IFRS IC – POTENTIAL AGENDA ITEM REQUEST

1 The issue

IAS 19 – Actuarial assumptions: discount rate

1.1 Narrowing market for 'high quality corporate bonds'

According to IAS 19.78[1], 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 or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.

The IFRS do not specify which listed corporate bonds qualify to be 'high quality corporate bonds' (HQCB), so that the term needs to be interpreted. In our jurisdiction and according to the prevalent opinion listed corporate bonds are considered to be HQCB if they receive one of the two highest ratings given by a recognised ratings agency (e.g. 'AAA' and 'AA' from Standard and Poor's Corp.). This view is largely based on a SEC Staff Announcement from 1993[2] which also was integrated in the UK FRS 17 *Retirement Benefits*[3]. The information needed for Euro-emissions is often taken from the 'AA'-universes provided by e.g. Barclays, Markit iBoxx or Bloomberg.

In the recent past number and volume of corporate bonds rated 'AA' has shrunk significantly, specifically in terms of bonds with maturities of more than ten years which are very important in determining the discount rate for post-employment benefit obligations (as an example: per August 2012 iBoxx provided for 'AA' rated corporate bonds with maturities of more than 10 years (iBoxx € Corporates AA 10+) only 6 Euro-issuers, accounting for 9 emissions and accounting for a trading volume of approx. 8 bn. Euro).

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[1] We refer to IAS 19 (revised 1998). The corresponding paragraphs of IAS 19 (revised 2011) are para. 83 et seqq.
[2] See ASC 715-20-S99; formerly referred to as EITF Topic D-36.
[3] See FRS 17 Appendix IV para. 21.

This development is mainly the result of extensive downgrading of corporate bonds in the aftermath of the financial crisis due to a more cautious rating process by the rating agencies and the so called 'sovereign ceiling'. According to the 'sovereign ceiling' a company may not have a better rating than the country in which it is headquartered (e.g. the bonds of EDF were downgraded from 'AA' to 'A' while France was downgraded from 'AAA' to 'AA' and EDF bonds represented 36% of iBoxx €Corporates AA 10+ index at this time).

In addition, in the recent past the 'AA' rated bonds are traded less frequently which is mainly due to market participants' prevailing preference to hold such bonds until their maturity. As a consequence single trades could influence the market yield more significantly than in the past and eventually distort the observable market rate and so the discount rate. This development also has contributed to the current situation that the market for 'AA' rated bonds is less deep than it used to be.

In light of the above, concerns are rising that the procedure as described before to determine the discount rate does not generate appropriate results anymore - the discount rate is considered to be distorted. Furthermore the variety of approaches used to determine an appropriate discount rate increases and results in a wider range of discount rates used. In consequence information about a reporting entity may not be compared with similar information about other entities.

In practice different solutions to determine the discount rate have partly been put into practice, are in the process of being implemented or are currently discussed.

View A: Expansion of the HQCB-universe

Considering 'AA' rated corporate bonds as HQCB is largely based on a SEC Staff Announcement which was made for accounting for post-employment benefit obligations according to US-GAAP (i.e. SFAS 87 and SFAS 106). These requirements (including the underlying concept) are not identical to the IFRS requirements and its underlying concept. Furthermore, the SEC staff suggestion was made for the US capital market. Other capital markets do not have the same characteristics as the US market, and therefore, transferring that view from a specific capital market to a capital market in another jurisdiction is not necessarily reasonable.

Therefore, in other jurisdictions with capital markets of different characteristics corporate bonds with a rating of 'A' may also be considered HQCB. Especially because corporate

bonds rated 'AA' compared with those rated 'A' have generally no significant differences in their default rates, and hence, the additional risk premiums in the market yields of 'A' rated corporate bonds compared with those rated 'AA' is usually small.

Using market yields of 'AAA', 'AA' and 'A' rated corporate bonds to determine the discount rate results only in a minor increase in the credit risk premium (included in market yields) but is based on a significantly broader data base for deriving the discount rate, especially for long term corporate bonds. It is generally preferred to derive the discount rate of a bond uni-verse from as many observable data points as possible, since it leads to a more reliable dis-count rate.

The less data points are observable in the market, the more data points (i.e. maturities) have to be estimated in order to determine the relevant yield curve. One general disadvantage of estimating is the estimation error typically connected with it. A second disadvantage is that the divergent methods and estimation parameters used result in differing outcomes. These variations in outcomes lead to diverse presentations of the same economic matter. There-fore, it is preferable to reduce estimations to determine the yield curve to a minimum level.

Another positive aspect of using also 'A' rated corporate bonds is that the impact of a single issuer on the market yield derived from a market index decreases. Changes in market yields are normally caused by changes in the behavior of the market participants which is largely affected by their expectations about the future development of the market. Therefore, market yields should represent the expectations of the market participants and thus, should only change while market participants' expectations change. Currently in the narrowing market, for example, a drop out of only one issuer out of the index or a single trade may cause a change of the yield. Such a distortion of the market yield could be avoided by expanding the bond universe to also include 'A' rated corporate bonds.

