STAFF PAPER

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Project	**IAS 19 *Employee Benefits*—Discount rate**		
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Introduction and objective of this paper

1. At the May 2013 meeting, having considered the staff proposals for a narrow-scope amendment, the IFRS Interpretations Committee (the Interpretations Committee) decided that the staff proposals were too broad an amendment to IAS 19. Consequently, the Interpretations Committee requested the staff to:
   (a) refocus their work on the original submission, that is whether corporate bonds with a rating lower than 'AA' can be considered to be high quality corporate bonds (HQCB), and
   (b) provide an analysis of whether 'high quality' is a relative or an absolute concept.
2. Consequently, the objective of this paper is limited to:
   (a) providing a brief description of the issue raised by the submitter;
   (b) providing an analysis of whether, in the staff's view, the reference in paragraph 83 of IAS 19 to HQCB is a relative or an absolute concept;
   (c) providing a pros and cons analysis on whether the reference to HQCB *should* be a relative concept or an absolute concept;

(d) considering the possible options to address the issue raised by the submitter; and

(e) asking the Interpretations Committee what its preferred option is.

Description of the issue

3. 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 they are traded less frequently. Consequently, single trades could influence market yield more significantly than in the past and eventually distort the observable market rate and in turn distort the discount rate.

4. In the light of the above, the issue raised by the submitter is whether corporate bonds with a rating lower than 'AA' can be considered to be HQCB.

5. The submitter notes that two views exist in practice:

(a) **View 1—only corporate bonds with a rating of 'AA' or higher 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 between corporate bonds rated 'AA' and those rated 'A'. Consequently, 'A'-rated corporate bonds can be used to determine the discount rate.

Staff analysis

Assumptions

6. For the purpose of this paper, we use the terms 'absolute' and 'relative' in the following context.

7. A *relative* concept of high quality means that:

   (a) the notion of high quality is defined by reference to the highest quality corporate bonds issued in the same currency of the liability;

   (b) the notion of high quality should not be linked to a fixed credit rating, such as 'AA'; and

   (c) the reference point for high quality will change as the population changes. Consequently, the population of bonds used as the reference for determining the highest quality bond will need to be defined based on a characteristic other than credit quality. In other words, the number of HQCB, or the market depth of HQCB, used to determine the discount rate should be stable over time (for example the top-rated 100 bonds).

   For example, in one year the reference point for high quality means 'AA' because there is a deep market in AA-rated corporate bonds, but in another year high quality may mean 'AA' plus 'A', because the number of AA-rated corporate bonds rated has decreased significantly and the population of HQCB needs to be extended to include 'A' rated bonds.

8. An *absolute* concept of high quality corporate bonds means that:

   (a) the reference point for high quality should be consistent over time and independent of the number of bonds, or the depth of the market in such bonds;

(b) it should be linked to a fixed credit rating, for example the two highest ratings given by an internationally recognised rating agency;

(c) changes in the depth of the HQCB market should not change the reference point for high quality. It should remain, for example, equivalent to 'AA' from period to period. In the absence of a deep market in HQCB, the entity should revert to a government bond rate; and

(d) the number of HQCB used to determine the discount rate may change over time.

9. This paper refers to credit ratings for the purposes of facilitating the analysis. Appendix D contains some additional background information on credit ratings that is relevant to the discussion.

Absolute vs relative in current IAS 19

10. Paragraph 83 of IAS 19 requires an entity to use a discount rate determined by reference to market yields at the end of the reporting period on HQCB. In countries where there is no deep market in such bonds, the market yields on government bonds should be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and the estimated term of the benefits.

11. In our view, the common understanding of paragraph 83 of IAS 19 is that it implies that the term 'high quality' is an absolute concept, because it does not require an entity to use the *highest* quality corporate bonds.

12. We also think that if a relative concept had been intended, then the backstop requirement for the government bond would not be required, or would only be required in absence of a deep market for corporate bonds of any credit quality (and not in absence of a deep market for HQCB).

13. Our view is confirmed by the predominant practice of considering corporate bonds to be high quality if they receive one of the two highest ratings given by an internationally recognised rating agency.

14. Consequently, we think that to introduce a relative concept of HQCB we need to amend paragraph 83. We also think that the potential amendment would be a narrow-scope amendment to IAS 19 and not an annual improvement, because it would change the basic requirements as well as the predominant practice of using AA-rated corporate bonds.

