

STAFF PAPER

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Meeting

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Project IAS 19 Employee Benefits—Discount rateCONTACT(S) Leonardo Piombino lpiombino@ifrs.org +44 (0)20 7246 0571

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Introduction

1. 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).
2. In its November 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 *Employee Benefits* (2011); and

- (d) an entity's policy for determining the discount rate should be applied consistently over time.
3. In its November meeting, the Interpretations Committee briefly discussed, but did not conclude, on whether a change to the way in which an entity determines the discount rate would be a change in accounting policy or a change in estimate. The Interpretations Committee decided to further discuss the requirements of IAS 19 on the determination of the discount rate.
 4. In December 2012, the Interpretations Committee received a comment letter on this issue. The sender asked the Interpretation Committee to clarify whether:
 - (a) the basket of HQCB should be determined at the Eurozone level or at country level; and
 - (b) whether the characteristics of the assets in which an entity is allowed to invest should be taken into account to decide which bonds should be used in determining the discount rate.
 5. The comment letter is reproduced in full in Appendix B to this paper.

Objective

6. The objective of this paper is to:
 - (a) provide background information on the issue;
 - (b) provide a summary of the issue;
 - (c) present an analysis of a possible way forward;
 - (d) make a recommendation that the Interpretations Committee should develop implementation guidance on the determination of the discount rate; and
 - (e) ask the Interpretations Committee whether they agree with the staff recommendation.

Background information

7. The discount rate is an important assumption used in measuring defined benefit obligations. According to paragraphs 83-86 of IAS 19 (2011):
- (a) The discount rate shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds (HQCB).
 - (b) In countries where there is no deep market in such bonds, the market yields on government bonds shall be used.
 - (c) 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.
 - (d) The discount rate reflects the time value of money.
 - (e) The discount rate does not reflect the actuarial or investment risk.
 - (f) The discount rate does not reflect the entity-specific credit risk borne by the entity's creditors.
 - (g) The discount rate does not reflect the risk that future experience may differ from actuarial assumptions.

Summary of the issue

8. 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 a 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.
9. In the light of the above, the issue is whether corporate bonds with a rating lower than “AA” can be considered to be HQCB.
 10. 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.
 11. We analysed these views in [Agenda Paper 14 \(November 2012\)](#).

Staff analysis—a possible way forward

12. We think that this issue is quite complex, because there is more than one problem in the current requirements on the determination of the discount rate. In our view the problems are:
 - (a) IAS 19 does not specify how to determine the market yields on HQCB, and in particular what grade of bonds should be designated as high quality.
 - (b) IAS 19 does not specify how to determine whether a market is deep and which market an entity should consider (eg the Eurozone or a single country).

- (c) A government bond's rate can be significantly different from a HQCB rate. This difference can be much greater as a result of the financial crisis.
13. The IASB tried to solve these problems in 2009 publishing the Exposure Draft *Discount Rate for Employee Benefits*. This Exposure Draft proposed eliminating the requirement to use a government bond rate if there is no deep market in high quality corporate bonds. However, many respondents disagreed with the proposal and consequently the IASB decided not to proceed with it and to address issues relating to the discount rate only within the context of a fundamental review. However, according to the results of the IASB Agenda Consultation 2011 there was not widespread support for this issue to be assessed as a priority issue for the IASB.
14. Consequently, we think that this issue cannot be solved on a timely basis in a manner that seeks to amend the requirements of IAS 19. We think that the best way forward is to develop implementation guidance that helps entities to understand and implement the current requirements of IAS 19.
15. The main assumptions of our proposed guidance are explained in the following paragraphs.

Credit risk

16. We think that the practice of considering as HQCB corporate bonds that receive one of the two highest ratings given by a recognised rating agency is compliant with IAS 19. However, when the volume of these bonds decreases and an entity concludes that the market for these bonds is no longer deep, there are two alternatives to consider: (i) using government bonds or (ii) expanding the bonds' population to include corporate bonds with a lower rating in order to calculate a more reliable estimate of the HQCB rate, but subject to ensuring that the resulting discount rate continues to reflect a HQCB rate.
17. We prefer the second alternative and we think that some of the IASB's tentative decisions on the *Insurance contracts* project can be useful to solve this issue. In particular, we refer to the following tentative decisions:

