the underlying principle for the determination of the discount rate is set out in paragraph 84 of IAS 19 (2011), and is described as "the discount rate reflects the time value of money but not the actuarial or investment risk";

(ii) to provide clarity about this sentence in paragraph 84;

(iii) to ask whether this sentence in paragraph 84 means that the objective for the discount rate for post-employment benefit obligations should be a risk-free rate; and

(iv) to confirm that IAS 19 should be amended to clarify that when government bonds are used to establish the discount rate in the absence of HQCBs, those government bonds used must themselves be high quality.

Objective

5. The purpose of this paper is to ask for IASB members' views on four consultation matters listed in paragraph 4(b) of this paper.

[1] See January 2013 IFRIC Update http://media.ifrs.org/2013/IFRIC/January/IFRICUpdateJan2013.pdf

Structure of the paper

6. This paper will therefore:
   - (a) provide a summary of the issue;
   - (b) provide an analysis of the issue;
   - (c) provide a recommendation for each of the consultation matters; and
   - (d) ask the IASB whether they agree with the staff recommendations.

Summary of the issue

7. The submitter states that:
   - (a) according to paragraph 83 of IAS 19 the discount rate should be determined by reference to market yields at the end of the reporting period on HQCB;
   - (b) IAS 19 does not specify which corporate bonds qualify to be HQCB;
   - (c) according to prevailing opinion, listed corporate bonds are considered to be HQCB if they receive one of the two highest ratings given by an internationally recognised rating agency (eg 'AAA' and 'AA' from Standard and Poor's); and
   - (d) because of the financial crisis, the number of corporate bonds rated 'AAA' or 'AA' (AA-Bonds) has decreased significantly and are traded less frequently. Consequently, single trades could influence market yield more significantly than in the past and eventually distort the observable market rate, which would in turn distort the discount rate.

   In the light of the above, the submitter asked whether corporate bonds with a rating lower than 'AA' can be considered to be HQCB.

8. The submitter notes that two views exist in practice:
   - (a) **View 1—only AA-Bonds are considered to be HQCB**. This is the predominant approach used in practice and it is consistent with guidance in US GAAP.

(b) **View 2—corporate bonds with a rating lower than 'AA' can be considered to be HQCB**. Those supporting this view claim that there are no significant differences in credit risk between corporate bonds rated 'AA' and those rated 'A'. Consequently, 'A' rated corporate bonds can be used to determine the discount rate.

9. We analysed these views in Agenda Paper 14 (November 2012).

Staff analysis

The underlying principle

10. Paragraphs 83 and 84 of IAS 19 (2011) state that:

> **83 The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.**
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> 84 One actuarial assumption that has a material effect is the discount rate. The discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.

11. Even though paragraph 83 is in bold[2] we think that underlying principle for the determination of the discount rate is set out in the second and third sentence of paragraph 84 (ie "the discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.").

12. In other words, we think that paragraph 84 is the objective and paragraph 83 explains the best way to achieve this objective. In our view, this is confirmed by paragraph BC 134 of IAS 19 [emphasis added]:

> BC134 IASC had not identified clear evidence that the expected return on an appropriate portfolio of assets provides a relevant and reliable indication of the risks associated

[2] According to paragraph 13 of the Preface to IFRSs: Standards approved by the IASB include paragraphs in bold type and plain type, which have equal authority. Paragraphs in bold type indicate the main principles.

with a defined benefit obligation, or that such a rate can be determined with reasonable objectivity. Consequently, **IASC decided that the discount rate should reflect the time value of money, but should not attempt to capture those risks**. **Furthermore, the discount rate should not reflect the entity's own credit rating, because otherwise an entity with a lower credit rating would recognise a smaller liability**. **IASC decided that the rate that best achieves these objectives is the yield on high quality corporate bonds**. **In countries where there is no deep market in such bonds, the yield on government bonds should be used**.

Question for the IASB
Do you agree that the objective for the determination of the discount rate is paragraph 84 (ie "the discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.") and that paragraph 83 explains the best way to achieve this objective?

What does "the discount rate reflects the time value of money but not the actuarial or investment risk" mean?

13. If the IASB agrees that the objective for the determination of the discount rate is paragraph 84, we think that the meaning of the sentence "*the discount rate reflects the time value of money but not the actuarial or investment risk*" should be clarified.

14. Some think that this sentence means that the discount rate for post-employment benefit obligations should be a risk-free rate, because:

    (a) the concept of "time value of money" is usually associated to the concept of risk free-rate and the fact that "time value of money" appears to be the central objective for the discount rate in this circumstance gives the impression that the objective is to achieve a risk-free rate; and

    (b) the discount rate excludes the investment risk but the investment risk includes credit risk, liquidity risk, market risk and other risks.

    We understand that many Interpretations Committee members support this view.

15. Others think that the discount rate is not a risk-free rate, because using a risk-free rate to discount post-employment obligations is in conflict with the requirement to use HQCB to determine the discount rate. HQCB necessarily have an element of risk (ie they are not risk free). They think that the discount rate should reflect the time value of money and the risk of HQCB.