15. We note that the potential effect of such an amendment could be significant because:

    (a) in jurisdictions that are now using government bonds to determine the discount rate, entities may start using corporate bonds because in these jurisdiction there is a deep market in A-rated (or BBB-rated) corporate bonds, but the market for AA-rated corporate bonds is not deep; and

    (b) in jurisdictions that are now using AA-rated corporate bonds to determine the discount rate, entities may start to include A-rated (or BBB-rated) corporate bonds in the population of bonds used to determine the discount rate.

Absolute vs relative: pro and cons analysis

16. In the table below we provide a pros and cons analysis on whether HQCB should be a relative concept or an absolute concept.

Absolute notion of HQCB	
Pros	**Cons**
• Comparability of discount rates between companies, because the discount rate has been determined by reference to the same reference point. • Consistency over time, because the definition of each credit rating is usually stable. Consequently, the credit risk included in the discount rates is expected to remain broadly the same over time. • Consistent with the predominant past/current practice and with US GAAP.	• Relies on identifying the reference point in order to increase comparability (ie we need to agree a rule, for example: only ‘AAA’ and ‘AA’ bonds, or ‘AAA’+‘AA’+‘A’, etc…). • If the population of the reference bonds decreases: o The reference point is more likely to be less observable or reliable because of the reduction in the number of observable data points.

Absolute notion of HQCB	
Pros	**Cons**
	○ The discount rate will be more dependent on the specific credit risk of bond issuers in the reference population. ○ Changes to the determination of the discount rate to refer to government yield curves may occur more frequently. • In the absence of a deep market for the reference point, it will require an entity to use government bonds (to be consistent with IAS 19), This would reduce comparability in the measurement of defined benefit obligations located in different jurisdictions, because the yields on government bonds could be significantly different from the yields on HQCB.

Relative notion of HQCB	
Pros	**Cons**
• Reliability; it is likely that the discount rate is determined on a larger and more stable universe of observable market yields (for example the top-rated 100 bonds, or the top X% layer of a bond population). • The discount rate is less dependent on the specific credit risk of bond issuers in the reference population. • Similarly, it is less likely that an entity will have to change the discount rate determination to look at government bond yield curves (even though this may happen if the depth	• Reduced comparability of the discount rates between companies and across jurisdictions, because of variability of the credit risk element that may be reflected in the discount rate. • We may need to set a floor (eg corporate bonds rated below X-rating cannot be used to determine the discount rate), because the highest quality corporate bonds with a deep market could be ‘junk’ rated. • We need to amend IAS 19. • It is likely that the discount rate

Relative notion of HQCB	
Pros	**Cons**
of the market is not sufficient). • The attribution of ratings by credit-rating agencies may not have been consistent over time. This approach allows the mitigation, to some extent, of that effect. It is less dependent on credit rating agencies.	would reflect a higher credit risk. • We would need to determine the criteria for selecting the universe of bonds and how an entity should select the bonds within that population as the reference rate.

Possible alternatives

17. On the basis of the analysis above, we have identified the following alternatives:

    (a) Option 1: Stop the project by issuing a tentative agenda decision.

    (b) Option 2: Develop guidance on the basis that HQCB is an absolute concept.

    (c) Option 3: Develop guidance on the basis that HQCB is a relative concept.

Option 1: Stop the project issuing a tentative agenda decision

18. Similarly to the November 2012 *IFRIC Update*, under this approach, the Interpretations Committee would:

    (a) highlight that an entity's policy for determining the discount rate should be applied consistently over time;

    (b) emphasise that an entity's method for determining the discount rate so as to reflect the yields on HQCB should not change significantly from period to period, other than to reflect changes in the time value of money and the estimated timing and amounts of benefit payments; and

    (c) decide not to add this issue to its agenda, because it cannot address this issue in an efficient manner.

19. The draft wording of the potential tentative agenda decision in presented in Appendix A of this paper.

Option 2: Develop guidance on the basis that HQCB is an absolute concept

20. Under this approach the Interpretations Committee would recommend to the IASB that it should issue implementation guidance to:

    (a) clarify that HQCB is an absolute concept; and

    (b) establish the credit ratings that should be used to determine the discount rate; for example 'AA', or 'AAA'+'AA'+'A', etc….

21. We think that is not necessary to amend the wording of paragraph 83 of IAS 19 to clarify that HQCB is an absolute concept. We only need to establish the reference point for HQCB. In our view, this can only be done by a reference to external credit ratings. We also think that this specification should not be given in the Standard, because rating agencies can change their rating scales over time and this change would automatically change our Standard (ie the guidance should be issued as Implementation Guidance).