- (a) the objective of the discount rate is to adjust the future cash flows for the **time value of money**¹ and reflect the characteristics of the insurance contract liability.²
 - (b) An insurer could use either a '**top-down**' or a 'bottom-up' **approach** to determine discount rates that reflect the characteristics of the insurance contract liability.
 - (c) In applying the top-down approach an insurer shall determine an appropriate **yield curve**³ **on the basis of current market information**⁴.
18. The IASB discussed the top-down approach in its meeting on April 2011⁵. In the following paragraphs we explain this approach.
19. In a top-down approach, the insurer selects a starting point based on assets, and adjusts that starting point to arrive at a discount rate that reflects only the time value of money and the characteristics of the liability. **The necessary adjustments depend on the starting point selected**: the closer the characteristics of the starting point to the characteristics of the liability, the fewer adjustments are needed to achieve the objective. Two types of adjustments may be needed:
- (a) Type I, which adjust for differences between the timing of the cash flows to ensure that the assets in the portfolio selected as a starting point are matched with the duration of the liability cash flows.
 - (b) Type II, which **adjust for risks** inherent in the assets (eg corporate bonds) that are not inherent in the liability. These risks can be summarised as investment risk. Investment risk can be credit risk, market risk, and other price risk.
20. Consequently, in the top-down approach the market yields on corporate bonds should be adjusted in order to exclude the market premium for credit risk.

¹ This is compliant with IAS 19.84 that states that the discount rate reflects the time value of money.

² See IASB Update February 2011 <http://media.iasb.org/IASBUpdateFebruary2011.html#3>

³ This is compliant with IAS 19.83 that states that the discount rate shall be determined by reference to market yields at the end of the reporting period.

⁴ See IASB Update April 2011 <http://media.iasb.org/IASBUpdateApril2011.html#2>

⁵ See Agenda Paper 5A <http://www.ifrs.org/Meetings/Documents/IC0411b05Aobs.pdf>

21. We think that this approach can be used in determining the discount rate for post-employment benefit obligations, because if an entity concludes that the market for corporate bonds rated “AAA” and “AA” is not sufficiently deep, the entity could expand the bonds’ population to include corporate bonds with a lower rating. In this case, the entity should adjust the market yields on corporate bonds with a lower rating, in order to remove the market premium for the additional credit risk.
22. We think that this approach is consistent with the latest thinking of the IASB on a discount rate that is similar to the discount rate for post-employment benefit obligations.
23. We propose that in determining the discount rate using HQCB the entity should first use corporate bonds with minimal and very low credit risk⁶. If the population of such HQCB is insufficient to enable the discount rate required by IAS 19 to be determined, then the discount rate should be determined using corporate bonds with minimal and very low credit risk plus corporate bonds with higher credit risk adjusted to remove the market premium for the additional credit risk.
24. If expanding the population of bonds (and adjusting to remove the credit risk of those lower-rated bonds) is still insufficient to determine the discount rate for IAS 19 purposes, then the government bonds should be used.
25. In Appendix B we provide an illustrative example of our proposal.

Should the basket of HQCB be determined at the Eurozone level or at country level?

26. In June 2005 the Interpretation Committee observed that the term “country” could be reasonably read as including HQCB that are available in a regional market to

⁶ Please 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**.

which an entity has access, provided that the currency of the regional market and the country were the same (eg the Eurozone)⁷.

27. We agree with that agenda decision and we believe that the predominant approach used in practice for euro-denominated pension obligations is to determine the basket of HQCB at Eurozone level.
28. Consequently, in our view, if the Eurozone market for corporate bonds with minimal and very low credit risk is not sufficiently deep then the discount rate should be determined using corporate bonds with minimal and very low credit risk plus corporate bonds issued in Euro with higher yields adjusted to remove the market premium for the additional credit risk. If the Eurozone market for corporate bonds is still not sufficiently deep, then high quality government bonds issued in Euro should be used.

Staff recommendation

29. We recommend that the Interpretations Committee should develop guidance that helps entities to understand and implement the current requirements of IAS 19.
30. We think that this guidance should establish a hierarchical approach to determine the discount rate for post-employment obligations. Consequently, we recommend that in determining the discount rate using HQCB the entity should first use corporate bonds with minimal and very low credit risk. If the population of such HQCB is insufficient to determine a reliable discount rate, then the rate should be determined using corporate bonds with minimal and very low credit risk plus corporate bonds with higher yields adjusted to remove the market premium for the additional credit risk. If expanding the population of bonds is still insufficient to determine the discount rate, then government bonds should be used.
31. We also think that this guidance should permit an entity to use HQCB issued in another country that have the same currency.

