

STAFF PAPER

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

This paper has been prepared by the staff of the IFRS Foundation for discussion at a public meeting of the IFRS Interpretations Committee. Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination. Decisions made by the IFRS Interpretations Committee are reported in *IFRIC Update*. The approval of a final Interpretation by the IASB is reported in *IASB Update*.

Introduction

1. This paper proposes amendments to the discount rate requirements of IAS 19. We have developed these amendments based on discussions of the IFRS Interpretations Committee (Interpretations Committee) and the IASB in previous meetings.
2. We recommend that:
 - (a) Paragraph 84 of IAS 19 is amended to provide an objective for the discount rate assumption; and
 - (b) Paragraph 83 of IAS 19 is replaced with non-authoritative implementation guidance to support the objective in (a).

Background

3. In October 2012, 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).

4. In its November 2012 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; and
 - (d) an entity's policy for determining the discount rate should be applied consistently over time.
5. In its January 2013 meeting, the Interpretations Committee:
 - (a) expressed support for the June 2005 Interpretations Committee agenda decision that, in determining the discount rate, an entity shall include HQCB issued by entities operating in other countries, provided that these bonds are issued in the currency in which the benefits are to be paid. A consequence of this view is that for a liability expressed in euros, the depth of the market for HQCB should be assessed at the Eurozone level; and
 - (b) requested the staff to consult the IASB.
6. In its March 2013 meeting, the Interpretations Committee was informed that the majority of the IASB members agreed that:
 - (a) the objective for the determination of the discount rate is set out in paragraph 84 of IAS 19, ie "the discount rate reflects the time value of money but not the actuarial or investment risk. Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, nor does it reflect the risk that future experience may differ from actuarial assumptions.";

- (b) the Interpretations Committee should clarify the sentence “the discount rate reflects the time value of money but not the actuarial or investment risk” and that this sentence does not mean that the discount rate for post-employment benefit obligations should be a risk-free rate;
 - (c) the discount rate should reflect the credit risk of HQCB and that a reasonable interpretation of HQCB could be corporate bonds with minimal or very low credit risk; and
 - (d) the Interpretations Committee should propose amendments to IAS 19 to specify that when government bonds are used to determine the discount rate they should be of high quality.
7. Consequently, the Interpretations Committee requested the staff to consult appropriate experts and to prepare proposals for a narrow-scope amendment to IAS 19 that reflects the IASB’s direction above. In addition, the Interpretations Committee asked that the proposed amendment should also clarify that, in determining the discount rate, an entity shall include high quality corporate bonds issued in other countries, provided that they are issued in the currency in which the benefits are to be paid.
8. We performed outreach on how determine the discount rate when there is no deep market for HQCB or high quality government bonds with capital market experts, actuaries and other IAS 19 experts. The results of this outreach are included as part of the staff’s analysis of this issue.

Proposed amendments to IAS 19

9. On the basis of the IASB’s tentative decisions reported in paragraphs 4(a)-(d) of this paper, we propose to replace paragraph 83 of IAS 19 with implementation guidance (see paragraphs 14 – 59 of this paper) and to modify paragraph 84 as follows:

Actuarial assumptions: discount rate

~~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 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 bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.~~

84 ~~One actuarial assumption that has a material effect is the discount rate. The objective of the discount rate is to reflect only the time value of money and at most very low credit risk, the currency and the estimated term of the post-employment benefit obligations. The discount rate does not reflect but not the actuarial or investment risk of the plan assets (as defined in paragraph 28). Furthermore, the discount rate does not reflect the entity-specific credit risk borne by the entity's creditors, and nor does it reflect the risk that future experience may differ from actuarial assumptions.~~

10. We are proposing “at most very low”, because some respondents to our outreach noted that some countries have AAA-rated government bonds but no deep market for AA-rated corporate bonds, so in their view they should adjust the government bonds yields adding the market premium for the additional credit risk between AAA-rated government bonds and AA-rated corporate bonds. We agree that this adjustment is consistent with the objective of a very low credit risk. However, we note that requiring adjustments means require a more complex approach that should not be mandatory. Therefore we think that “at most very low” should be used. In other words, we think that “very low” should be a threshold and not a target.
11. In our view, the above amendments provide a suitable objective for the discount rate assumption under IAS 19. As a result of the amendments above, an entity shall consider the following factors when estimating the discount rate:
 - (a) Time value of money (ie risk-free rate).
 - (b) Very low credit risk (see paragraphs 15 – 21).
 - (c) Currency (see paragraphs 25 – 29).
 - (d) Maturity.
12. The amendment above will preclude an entity from including other risk factors in the estimate of the discount rate. The risk factors that are excluded from the estimate of the discount rate are, among other risks, the following:

