IFRS

STAFF PAPER

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IFRS Interpretations Committee Meeting

Project	**IAS 19—*Employee Benefits***
Paper topic	Should longevity swaps held under a defined benefit plan be measured at fair value as part of plan assets or on another basis as a qualifying insurance policy?

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Introduction

1. In August 2014, the IFRS Interpretations Committee (the 'Interpretations Committee') received a request to clarify the accounting for longevity swaps held under a defined benefit plan.

2. The objective of this Agenda Paper is to provide the Interpretations Committee with a summary of the issue and the outreach result. This Agenda Paper also contains questions for the Interpretations Committee.

3. This Agenda Paper is structured as follows:

    (a) summary of the issue;

    (b) summary of the outreach result;

    (c) agenda criteria assessment;

    (d) staff recommendation;

    (e) questions for the Interpretations Committee;

    (f) Appendix A—Proposed wording for tentative agenda decision;

    (g) Appendix B—Assessment of the Interpretations Committee's agenda criteria; and

(h) Appendix C—Submission.

Summary of the issue

4. A longevity swap transfers the risk of pension scheme members living longer (or shorter) than expected. The swap transfers this risk from the pension scheme to an external party (usually an insurance company or a bank).

5. If a defined benefit plan enters into a longevity swap, it pays fixed amounts and receives variable amounts. These amounts are settled on a net basis. The amounts under the variable leg are calculated at the amounts actually paid to beneficiaries.

6. The question is how the longevity swap under a defined benefit plan should be treated. The submitter has identified the following views.

View 1: The longevity swap is a part of plan assets that should be measured at fair value.

7. The supporters of View 1 think that the asset held is a single contract for the swap of two streams of cash flows in each period; a net cash flow takes place.

8. They think that the longevity swap is measured at fair value as part of plan assets, as required in paragraphs 8 and 113 of IAS 19 *Employee Benefits* and IFRS 13 *Fair Value Measurement*.[1]

9. Paragraph 8 of IAS 19 states that:

> ***Plan assets* comprise:**
>
> **(a) assets held by a long-term employee benefit fund; and**
>
> **(b) qualifying insurance policies.**

[1] The disclosures required by IFRS 13 are not required for plan assets measured at fair value in accordance with IAS 19. However, the measurement requirements of IFRS 13 do apply them (see paragraphs 6 and 7 of IFRS 13).

Assets held by a long-term employee benefit fund are assets (other than non-transferable financial instruments issued by the reporting entity) that:

(a) are held by an entity (a fund) that is legally separate from the reporting entity and exists solely to pay or fund employee benefits; and

(b) are available to be used only to pay or fund employee benefits, are not available to the reporting entity's own creditors (even in bankruptcy), and cannot be returned to the reporting entity, unless either:

(i) the remaining assets of the fund are sufficient to meet all the related employee benefit obligations of the plan or the reporting entity; or

(ii) the assets are returned to the reporting entity to reimburse it for employee benefits already paid.

A *qualifying insurance policy* is an insurance policy issued by an insurer that is not a related party (as defined in IAS 24 *Related Party Disclosures*) of the reporting entity, if the proceeds of the policy:

(a) can be used only to pay or fund employee benefits under a defined benefit plan; and

(b) …

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. (See IFRS 13 Fair Value Measurement.) [Extracted and emphasis added]

10. Paragraph 113 of IAS 19 states that:

The fair value of any plan assets is deducted from the present value of the defined benefit obligation in determining the deficit or surplus. [Emphasis added]

11. The supporters of View 1 also think that paragraph 142 of IAS 19 support this view, which mentions longevity swaps as an example of plan assets. Paragraph 142 of IAS states that:

> **An entity shall disaggregate the fair value of the plan assets into classes** that distinguish the nature and risks of those assets, subdividing each class of plan asset into those that have a quoted market price in an active market (as defined in IFRS 13 *Fair Value Measurement*) and those that do not. **For example,** and considering the level of disclosure discussed in paragraph 136, an entity could distinguish between:
>
> (a) …
>
> (e) **derivatives** (segregated by type of underlying risk in the contract, for example, interest rate contracts, foreign exchange contracts, equity contracts, credit contracts, **longevity swaps** etc)… [Extracted and emphasis added]

12. If the swap is entered into at arm's length with no premium paid, and therefore entered into 'at-the-money', the initial carrying amount of the swap would be zero. Paragraph 4 of IFRS 13 states that:

> Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction. [Extracted]

13. In View 1, the swap should be measured at fair value as of each measurement date, as required by IAS 19, and changes in fair value should be included in the remeasurement gain or loss and recognised in other comprehensive income, as required in paragraph 57(d) of IAS 19.