22. If the Interpretations Committee decides to follow this way forward, we will provide at a future meeting a pros and cons analysis of the various alternatives (ie credit ratings) that could be considered for specifying the absolute concept of HQCB.

23. An illustrative example of the potential implementation guidance is presented in Appendix B of this paper.

Option 3: Develop guidance on the basis that HQCB is a relative concept

24. Under this approach the Interpretations Committee would recommend to the IASB that it should issue a narrow-scope amendment to IAS 19 that states that HQCB is a relative concept. Consequently, the discount rate should be determined using market yields at the end of the reporting period on the highest quality corporate bonds issued in the same currency of the liability for which there is a deep market.

25. Under such an approach, the requirements would have to set out how the entity should select the population of bonds to use to determine the discount rate. Setting the boundary for the population will be an important aspect of this approach, because it will determine the circumstances in which an entity can use lower quality bonds. For example: one way of achieving this would be to require entities to start at the highest quality bond and increase the population of bonds until it is considered 'deep'. The reference rate would then be the average rate for that population of bonds.

26. Another example of how an entity should select the population of bonds to use to determine the discount rate is to consider all corporate bonds within the Investment grade universe to be 'quality bonds' and, within this universe, corporate bonds shall be considered 'high quality' if their credit rating is at or above the average credit rating of all 'quality bonds'.

27. If the Interpretations Committee decides to follow this way forward, we will provide at a future meeting a draft amendment to paragraph 83 of IAS 19 and an analysis of the various alternatives that could be considered for selecting the highest quality corporate bonds.

28. In Appendix C of this paper we provide a preliminary draft of the potential amendment to IAS 19 and some illustrative examples of the relating implementation guidance.

Staff recommendation

29. We recommend that the Interpretations Committee should stop the project (Option 1) because, in our view:

    (a) Option 2 requires the determination of the "absolute" reference point for high quality. On the basis of the Interpretations Committee's previous discussions, we are concerned that the Interpretations Committee will not reach a consensus on a timely basis on whether the reference point should be, for example, 'AA' or 'A'.

(b) Similarly to Option 2, Option 3 would require setting out how the entity should select the population of bonds to use to determine the discount rate. We are concerned that the Interpretations Committee will not reach a consensus on a timely basis on setting the boundary for the population of HQCB or on determining the circumstances in which an entity can/should use lower quality bonds.

Questions for the Interpretations Committee
1. Does the Interpretations Committee agree to stop the project? If not, what is your preferred option? 2. Does the Interpretations Committee have any comments on the proposed tentative agenda decision in Appendix A?

Appendix A—Option 1: Proposed wording for the potential tentative agenda decision

A1 The proposed wording for the potential tentative agenda decision is presented below.

IAS 19 *Employee Benefits*—Actuarial assumptions: discount rate

The Interpretations Committee received a request for guidance on the determination of the rate used to discount post-employment benefit obligations. The submitter stated that:

- according to paragraph 83 of IAS 19 (2011) the discount rate should be determined by reference to market yields at the end of the reporting period on "high quality corporate bonds" (HQCB);
- IAS 19 does not specify which corporate bonds qualify to be HQC bonds;
- according to prevailing past practice, listed corporate bonds have usually been considered to be HQC bonds if they receive one of the two highest ratings given by a recognised rating agency (eg 'AAA' and 'AA'); and
- because of the financial crisis, the number of corporate bonds rated 'AAA' or 'AA' has decreased in proportions that the submitter considers significant.

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

The Interpretations Committee noted that according to paragraphs 84 and 85 of IAS 19 (2011) the discount rate:

- reflects the time value of money but not the actuarial or investment risk;
- does not reflect the entity-specific credit risk;
- does not reflect the risk that future experience may differ from actuarial assumptions; and
- reflects the currency and the estimated timing of benefit payments.

The Interpretations Committee further noted that 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 a recognised rating agency (eg 'AAA' and 'AA').

The Interpretations Committee observed that 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. The Interpretations Committee considers that 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 (2011).

The Interpretation Committee also observed that the entity's policy for determining the discount rate should be applied consistently over time. The Interpretations Committee does not expect that an entity's method of determination of the discount rate so as to reflect the yields on HQCB will change significantly from period to period, other than to reflect changes in the time value of money and the estimated timing and amounts of benefit payments.

The Interpretations Committee discussed this issue in several meetings and noted that the issue is too broad for it to address in an efficient manner. Consequently the Interpretations Committee [tentatively] decided not to add this issue to its agenda.