- (a) Actuarial or investment risk of the plan assets (eg it shall not be based on the expected return of the plan assets).
 - (b) Entity-specific credit risk.
 - (c) Actuarial risk of the defined benefit obligation.
13. The staff proposes additional implementation guidance to support the objective in paragraphs 14 – 59.

Question 1

Do you agree with the proposed amendment to IAS 19 in paragraph 9 of this paper?

Proposed Implementation Guidance for IAS 19

14. This section proposes implementation guidance to support the objective as recommended by the staff above. The implementation guidance addresses the following matters:
- (a) Clarifying *very low credit risk* (paragraphs 15 – 21)
 - (b) The reference rate that best meets the objective (paragraphs 22 – 24)
 - (c) The currency issue (paragraphs 25 – 29)
 - (d) The high quality government bonds issue (paragraphs 30 – 35)
 - (e) How to meet the objective if there is no deep market in high quality corporate bonds or high quality government bonds (paragraphs 36 – 59)

Is “very low credit risk” clear enough?

15. Some think that “very low credit risk” is not clear enough and suggest that we should clarify that credit risk is very low if the reference bonds receive one of the two highest ratings given by an internationally recognised rating agency.

16. In our view, if the Interpretations Committee wants to clarify the amount of credit risk to be included in the discount rate, this can only be done by a reference to external credit ratings.
17. We think that this clarification 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.
18. In our view, this clarification could only be done by providing non-authoritative guidance to accompany the Standard, rather than in the Standard itself.
19. We propose the following implementation guidance:

The rate that best achieves the objective in paragraph 84 of IAS 19 is the market yield, at the end of the reporting period, on the bonds that receive one of the two highest credit ratings given by an internationally recognised rating agency (ie high quality bonds). The discount rate should be based on reliable data and should not reflect the liquidity risk. Consequently the market used to determine the discount rate should be a deep market.

20. We are proposing “high quality bonds”, because in our view, an entity can use either corporate or government bonds to meet the objective of our proposed amendment. In our view the hierarchy in paragraph 83 of IAS 19 (ie if there is no deep market in high quality corporate bonds, government bonds shall be used) is not relevant given the proposed amendments. In our view, when government bonds are used to determine the discount rate they should be of high quality (this issue is further discussed in paragraphs 30-35 of this paper)
21. The alternative to a direct reference to external rating grade would be to describe the amount of risk using similar words to the external credit rating agencies. For example, S&P describes AA as “the obligors capacity to meet its financial commitments on the obligation is very strong” and describes A as “somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories”. We do not support this approach because we think it is less clear.

Question 2

Do you agree with the proposed implementation guidance in paragraph 19 of this

paper?

The reference rate that best meets the objective

22. In paragraph 9 of the paper, we are proposing that: “The objective of the discount rate is to reflect only the time value of money and a very low credit risk for the currency and the estimated term of the post-employment benefit obligations.”
23. Some think that this objective (ie time value of money plus very low credit risk) can be difficult to meet in practice. They think that we should provide guidance on how entities can achieve the objective set out in our proposed amendment.
24. Consequently, we propose the following implementation guidance:

The rate that best achieves the objective in paragraph 84 of IAS 19 is the market yield, at the end of the reporting period, on high quality bonds (ie corporate or government bonds with very low credit risk). The discount rate should be based on observable data and should not reflect the liquidity risk. Consequently the market used to determine the discount rate should be a deep market.

Question 3

Do you agree with the proposed implementation guidance in paragraph 24 of this paper?