View 2: The swap should be split into a variable leg and a fixed leg.

14. The supporters of View 2 think that a longevity swap is economically identical to the purchase of a qualifying insurance policy (the variable leg); the only

difference being that the premium is not paid immediately but in instalments over time. Accordingly, they think that the swap should be split into a variable leg and a fixed leg and each leg is treated as follows.

Accounting for the variable leg

15. The supporters of View 2 think that the variable leg represents a qualifying insurance policy that exactly matches the amount and timing of some or all of the benefits payable under the plan and that the variable leg should be measured at the present value of the related obligation, in accordance with paragraph 115 of IAS 19. Paragraph 115 of IAS 19 states that:

> Where plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan, the fair value of those insurance policies is deemed to be the present value of the related obligations (subject to any reduction required if the amounts receivable under the insurance policies are not recoverable in full).

16. Changes in the deemed fair value of the variable leg should be included in the remeasurement gain or loss and recognised in other comprehensive income as required by paragraph 57(d) of IAS 19.

Accounting for the fixed leg

17. The supporters of View 2 think that the fixed leg represents either a financial liability or part of plan assets. Either way, they think that the initial measurement of the fixed leg is at the 'fair value' of the fixed leg. In each view, the subsequent accounting would be:

View 2(i): using the fair value of the fixed leg, because it is part of plan assets; or

View 2(ii): using amortised cost as a financial liability, because the entity had a financial liability as if the plan had borrowed externally to buy the insurance (variable leg).

18. In View 2(i), changes in fair value of the fixed leg should be included in the remeasurement gain or loss and recognised in other comprehensive income, as required by paragraph 57(d) of IAS 19.

19. In View 2(ii), an entity should apply the effective interest rate for the fixed leg and recognise interest in profit or loss in the subsequent accounting.

Accounting of the difference between the value under the variable leg and the value under the fixed leg at initial recognition, in View 2

20. In View 2, the value under the variable leg and the liability under the fixed leg are not necessarily equal at inception, because of the premium for the risk to be transferred. As such, it raises the question of how to treat this difference.

21. The submitter identified the following views.

View 2A: It should be recognised in profit or loss, because it is similar to a settlement loss, which is recognised in profit or loss in IAS 19.

View 2B: It should be included in the remeasurement gain or loss and recognised in other comprehensive income, as required by paragraph 57(d) of IAS 19, because the loss results from exchanging one plan asset for another.

22. The supporters of View 2B support this view because it is similar to the typical bid-offer spread in quoted investments and the spread is included in the remeasurement gain or loss and recognised in other comprehensive income, as required by paragraph 57(d) of IAS 19.

Summary of the results of outreach

23. In order to gather information about the issue described in the submission, we sent requests to the International Forum of Accounting Standard-Setters, regulators,

global accounting firms and specialists for pension accounting and actuarial practices. Specifically, we asked:

Q1: In your jurisdiction, is the use of longevity swaps by a defined benefit plan common?

Q2: If you answered 'yes' to Question 1, what is the predominant accounting treatment for longevity swaps? In addition, could you please briefly describe the rationale for that accounting treatment?

Q3: On the basis of your response to Question 2, to what extent do you observe diversity in the accounting treatment?

24. The views received represent informal opinions and do not reflect the formal views of those organisations.

Responses from national standard-setters

25. The geographical breakdown for the responses received from the national standard-setters is as follows:

Geographical region	**Number of respondents**
Asia	3
Europe	4
Americas	3
Oceania	2
Africa	1
Total respondents	13

26. No respondents reported that the use of longevity swaps is common. (One respondent reported that this issue has been quite rare to date but discussions regarding the use are becoming more common.)