16. We think that the sentence “the discount rate reflects the time value of money but not the actuarial or investment risk” does not mean that the discount rate for post-employment benefit obligations should be a risk-free rate, because we think that the discount rate should reflect the time value of money and the credit risk of HQCB issued in the currency in which the benefits are to be paid.

17. We think that the investment risk referred to in paragraph 84 of IAS 19 is in relation to the investment risk of the plan assets used to fund the liability and that it is not related to the credit risk[3] of the HQCB. From the discussion in the Basis for Conclusions[4], the exclusion of the investment risk appears to be related more to the rejection of a discount rate based on the expected return on plan assets, than related to the selection of a HQCB rate.

18. Paragraph 28 of IAS 19 states that [emphasis added]:

> 28 Under defined contribution plans the entity's legal or constructive obligation is limited to the amount that it agrees to contribute to the fund. Thus, the amount of the post-employment benefits received by the employee is determined by the amount of contributions paid by an entity (and perhaps also the employee) to a post-employment benefit plan or to an insurance company, together with investment returns arising from the contributions. In consequence, actuarial risk (that benefits will be less than expected) and **investment risk (that assets invested will be insufficient to meet expected benefits)** fall, in substance, on the employee.

19. In our view, the requirements and the Basis of Conclusions of IAS 19 state that the discount rate s*hould* reflect the time value of money and some credit risk but *should*

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[3] The Appendix A of IFRS 7 defines the credit risk as *the risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation.*

[4] Paragraph BC 134 of IAS 19 states that: *IASC had not identified clear evidence that the expected return on an appropriate portfolio of assets provides a relevant and reliable indication of the risks associated with a defined benefit obligation, or that such a rate can be determined with reasonable objectivity. Consequently, IASC decided that the discount rate should reflect the time value of money, but should not attempt to capture those risks…*

not reflect entity specific credit risk, the investment risk of the plan assets (as defined in paragraph 28) and actuarial risk.

Questions for the IASB

1. Do you agree that the meaning of the sentence "*the discount rate reflects the time value of money but not the actuarial or investment risk*" should be clarified?
2. Do you agree that the sentence "the discount rate reflects the time value of money but not the actuarial or investment risk" does not mean that the discount rate for post-employment benefit obligations should be a risk free rate?

20. If the IASB agrees that the discount rate should not be a risk-free rate, we think that it should clarify what risk should be included in the discount rate.

21. In our view, according to the current requirements of IAS 19, the discount rate should reflect the time value of money and the credit risk of HQCB. We think that a reasonable interpretation of HQCB could be corporate bonds with minimal or very low credit risk and that the Interpretations Committee should develop proposals that will clarify the meaning of HQCB.

22. We note that the general meaning of Moody's credit rating opinion is [emphasis added]:

- AAA: Obligations rated AAA are judged to be of the highest quality, **with minimal credit risk**.
- AA: Obligations rated AA are judged to be of high quality and are subject to **very low credit risk**.
- A: Obligations rated A are considered upper-medium grade and are subject to **low credit risk**.

Question for the IASB

3. Do you agree that the discount rate should reflect the credit risk of HQCB and that a reasonable interpretation of HQCB could be corporate bonds with minimal or very low credit risk?
4. Do you agree that the Interpretations Committee should develop proposals that will clarify the meaning of HQCB?

Government bonds

23. According to paragraph 83 of IAS 19, government bonds should be used to determine the discount rate when there is no deep market in HQCB. In some cases, government bonds may include a high degree of credit risk.

24. We understand that the majority of the Interpretations Committee members do not believe that it was the IASC's intention that "junk" rated government bonds should be used in determining the discount rate. Therefore, they think that an entity should not use a rate determined by reference to government bonds that are not "high quality".

25. We agree that the unwritten assumption in paragraph 83 is that government bonds are high quality bonds. However, we note that if a high quality government bond rate is not available in the same currency as the obligation, in our view, there are only two alternatives to consider:
    (a) an entity would be required to estimate the discount rate using yields on high quality government bonds in another currency[5], or
    (b) the entity would be required to determine the component of the yield on the (not high quality) government bond that relates to credit risk and adjusting the rate for that component (for example, if the yield of a government bond is 20%, the time value of money is 5% and the market premium for the credit risk is the remaining 15%, then an entity should adjust the yield of the government bond removing the market premium for the credit risk).

[5] This is not consistent with the last sentence of paragraph 83 of IAS 19 that states: "The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations".

We recommend this alternative because it maintains consistency of the currency of the government bond with the currency of the post-employment benefit obligation.

26. We think that amending IAS 19 to specify that the government bonds used to determine the discount rate should be high quality is a non-trivial amendment to IAS 19. In our view, if the IASB agrees that the objective for the determination of the discount rate is paragraph 84, then we think that the IASB should ask the Interpretations Committee to propose amendments to IAS 19 to reflect the approach described in paragraph 25(b).

Question for the IASB
Do you agree that the Interpretations Committee should propose amendments to IAS 19 to specify that when government bonds are used to determine the discount rate those bonds should be high quality?