The currency issue

25. In its March 2013 meeting, the Interpretations Committee requested that the proposed amendment to IAS 19 should also clarify that, in determining the discount rate, an entity shall include high quality corporate bonds issued in other countries, provided that they are issued in the currency in which the benefits are to be paid.
26. The concern that an entity might only look at bond rates in its own country is caused by the following sentence of paragraph 83 of IAS 19 [emphasis added]
 - 83 ...**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...
27. In our proposed amendment in paragraph 9 of this paper:

- a. we deleted the sentence above;
 - b. we have not used the term ‘countries’; and
 - c. we clarify that the discount rate reflects the currency and the estimated term of the post-employment benefit obligations.
28. Consequently, we think that the proposed amendment will address the ‘Eurozone issue’. However, for the sake of clarity we propose the following implementation guidance [emphasis added]:
- According to paragraph 84 of IAS 19 the discount rate reflects the currency of the post-employment benefit obligations. Consequently, in determining the discount rate, an entity shall include market yields on **high quality bonds** issued in other countries, provided that these bonds are issued in the same currency in which the benefits are to be paid.
29. We are proposing “high quality bonds”, because in our view, this proposed guidance should be applied regardless of whether an entity uses corporate or government bonds to determine the discount rate.

Question 4

Do you agree with the proposed implementation guidance in paragraph 28 of this paper?

Government bonds

30. In the February 2013 IASB meeting, the majority of the IASB members agreed that the Interpretations Committee should propose amendments to IAS 19 to specify that when government bonds are used to determine the discount rate they should be of high quality.
31. Some proposed to use government bonds, even though they are not high quality, because government bonds reflect the inflation or the currency risk.
32. We think that usually the credit risk of government bonds is minimal, because a government (usually) can issue currency in order to avoid defaulting on a payment. The decision of a government to issue more currency in order to avoid defaulting on a payment usually has consequences for the inflation rate in the country and the exchange rate with other currencies. Thus, a government may

decide not to pay a liability, or may be unable to issue currency, and so the credit risk of government bonds may be higher than “very low” (ie government bonds may be not “high quality government bonds”).

33. In our view, the discount rate should reflect a very low credit risk regardless of whether corporate or government bonds are used to determine the discount rate. This is consistent with the direction given by the IASB at its February 2013 meeting.
34. We also think that government bonds with high currency risk and government bonds issued in countries with an high inflation rate, can be considered to be high quality provided that the credit risk is very low, because we note that:
- (a) actuarial assumptions shall be mutually compatible (IAS 19.75):
 - (b) actuarial assumptions are mutually compatible, if they reflect the economic relationship between factors such as inflation, rates of salary increase and discount rates (IAS 19.78);
 - (c) according to paragraph 79 of IAS 19 an entity should determine the discount rate and other financial assumptions in nominal terms, unless estimates in real (inflation-adjusted) terms are more reliable, for example, in a hyperinflationary economy.
35. Consequently, we propose the following guidance:
- According to paragraph 84 of IAS 19 the discount rate shall reflect the currency of the liability and a very low credit risk, therefore:
- a) government bonds with high currency risk (ie inflation) and very low credit risk meet this objective (ie they are high quality bonds); but
 - b) government bonds with credit risk higher than very low and very low currency risk do not meet this objective (ie they are not high quality bonds).

Question 5

Do you agree with the proposed implementation guidance in paragraph 35 of this paper?

No deep market for HQCB or high quality government bonds

36. If the Interpretations Committee agrees that the government bonds (as well as corporate bonds) used to determine the discount rate should be high quality bonds, we should provide guidance for determining the discount rate that meets the objective in the absence of a deep market in high quality corporate or high quality government bonds. In our view, the estimation processes would not just be applied to government bonds but all bonds.
37. We identified two possible alternatives to address this situation:
- (a) Option 1: Estimate the appropriate discount rate (paragraphs 38 – 46); or
 - (b) Option 2: Use the highest quality bonds for which there is a deep market (paragraphs 47 – 48).

Option 1: Estimating the appropriate discount rate

38. Under this approach, the entity would estimate the discount rate using either the requirements in IFRS 13 *Fair Value Measurement* or requirements developed specifically for IAS 19 for constructing a synthetic yield curve.