27. No diversity in the accounting treatment was reported because the transactions are rare.

28. One respondent stated that it could become part of a broader project if it were to be solved, because this issue touches broader points of IAS 19.

Responses from regulators

29. We also obtained three responses from regulators.

30. One respondent reported that the use of longevity swaps is not common in its jurisdiction.

31. One respondent (a group of regulators) reported that none of its members indicated that longevity swaps are common in the members' jurisdictions.

32. One respondent reported that only one enforcer is aware of pension plans using longevity swaps in its jurisdiction and that the other enforcers do not observe the use of longevity swaps. Enforcers expressed their preference for View 1 because it is consistent with IAS 19 as well as with accounting for other swaps. One enforcer doubted that such swaps could qualify as insurance contracts.

Responses from global accounting firms

33. We also obtained three responses from global accounting firms.

34. One respondent reported that the use of longevity swaps by defined benefit plans is not common but is increasing in some jurisdictions, particularly in the UK. It reported that the predominant approach is View 1. It reported that they are not aware of diversity in practice in respect of its clients but there might be diversity in practice in respect of other companies. It also explained additional reasoning of View 1 as follows:

    (a) as the payments under the longevity swap are net payments, it would seem inappropriate to measure the two legs as if they were separate financial instruments. The swap should be measured as a single instrument to be consistent with the unit of account for other swaps.

    (b) paragraph 115 of IAS 19 does not apply, because the net payments can be positive or negative and do not exactly match the benefit payments.

    (c) paragraph 114 of IAS 19 explains that liabilities of the fund that are held are reduced from the plan assets. Paragraph 114 of IAS 19 states:

        > Plan assets exclude unpaid contributions due from the reporting entity to the fund, as well as any non-

> transferable financial instruments issued by the entity and held by the fund. **Plan assets are reduced by any liabilities of the fund that do not relate to employee benefits, for example, trade and other payables and liabilities resulting from derivative financial instruments.** [Emphasis added]

(d) the value of the swap at initial recognition should be zero assuming no premium has been paid to the counter party. This implicitly incorporates market longevity assumptions into the fixed leg, because these are assumptions that have been used in setting the price at zero for the swap.

(e) because the swap is recognised as part of plan assets, any changes in the value of the contract should be included as changes in plan assets.

(f) the swap could meet the definition of insurance contracts in IFRS 4 *Insurance Contracts* but IFRS 4 only deals with issuers' accounting. Consequently, IAS 19 and IFRS 13 are relevant to this issue.

35. One respondent reported that View 1 is more common in practice. It also supports View 1 and notes that it is not aware of a robust technical basis to split a single swap contract into fixed and variable legs.

36. One respondent reported that these transactions are rare but increasing and that they may become common in the future. It reported that View 1 is common but the details of techniques to measure fair value may vary. It understands the arguments in favour of View 2 but it has never seen View 2 applied in practice.

37. Two respondents provided several disclosures of published financial statements that mention the use of longevity swaps. All disclosures are prepared by UK-based entities or they indicate that the entities use the longevity swaps for their UK pension plans. A majority of disclosures indicates that their accounting treatments are consistent with View 1, particularly after the application of IFRS 13. The other examples are not clear for us to know whether their

treatments are consistent with View 1 or not. We found no examples clearly based on View 2 among recently published financial statements.

Additional comments from employee benefits specialists

38. We also obtained comments from experts (pension accounting specialists and actuarial consultants).

39. Two respondents reported that they do not observe the use of longevity swaps in their jurisdictions.

40. One respondent supported View 1, because the use of longevity swaps has similarity to hedging interest risk by the use of long duration bonds that matches with the duration of defined benefit obligations.

41. One respondent reported that View 1 is the prevalent approach.

42. An international group of actuaries reported that the use of longevity swaps is increasing in the UK. It reported that diversity had existed and View 2 had probably been the more favoured approach before the application of IFRS 13. It thinks that the real value of the swap is not zero because it thinks that:

    (a) the pension scheme is contractually liable to pay future premiums to cover expenses and insurance company profits; and

    (b) if the pension scheme were able to surrender the swap contract (theoretically possible but unlikely in most cases) it would have to pay a premium for doing so.