View B: Only corporate bonds with a rating of 'AA' or 'AAA' are considered to be HQCB

Only corporate bonds with a rating of 'AA' or 'AAA' are considered to be HQCB. This view is largely based on the idea that the SEC Staff Announcement is also applicable to IFRS finan-cial statements even if the announcement was made for another set of rules and for another capital market. Therefore, changes in determining the discount rate are not necessary.

In the context of View B it should be noted that the yields of 'AA' rated bonds may also be determined synthetically. In this case market yields of other bonds (e.g. 'A' rated bonds or government bonds) are adjusted by the spread difference between 'AA' rated bonds and the bonds used to determine the market yields to reflect the different credit risks.

1.2 Question to the IFRS IC

In light of the discussion above, is the expansion of the HQCB-universe an acceptable approach under IAS 19?

1.3 Conceptual Issue

Changes in the financial markets since the time when IAS 19 was developed (back in the 1990's) result in a more conceptual issue. In general, when a discount rate is intended to reflect only the time value of money, the discount rate is seen to be a risk-free rate.[4] According to IAS 19.79 the discount rate reflects the time value of money, which implicates the rate to discount the post-employment benefit obligations should be a risk-free rate. However, due to the determination of the discount rate by reference to the market yields on HQCB, a premium in addition to the risk-free rate is included in the discount rate, which nowadays is of some significance as detailed in the following.[5]

At the time when the requirements for the discount rate in IAS 19 were developed the credit spreads for 'AA' rated corporate bonds were rather small and negligible. Hence the discount rate included only a small premium for the credit spread and was very close to the risk-free rate, i.e. reflected almost only the time value of money. In the aftermath of the financial crisis the credit spreads for 'AA'-rated corporate bonds increased significantly. As a consequence, nowadays the discount rates comprise much higher risk premiums and move away from reflecting mainly the time value of money.

This change leads to the question, whether the shift from a mainly risk-free rate for discounting post-employment benefit obligations, as it was intended when the standard was developed, to a discount rate including a significant premium for credit risk nowadays, still is in line with the intention underlying IAS 19.

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[4] With respect to the view that a discount rate reflecting the time value of money is a risk-free rate, please refer, for example, to IAS 36.A1 (c) and to ED/2010/8 *Insurance Contracts* para. 30 and the Basis for Conclusions of ED/2010/8 *Insurance Contracts* para. BC98.

[5] See FRS 17 Appendix IV para. 21.

Furthermore, the IASB discusses in its project *Insurance Contracts* different approaches to determine the rate to discount future liabilities from insurance contracts. According to one approach the discount rate is a risk-free rate (i.e. reflects only the time value of money) plus a premium for illiquidity.

Against this background, in our view it would be very helpful to clarify the underlying intention in determining the rate to discount post-employment benefit obligations (i.e. whether the discount rate should be a risk-free rate or should include a risk premium for credit risk pertaining to the market yields on HQCB referenced to and may additionally include a premium for illiquidity).

Another general issue is whether 'high quality' is to be understood

- absolutely, i.e. whether only bonds with a rating of at least 'AA' given by an internationally recognised ratings agency are considered to be of 'high quality', or
- relatively, i.e. whether bonds of high quality in the relevant/local market are considered to be HQCB even if those bonds would get a rating of – for example – 'BB' if rated by an internationally recognised ratings agency.

2 Current practice

The outcome of a request for information circularised to other national standard-setters confirms the view that there is diversity in practice. In several countries a deep market in HQCB never existed and therefore government bonds were always used to determine the discount rate. In a few other countries deep markets in HQCB still exist and consequentially no problems are evident. Other countries used to have a deep market in HQCB in the past and now are confronted with a narrowing market. Some of the entities in the latter countries expanded the universe of HQCB to 'AAA' and 'A' rated corporate bonds in order to determine the discount rate. Others use the rates of government bonds plus a spread to adjust for the additional credit risk associated with corporate bonds.

3 Reasons for the IFRS IC to address the issue

3.1 Is the issue widespread and has it practical relevance?

Based on investigations and inquiries made (a request for information was circularised to other NSS), it was confirmed that the issue as described in this document is widespread and of practical relevance. Based on our investigations the issue applies to a whole number of jurisdictions world-wide.

3.2 Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?

As outlined above, there are at least two views (A and B), which lead to the expectation that significantly divergent interpretations are existent or are in the process to emerge.

3.3 Would financial reporting be improved through elimination of the diversity?

Financial reporting would be improved by clarifying this issue since determining the discount rate for post-employment benefit obligations would be based on harmonised approaches in line with the requirements of IAS 19. If divergent interpretations and practices will not be prevented, information about a reporting entity may not be compared with similar information about other entities. Therefore, an appropriate clarification would enhance comparability among companies' financial reporting.

3.4 Is the issue sufficiently narrow in scope to be capable of interpretation within the confines of IFRSs and Framework for the Preparation and Presentation of Financial Statements, but not so narrow that it is inefficient to apply the interpretation process?

We are of the opinion that the issue is sufficiently narrow in order to be addressed by the IFRS IC, but not so narrow that it is inefficient to apply the interpretation process.

3.5 If the issue relates to current or planned IASB project, is there a pressing need for guidance sooner than would be expected from the IASB project? (The IFRS IC will not add an item to its agenda if an IASB project is expected to resolve the issue in a shorter period than the IFRS IC would require to complete its due process).

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