Using the requirements in IFRS 13

39. Using the requirements in IFRS 13 for estimating the discount rate would be a similar approach to that proposed in the Exposure Draft *Discount Rate for Employee Benefits* published in August 2009 (the ED). However, the objective of the estimation would be as we proposed in paragraph 9 of the paper and not limited to the estimation of the yield on a high quality *corporate* bond as proposed in that ED.
40. We think that the principles in IFRS 13 may be used to determine a discount rate that reflects the time value of money and a very low credit risk, because in our view:
- (a) the market yield of a bond is a different way of expressing the fair value of that bond;
 - (b) IFRS 13 provides guidance to estimate fair value using valuation technique;

- (c) the yield curve and credit spreads¹ are inputs to valuation techniques used to measure fair value; and
- (d) an entity can estimate a yield curve by applying the guidance in IFRS 13 in the inverse way (ie considering the fair value as an input).

41. IFRS 13 requires an entity to maximise the use of observable inputs and minimise the use of unobservable inputs, therefore we think that the principles of IFRS 13 would be consistent with the objective and the other proposed implementation guidance.

42. We propose the following implementation guidance for such an approach:

If there is no deep market in high quality corporate bonds or high quality government bonds, an entity shall apply the requirements of IFRS 13 *Fair Value Measurement* to determine the discount rate that meets the objective of paragraph 84 of IAS 19.

Developing specific requirements in IAS 19 for constructing a yield curve

43. The other approach under Option 1 is to develop specific implementation guidance for constructing a yield curve when there is no deep market in high quality bonds. In our view, an entity should determine the discount rate using a yield curve that best models a high quality yield curve. We consulted with actuaries and other experts on this specific topic and we understand that the “principle” to construct a synthetic yield curve is establishing a reliable reference yield curve (base curve) usually in the same currency of the liability and then either removing or adding the market premium for credit risk (credit risk adjustment).

44. Consequently, a synthetic yield curve may be constructed:

- (a) using corporate and government bonds with a rating lower than AA (for example A-rated bonds) issued in the same currency of the liability and adjusting the yields of these bonds in order to remove the market premium for the additional credit risk between AA-rated bonds and bonds with a lower rating (Method 1);

¹ See paragraph 82 of IFRS 13

- (b) using the average spread of a basket of Credit Default Swaps (CDS) with a AA rating. This spread curve is added to the risk-free yield curve. The spread curve may be determined using CDS denominated in a currency different from the currency of the liability, but the risk-free yield curve shall be determined in the same currency of the liability (Method 2).
- (c) establishing the base curve from high quality bonds of a suitable reference currency (ie in a currency different from the liability) and then adjust to remove the relative credit spread between the two currencies (Method 3).

45. We also think that the three methods outlined above are an application of IFRS 13 techniques and thus consistent with that approach. However, they are more specific and therefore might be more helpful than a general reference to IFRS 13.

46. We propose the following implementation guidance for such an approach:

If there is no deep market in high quality bonds, an entity shall determine the discount rate using a synthetic yield curve that best models a high quality yield curve. The synthetic yield curve is constructed by first establishing a reliable reference yield curve (base curve) in the same currency of the defined benefit obligation and then either removing or adding the market premium for credit risk (credit risk adjustment). If the base curve is denominated in a currency different from the defined benefit obligation, then the credit spread between the two currencies shall be adjusted. The synthetic yield curve may be constructed, for example, as follows:

- a) establish the base curve using corporate and government bonds data that are more reliable than data available on high quality bonds; then adjust the base curve in order to remove the market premium for the credit risk to arrive at a yield curve that models a high quality yield curve;
- b) establish the risk-free yield curve for the relevant currency as the base curve and then add the credit spreads of high quality Credit Default Swaps. This spread curve shall be added to the risk-free yield curve for the relevant currency. The spread curve may be determined using Credit Default Swaps denominated in a currency different from the currency of the liability; or
- c) establishing the base curve from high quality bonds of a suitable reference currency (ie in a currency different from the defined benefit obligation) and then adjust to remove the relative credit spread between the two currencies.

Option 2: Using the highest quality bonds for which there is a deep market

47. Under this approach, an entity would determine the discount rate by using the highest quality bonds in the same currency of the liability for which there is a deep market. These bonds can be either government bonds or corporate bonds. We think that when the highest quality bonds are used to determine the discount rate, the market yields and the credit ratings of the bonds used should be disclosed.