43. The group of actuaries also provided several samples of reports that mention the use of longevity swaps. The samples were consistent with the disclosures of published financial statements described in paragraph 37 of this paper. A majority of the samples indicated that their accounting treatments are consistent with View 1, particularly after the application of IFRS 13. (The other examples are not clear for us to know whether their treatments are consistent with View 1 or not. Some examples are within the scope of IAS 26 *Accounting and Reporting by Retirement Benefit Plans*.)

Agenda criteria assessment

44. We assessed the issue against the agenda criteria of the Interpretations Committee described in paragraphs 5.16–5.17 of the IFRS Foundation *Due Process Handbook*. (Refer to **Appendix B** of this paper for the details of the agenda criteria and the assessment of the issue against the criteria.)

45. As a result of this assessment, we do not think that the Interpretations Committee should address the issues, because this issue is not currently widespread. When such transactions do take place the predominant practice seems to be to apply paragraphs 8 and 113 of IAS 19 and IFRS 13.

Staff recommendation

46. We recommend to the Interpretations Committee that it should not add this issue to its agenda, because this issue is not currently widespread and material diversity in practice is not observed.

Questions for the Interpretations Committee

Questions
1. Does the Interpretations Committee agree with the staff's recommendation that it should not add this issue to its agenda? 2. If the answer to Question 1 is 'Yes', does the Interpretations Committee agree with the wording of the tentative agenda decision in Appendix A of this Agenda Paper?

Appendix A—Proposed wording for the tentative agenda decision

IAS 19 *Employee Benefits*—Longevity swaps

The IFRS Interpretations Committee (the ‘Interpretations Committee’) received a request to clarify the measurement of longevity swaps that are held by an entity’s defined benefit pension plan.

The submitter raised a question about whether such a longevity swap should be measured by the entity at:

(a) fair value as part of plan assets in accordance with paragraphs 8 and 113 of IAS 19 and IFRS 13 *Fair Value Measurement* with changes in fair value in other comprehensive income; or

(b) another basis of measurement for a qualifying insurance contract in accordance with paragraph 115 of IAS 19.

The submitter also raised questions about presentations if the measurement in the above paragraph (b) should be used.

The outreach undertaken led the Interpretations Committee to conclude that longevity swaps are rare. When such transactions do take place the predominant practice seems to be to apply paragraphs 8 and 113 of IAS 19 and IFRS 13. On this basis, the Interpretations Committee concluded that diversity should not develop in practice and it therefore [decided] not to add this issue to its agenda.

Appendix B—Assessment against the Interpretations Committee's agenda criteria

B1. In the following table, we have assessed the issue against the agenda criteria of the Interpretations Committee, as described in paragraphs 5.14–5.22 of the IFRS Foundation *Due Process Handbook*.

Agenda criteria of the Interpretations Committee	
We should address issues (see paragraph 5.16 of the IFRS Foundation *Due Process Handbook*):	
that have widespread effect and have, or are expected to have, a material effect on those affected;	**No, because the result of the outreach indicates that this issue is not widespread.**
in which financial reporting would be improved through the elimination, or reduction, of diverse reporting methods; and	**No. When such transactions do take place, the predominant practice seems to be to apply paragraphs 8 and 113 of IAS 19.**
that can be resolved efficiently within the confines of existing Standards and the *Conceptual Framework for Financial Reporting*.	**N/A**
In addition:	
Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRS (see paragraph 5.17 of the IFRS Foundation *Due Process Handbook*)?	N/A
Will the solution developed by the Interpretations Committee be effective for a reasonable time period (see paragraph 5.21 of the IFRS Foundation *Due Process Handbook*)? (The Interpretations Committee will not add an item to its agenda if the issue is being addressed in a forthcoming Standard and/or if a short-term improvement is not justified).	N/A

Appendix C—Submission

C1. We received the following request. We have deleted details that would identify the submitter of this request.

IFRIC POTENTIAL AGENDA ITEM REQUEST

How to treat longevity swaps under a defined benefit scheme?