Appendix B—Option 2: Example of implementation guidance

B1 The illustrative example of the potential implementation guidance to specify the absolute concept of HQCB is presented below.

> Paragraph 83 of IAS 19 requires that the rate used to discount post-employment benefit obligations shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. Corporate bonds that receive one of the two highest ratings given by an internationally recognised rating agency should be considered to be high quality.

Appendix C—Option 3: Draft potential amendment to IAS 19 and examples of implementation guidance

B1 A preliminary draft wording of the potential amendment to paragraph 83 of IAS 19 is presented below (deleted text is struck through and new text is underlined).

> **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 <u>the</u> high<u>est</u> quality corporate bonds. In countries where there is no deep market in ~~such~~ <u>high quality corporate</u> 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.**

B2 Some illustrative examples of the accompanying implementation guidance are presented below.

> **Example 1**
>
> Paragraph 83 of IAS 19 requires that the rate used to discount post-employment benefit obligations shall be determined by reference to market yields at the end of the reporting period on the highest quality corporate bonds. Consequently, in selecting the population of corporate bonds to determine the discount rate, an entity should start with the highest quality corporate bond and increase the population of bonds only if the market for the highest quality corporate bond is not deep. For example, in countries where the market for AA-rated corporate bonds is deep, A-rated corporate bonds shall not be used to determine the discount rate.
>
> Paragraph 83 of IAS 19 also requires that if there is no deep market in high quality corporate bonds, the market yields (at the end of the reporting period) on government bonds shall be used. Corporate bonds that receive one of the three highest ratings given by an internationally recognised rating agency should be considered to be high quality.
>
> **Example 2**
>
> Paragraph 83 of IAS 19 requires that the rate used to discount post-employment benefit obligations shall be determined by reference to

market yields at the end of the reporting period on the highest quality corporate bonds. Consequently, in selecting the population of corporate bonds to determine the discount rate, an entity should consider all corporate bonds within the Investment grade universe to be ‘quality bonds’ and, within this universe, corporate bonds shall be considered ‘high quality’ if their credit rating is at or above the average credit rating of all ‘quality bonds’.

Appendix D—Credit ratings background

D1. This Appendix is part of the staff analysis; its purpose is to provide a brief background and note some issues regarding ratings that might be relevant for the purposes of the discussion. This paper refers to credit ratings for the purpose of facilitating the discussion and analysis. **However, care needs to be taken when referring to credit ratings, especially when discussing whether 'high quality' is a relative or an absolute concept.**

D2. There is a wide variety of credit rating systems in place, both external and internal. For the purpose of this paper, references to credit ratings should be considered references to the credit ratings of an internationally recognised rating agency, which typically includes Moody's, Standard and Poor's and Fitch Ratings. All three of these agencies have published material on their websites on their credit rating definitions, methodology and processes, which can be accessed if further information is required. Some of the material has been included in the form of hyperlinks below. Notwithstanding the materials published by the rating agencies on their website, the ratings methodology and process of a rating agency is proprietary, and while ratings agencies typically disclose the factors that might trigger a rating action (eg a downgrade), they do not generally disclose the weighting of factors. For example, one rating agency may place more emphasis on the likelihood of default than another agency.

D3. The staff notes the following matters that might be relevant to the discussion:

(a) Ratings systems can either be **ordinal** or **cardinal**.

(i) Ordinal ratings systems are based on a relative rank ordering (ie a 'AA' rated credit is relatively less risky than an 'A' rated credit).

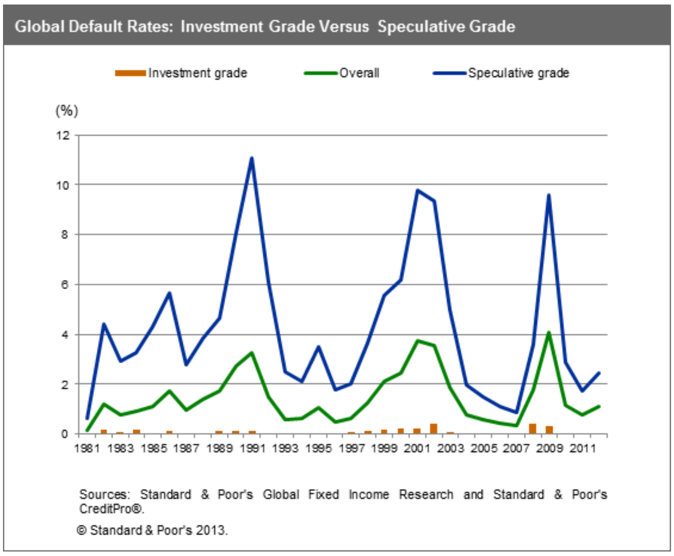
(ii) Cardinal ratings systems are based on absolute amounts or ranges of probabilities of default or expected loss.