48. We propose the following implementation guidance for Option 2:

If there is no deep market in high quality corporate bonds and government bonds are not high quality, an entity shall determine the discount rate using the market yield on the highest quality bonds issued in the currency in which the benefits are to be paid. The market yields and the credit ratings of the bonds used shall be disclosed.

Staff analysis

49. We consulted capital market experts on this topic. The main comments received are the following:

- (a) The list of currency areas or countries that have neither a deep market in high quality corporate bonds nor government bonds that are of high quality includes most countries in the world. For that reason, the respondent thinks that the proposal would give rise to significant change in established practice in those countries.
- (b) In some economies, the three methods explained in paragraph 44 of this paper can be complex to apply.
- (c) Another important issue to consider is why an entity should not adjust yields for factors apart from the credit risk (eg liquidity). Differences in liquidity can play a significant role because a high quality bond can be assumed to be more liquid than a low quality bond.
- (d) There is no definition for 'risk-free'. 'Risk-free' may be interpreted to mean 'AAA'.

50. Our responses on the comments above are the following:

- (a) We are aware that the disadvantage of Option 1 is that it would change the current practice in many jurisdictions. However, we think that Option 1 is consistent with the objective of our proposed amendment.
- (b) We are aware that another disadvantage of Option 1 is that it is difficult to apply. However, we note that IFRSs and other IASB projects include requirements that in our view are of similar complexity as Option 1 (eg valuation techniques in IFRS 13 and the proposed requirements for determining the discount rate in the Insurance Contracts project)

- (c) We are aware that liquidity risk affects market yields; however in our view by requiring that the market of high quality bonds should be deep we are mitigating this issue.
51. We think that Option 1 is more consistent with the objective of our proposed amendment than Option 2, however Option 2 would be less complex to apply and a smaller change for some jurisdictions that are currently using a low quality government bond rate. A discount rate determined using Option 2 is more reliable, but is less comparable, because in Option 2 ‘highest quality’ is a relative concept.
52. We support Option 1, because we think that the difference between the yields of high quality bonds and a highest quality bonds can be significant and the effect on the financial statements can be material. Option 1 requires complex estimations, but, in our view, IFRSs and other IASB projects include requirements that are similarly complex as Option 1.
53. In our view, under Option 1 both a discount rate determined using IFRS 13 or with the proposed specific implementation guidance for constructing a yield curve would meet that objective. While the specific implementation guidance may be more relevant to estimating the discount rate, the principles in IFRS 13 are more general. Our recommendation is to provide specific implementation guidance for constructing a yield curve.

Question 6

Do you agree that we provide specific implementation guidance for constructing a synthetic yield curve? If not, which is your preferred option?

Deep market or active market?

54. IAS 19 does not define the term ‘deep market’. Some interested parties think that the term ‘deep market’ is not sufficiently clear. We understand that some

Interpretations Committee members and some IASB members raised the same question (ie what does deep market mean?).

55. We discussed this issue with some interested parties and we understand that:
- (a) some think that, while a deep market is an active market, an active market is not necessarily a deep market. They interpret the term ‘deep’ to mean a robust or stable market.
 - (b) others consider a market to be deep if the size (or quantity) of the transaction would not influence the price.
56. In addition, we think that the words as used in IAS 19 may refer to the intention to achieve a reliable measure, or to limit the liquidity risk component of the yield.
57. We note that IFRS 13 defines ‘active market’ as follows:
- A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis.
58. We also note that in IFRS 13, the fair value is the end result, while in IAS 19 the discount rate is not the end result, it is an input into the calculation for the defined benefit obligation, so we are concerned about the reliability impact of using active market instead deep market in our proposed amendment to the Standard.
59. However, in our view, if the Interpretations Committee prefers to use the requirements in IFRS 13 to estimate the discount rate in accordance with the proposed objective, then we propose to use the term active market in the IAS 19 implementation guidance instead of the term deep market. Doing so will ensure consistency of the implementation guidance proposed.

Question 7

Do you agree that in the proposed implementation guidance to IAS 19 we should use the term ‘active market’ instead of ‘deep market’ if the Interpretations Committee decided to reference IFRS 13?