The IFRS Interpretations Committee is requested to address the following issue with respect to the application of IAS 19 *Employee benefits.*

Background and issue:

Longevity (participants living longer than estimated) is one of the biggest risks faced by defined benefit pension schemes as it potentially leads to higher pension payments than anticipated and used in the original pension premium determination. Therefore, the longevity risk can lead to deficits in pension funds. A longevity swap transfers the risk of pension scheme members living longer (or shorter) than expected from pension schemes to an external party (usually an insurer or bank provider).

If a defined benefit pension plan enters into a longevity swap, it pays fixed amounts and receives variable amounts. These amounts are settled on a net basis. The amounts under the variable leg are calculated at the amounts actually paid to beneficiaries. The longevity swap thereby hedges the risk that participants live longer than under the mortality assumptions built into the pension agreement. Similarly, the pension plan no longer benefits from positive developments in longevity. It has in substance 'settled' or 'frozen' its obligations to beneficiaries.

The question for the IFRS IC is how the longevity swap should be treated under IFRS?

View 1
The longevity swap is a plan asset that should be measured at fair value. The asset held is a single contract for the swap of two streams of cash flows in each period, a net cash flow takes place. This view is supported by paragraph 142 of IAS 19, which mentions longevity swaps as an example of plan assets.

Assuming the swap is entered into at arm's length, the initial carrying amount of the swap would be zero as it is entered into 'at-the-money' with no premium paid.

View 2
A longevity swap is economically identical to the purchase of a qualifying insurance policy, the only difference being that the premium is not paid immediately but in instalments over time. Accordingly, the swap should be split into a variable leg (the reinsurance) and a fixed leg (the premium). Not doing so would not reflect the fact that the net present value of the fixed payments in many circumstances exceeds the defined benefit obligation and would therefore have led to an actuarial loss.

Accounting for the variable leg

As required by IAS 19, and as the variable leg represents a qualifying insurance policy that exactly matches the amount and timing of some or all of the benefits payable under the plan, the variable leg will be measured at the present value of the related obligation, measured according to IAS 19.

Accounting for the fixed leg

— The fixed leg represents either a financial liability or a component of plan assets. Either way, the initial measurement would be at fair value. The subsequent accounting would be: (i) fair value if considered a component of plan assets; or
(ii) amortised cost if considered a financial liability, for the reason that if the plan had borrowed externally to pay a premium to buy the variable leg, it would naturally default to the 'normal' accounting standard for it.

It should be noted the receivable under the variable leg and the liability under the fixed leg are not necessarily equal at inception, and often will be different. This is no different from a situation where the premium had been paid upfront. As such, it raises the question of how to treat the resultant debit entry.

One view might be that the loss is, in substance, very similar to a settlement loss and should be recognised in profit or loss. This treatment may be appropriate, for example, if the purchase of the insurance is in anticipation of full settlement with the insurer at a later date.

Another view is that because the loss results from exchanging one plan asset for another, it is an actuarial loss. The typical bid-offer spread in quoted investments results in the same type of actuarial loss, albeit typically less significant.

Current practice:

Current practice appears to be mixed.

Reasons for the IFRS Interpretations Committee to address the issue:

(a) Is the issue widespread and has, or is expected to have, a material effect on those affected?

The issue is relevant to defined benefit plans that use longevity swaps. The use of longevity swaps has been increasing in recent years to address longevity risk.

(b) Would financial reporting be improved through the elimination, or reduction, of diverse reporting methods?

Yes, financial reporting would be improved if it was clear how longevity swaps are to be treated, given diversity in practice.

More importantly, under view 2, a day one loss would be recognised, as would be the case if the fixed leg were pre-paid at inception.

(c) Can the issue be resolved efficiently within the confines of IFRS and the Conceptual Framework for Financial Reporting?

We believe that this issue can be resolved using existing IFRS.

(d) Is the issue sufficiently narrow in scope that the Interpretations Committee can address this issue in an efficient manner, but not so narrow that it is not cost-effective for the Interpretations Committee to undertake the due process that would be required when making changes to IFRS?

We consider the issue sufficiently narrow in scope to be addressed.

(e) Will the solution developed by the Interpretations Committee be effective for a reasonable time period?

We are unaware of any current or planned short-term IASB project that will address this issue.

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