STAFF PAPER

December 2018

Accounting Standards Advisory Forum

Project	**Pension Benefits that Depend on Asset Returns**		
Paper topic	Approach being explored in this project		
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Purpose of this paper

1. In 2016, on completing the Agenda Consultation, the Board set up a pipeline of future research projects. One of those projects was Pension Benefits that Depend on Asset Returns, which became active in September 2018.

2. The purpose of this paper is to obtain advice from ASAF members on whether the approach we are exploring in this project would:

   (a) solve the measurement inconsistency identified in this paper.

   (b) have any unintended consequences.

3. This paper is organised as follows:

   (a) scope of the research project (paragraphs 4-8);

   (b) application of the current IAS 19 *Employee Benefits* model to pension benefits that depend on asset returns (paragraphs 9-12); and

   (c) approach being explored in this project (paragraphs 13-18).

Scope of the research project

4. Pension Benefits that Depend on Asset Returns is a narrow-scope research project designed to consider only some types of pension benefits paid that depend, wholly or partly, on asset returns. The assets could be held by the plan itself (as plan assets) or by the employer. It might be that they are held by neither the plan nor the employer, being used solely as a reference point to determine the amount to be paid.

5. The scope of the project is defined in terms of types of benefit, not types of plan. Some plans might provide some benefits within the scope of the project and other benefits that are not.

6. The project will not investigate other aspects of these benefits, or other aspects of plans that provide such benefits. For example, it will not investigate:

   (a) 'higher of' guarantees (ie when the employee is guaranteed the higher of two or more possible outcomes, of which one is based on the actual return on plan assets); or

   (b) risk-sharing or other features of what are sometimes called 'hybrid plans'.

7. The expected output of this research project is evidence to help the Board decide whether to undertake standard-setting to develop proposals for a targeted amendment to IAS 19 to implement the approach described in this paper, without changing other aspects of IAS 19. The amendment would relate only to employee benefits that depend on the return on a specified pool of assets.

8. If the research establishes that this approach would not be feasible, the staff expects to recommend no work on pensions.

Application of the current model in IAS 19 *Employee Benefits* to pension benefits that depend on asset returns

9. Applying paragraph 67 of IAS 19, the ultimate cost of the benefits to be paid is estimated using the projected unit credit method[1]. The assumed future returns used to estimate the ultimate cost of the benefits to be paid are subject to variability. Applying paragraph 83 of IAS 19, the discount rate used to determine the present value (PV) of the defined benefit obligation (DBO) is generally based on interest rates for high quality corporate bonds. Consequently, a measurement inconsistency arises because the assumed rate of return used to estimate the cost of the benefits to be paid is often higher than the interest rate used to discount the pension benefits to their present value. Thus, that discount rate does not reflect the variability (risk) inherent in the asset returns and hence in the pension benefits that depend on those returns.

[1] The projected unit credit method is an actuarial technique that sees each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation.

10. For example, suppose a plan promised a benefit equal to contributions plus the rate of return on a specified pool of assets for which the currently expected rate of return was 5%, and the discount rate specified by IAS 19 was 3%. Under the current IAS 19 model, an entity would measure the DBO by projecting forward the cash outflows at the expected rate of return on the assets of 5% and then discounting the cash flows back to their PV at 3%.

11. This measurement inconsistency arises regardless of whether the specified assets are actually held by the plan (or by the employer). However, the measurement inconsistency is made worse if those assets are held by the plan (or by the employer itself and measured at fair value). In such cases, the assets would be measured at fair value, but the obligation to pay benefits that depend on returns from the assets would be measured at a different (higher) amount. Thus, there would then be inconsistencies both internally, within the measurement of the PV of the DBO, and between that measurement and the measurement of the plan assets that ultimately earn the returns from which the benefits will be paid.

12. As a result of those measurement inconsistencies, we think that the existing IAS 19 requirements do not always provide users of financial statements with relevant information about pension benefits that depend on asset returns.

Approach being explored in this project

13. The objective set for this research project is to assess whether it would be feasible to eliminate the measurement inconsistency described above by capping asset returns used in estimates of pension benefits that depend on asset returns, without changing other aspects of IAS 19. Applying this approach, the asset returns used in those estimates would not exceed the discount rate used to determine the present value of those benefits.

14. Returning to the example discussed in paragraph 10, the approach being explored would cap the rate of return used to estimate the cash outflows at the discount rate of 3%. That capped estimate of the benefits would then be discounted back at 3%.

15. We think that this approach could address the measurement inconsistency that currently arises when the benefit depends on future asset returns.

16. Moreover, we think that this approach could be relatively simple to develop and give a cost-beneficial short-term solution for the inconsistency identified in this paper for pension benefits that depend on asset returns, because:

    (a) it would not need an arbitrary scope to be set—the model automatically applies to the situations that cause the measurement consistency that it intends to resolve;

    (b) it would fit well within the current IAS 19 requirements. In particular:

        (i) it would not change the fundamental approach underlying the measurement of a defined benefit plan when applying IAS 19; and

        (ii) it would be consistent with the 'net interest approach' in IAS 19, which requires an entity to use the discount rate to determine the interest income on plan assets, even when the expected return on the plan assets is different from that discount rate.

17. We also note that IAS 19 already includes a requirement intended to avoid a measurement inconsistency when the plan assets include qualifying insurance policies that exactly match the amount and timing of some or all of the benefits payable under the plan. Applying paragraph 115 of IAS 19, the fair value of those insurance policies is deemed to be equal to the PV of the DBO. That requirement could be viewed as a practical expedient that avoids creating a measurement inconsistency between the PV of the DBO and the qualifying insurance policies, and also avoids the need to determine separately the fair value of the qualifying insurance policies. We see some similarities between that practical expedient and the approach described in this paper.

18. We have not yet explored in detail the approach described in this paper and intend to perform further analysis and outreach to assess whether it can be developed without unintended consequences. We expect that advice from ASAF members will provide valuable input for our analysis.

Questions for ASAF members

- Do you have any questions or comments on the approach described in paragraphs 13 to 18 of this agenda paper?
- Do you think that this model could be helpful in addressing the measurement consistency identified in the application of IAS 19 to pension benefits that depend on asset returns? If yes, why? If not, why not?
- Do you think this approach would have any unintended consequences?