⁷ See IFRIC Update June 2005 <http://www.ifrs.org/Updates/IFRIC-Updates/2005/Documents/jun05.pdf>

32. A draft of our proposed guidance is included in Appendix A of this paper.

Questions for the Interpretations Committee

1. Does the Interpretations Committee agree with the staff's recommendation that the Interpretations Committee should develop guidance that helps entities to understand and implement the requirements of IAS 19?
2. Does the Interpretations Committee agree with our proposed hierarchical approach to determine the discount rate?
3. Does the Interpretations Committee agree that an entity can use HQCB issued in another country that have the same currency?
4. Does the Interpretations Committee have any comments on the proposed draft guidance in Appendix A?

Appendix A—Proposed guidance on the determination of the discount rate for post-employment benefit obligation

A1 The proposed wording for the guidance on the determination of the discount rate for post-employment benefit obligations is presented below.

Guidance on implementing IAS 19 *Employee Benefits*

Actuarial assumptions: discount rate

- IG1. The discount rate should be determined with objectivity.
- IG2. A discount rate determined by reference to market yields on high quality corporate bonds should reflect the time value of money and the credit risk of high quality corporate bonds issued in the currency in which the benefits are to be paid. In order that the discount rate reflects the time value of money but does not reflect the entity-specific credit risk borne by the entity's creditors, the corporate bonds used to determine the discount rate shall consistently be ones with minimal or very low credit risk.
- IG3. The market yield range used by the entity to determine the discount rate should be kept as narrow as possible.
- IG4. The discount rate should be determined consistently over time. The credit risk included in the discount rate should not change significantly from period to period.
- IG5. An entity should determine the discount rate following the steps described in paragraphs IG6-IG9.
- IG6. An entity should estimate whether there are sufficient corporate bonds with minimal or very low credit risk in the market to determine a reliable discount rate. For that purpose:
 - (a) The entity should use the largest available population of corporate bonds in one or both of the categories “minimal” or “very low” credit risk as defined by internationally recognised rating agencies. For

example, an entity can include in the population bonds of small issue size.

- (b) If there is no deep market in corporate bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments, the entity can estimate the discount rate for long maturities by extrapolating current market rates along the yield curve (see IAS 19 paragraph 86).
- (c) The entity may include bonds issued by entities operating in other countries, provided that these bonds are issued in the currency in which the benefits are to be paid.

IG7. If there is no deep market for corporate bonds with minimal and very low risk, the entity should expand the bonds' population to include corporate bonds with a lower rating. In this case the entity should adjust the market yields on corporate bonds with a lower rating, in order to remove the market premium for the additional credit risk. Therefore, adding bonds with a lower rating should not significantly change a yield curve established for minimal or very low risk bonds but instead help to facilitate the development of a statistically credible yield curve across a range of maturities.

IG8. If the entity proceeds according to IG 7 it should disclose:

- (a) the judgements that the management has made in determining that the market for corporate bonds with minimal or very low credit risk is not deep;
- (b) the rating of the corporate bonds included in the population and the adjustments made to the credit risk for such bonds.

IG9. If after exploring the appropriate corporate bond market according to IG7 an entity determines that the market is still not deep, the entity should determine the discount rate by using the government bonds issued in the currency in which the benefits are to be paid.

Appendix B—Illustrative example

- B1. This example illustrates our proposed approach to determine a HQCB discount rate.
- B2. An entity concludes that:
- (a) the market for corporate bonds with minimal and very low credit risk ('AA-Bonds') is not sufficiently deep, because the population of long-term (eg maturity longer than 5 years) AA-Bonds is insufficient to determine reliable market yields;
 - (b) the market for long-term corporate bonds with low risk ('A-Bonds') is sufficiently deep;
 - (c) the market premium for the additional credit risk is 100 basis points at all maturities in excess of 5 years.
- B3. According to the approach proposed in IG 7, the entity should:
- (a) include the A-Bonds in the population of HQCB with maturity longer than 5 years and
 - (b) adjust the market yields of A-Bonds removing the market premium for the additional credit risk included in the market yields on A-Bonds, as shown in the table below.

	Maturity (years)						
	1	3	5	7	10	15	20
Market Yields on AA-Bonds	1.0%	1.5%	2.5%	2.7%	3.5%	4.5%	5.5%
Market Yields on A-Bonds				4.0%	5.0%	6.0%	7.0%
Market premium for additional credit risk				1.0%	1.0%	1.0%	1.0%
Adjusted Market Yields on A-Bonds				3.0%	4.0%	5.0%	6.0%
Market Yields on HQCB	1.0%	1.5%	2.5%	2.9%*	3.9%*	4.9%*	5.8%*

* These market yields on HQCB should be calculated considering both the market yields on AA-Bonds and the adjusted market yields on A-Bonds taking due account of the respective market depths.