(b) The ratings issued by the three ratings agencies are ordinal ratings. Consequently, they express a relative ranking of creditworthiness. However, there are some elements of the ratings process and methodology that result in a more absolute rating for higher quality credits than lower quality credits (for example issuers and obligations rated in the highest categories are usually associated with the ability to withstand extreme or severe stress in **absolute** terms without defaulting)[1].

(c) Because the credit ratings are relative ratings, the actual amounts and ranges of probabilities of default, expected loss and credit spreads **change depending on the current economic conditions**. This may result in (and is observed as):

   (i) smaller differences in credit spreads and default frequencies between different ratings in good economic conditions; and

   (ii) larger differences in credit spreads and default frequencies between different ratings in stressed economic conditions.



(d) Thus, credit ratings indicate an issuer's relative exposure to adverse economic conditions. For example, the difference between an 'AA' and an 'A' rated issuer can be illustrated by reference to the level of adverse economic conditions that they can withstand[2]:

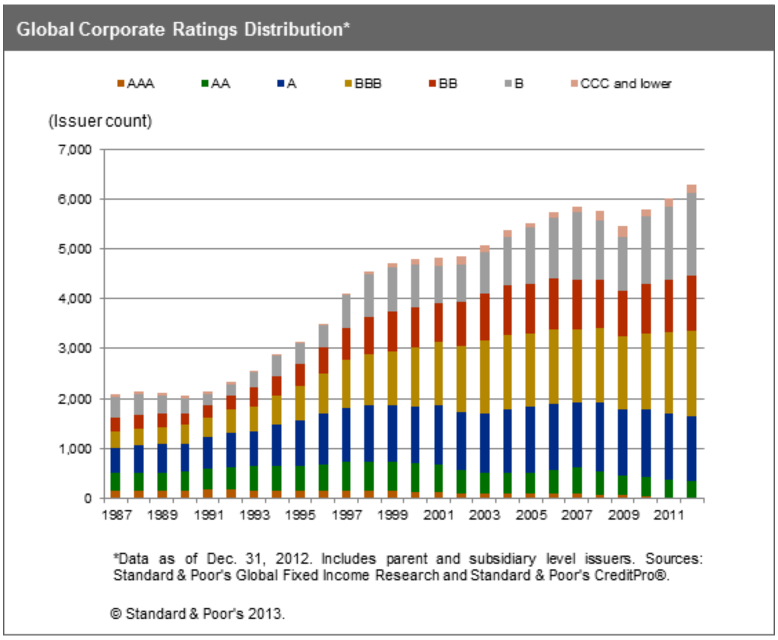
> An issuer or obligation rated 'AA' should be able to withstand a severe level of stress and still meet its financial obligations. Such a scenario could include GDP declines of up to 15%, unemployment levels of up to 20%, and stock market declines of up to 70%.

[1] Refer to *Understanding Standard & Poor's Rating Definitions*.

[2] Refer to *Understanding Standard & Poor's Rating Definitions*.

An issuer or obligation rated 'A' should be able to withstand a substantial level of stress and still meet its financial obligations. In such a scenario, GDP could decline by as much as 6% and unemployment could reach up to 15%. The stock market could drop by up to 60%.

D4. Other charts and data that might be useful for the discussion:



Issuer Ratings Distribution By Region*

Rating (%)	U.S.	Europe	Other developed	Emerging markets	Global
AAA	0.1	0.6	0.5	0.5	0.3
AA	4.7	8.1	8.2	1.8	5.1
A	17.2	30.4	35.8	12.4	20.7
BBB	24.8	29.8	30.3	29.0	27.3
BB	16.2	12.8	12.1	27.7	17.6
B	33.9	16.7	11.0	26.0	26.4
CCC and lower	3.0	1.6	2.0	2.6	2.6
Total (count)	3068	1239	643	1366	6285
Median rating	BB+	BBB+	BBB+	BB+	BBB-
Speculative grade (%)	53.1	31.2	25.2	56.3	46.6

*Data as of Dec. 31, 2012. Includes parent and subsidiary level issuers. Sources: Standard & Poor's Global Fixed Income Research and Standard & Poor's CreditPro®.

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