Comments on ED 187 Discount Rate for Employee Benefits (proposed amendments to AASB 119) - August 2009

Summary

Paragraph Aus78.1 should be retained within AASB 119, to ensure that the liabilities of public sector entities are valued appropriately. This position is reinforced when it is recognised that the more comprehensive review of IAS 19 will be undertaken in due course – in the meantime, AASB 119 should not be changed unless absolutely necessary.

There are arguments that the IASB's quest for consistency would be better served by restricting the choice of discount rate to that based on sovereign bond yields, rather than corporate bond yields. However, the proposed change to IAS 19 is not unreasonable given:

- the increase in liabilities that would result from any change to sovereign yields;
- the arguments supporting a high quality bond yield in most private sector schemes;
- the reference to the IAS 39 techniques to estimate yields in shallow or non-existent markets (notwithstanding the practical issues in countries without a deep corporate bond market); and
- the intention to comprehensively review of IAS 19 in due course.

In summary, **I accept the restriction to high quality corporate bond yields for schemes sponsored by private sector entities**.

Discussion

The IASB has stated in its corresponding Exposure Draft that it is not asserting that the yield on high quality corporate bonds is the most appropriate discount rate for post-employment benefit obligations. Comprehensive consideration of this question is to be included in a more wide ranging review of IAS 19 in due course. The IASB's current intent is to reduce the inconsistency in the application of the existing standard where different discount rates (sovereign versus high quality corporate) produce materially different liability estimates on substantially similar benefit obligations. Whilst this is a reasonable objective, it is important that the validity of liability estimates is not sacrificed in the quest for consistency.

Although comments on the conceptual basis underlying the selection of discount rates should rightly wait until the comprehensive review of IAS 19, it is worth noting the following points:

- Putting aside the issue of risk margins, the value of a stream of liability cash flows should be equivalent to the value of an asset that reproduces those cash flows. For this replication to occur in practice the cash flows must be matched by the flows generated by bonds, that are assumed, for all practical purposes, of being paid with certainty (i.e. correlations are not good enough). In most countries, these bonds would be issued by the Government so that the yield on a matching portfolio of sovereign bonds would be the appropriate discount rate with which to value the liability cash flows.
- The use of "high quality" corporate bond yields in IAS 19 reflects a small premium for the risk that the benefits will not be fully paid; i.e. the option of the employer

sponsor to "walk away". It will be noted that this premium is not directly related to the credit standing of the sponsor in funded schemes, as the pension debt is collateralised by the scheme assets. Whilst the credit standing of the sponsor is indirectly related to the value of the benefit flows, consistency and simplicity required that IAS 19 limit the range of discount rates to "high quality" corporate bond yields which, in practice, are generally taken to be AA yields.

- One consequence of the arguments above is that the discount rate for public sector schemes should be based on sovereign bond yields, at least in circumstances where all stakeholders treat the constructive obligation as fixed; i.e. the sponsor is assured of perpetual existence and the benefit payments are effectively certain.

The IASB ED states that the "problems" resulting from the definition of discount rates in IAS 19 were exacerbated by the widening of spreads caused by the global financial crisis (GFC). I would assert that the markets for corporate bonds were more adversely affected than the sovereign markets during the GFC and consequently that observed corporate yields were more likely to be distorted[1]. This would have resulted in liabilities that were quite volatile and less likely to represent the "true" solvency position.

Therefore, if consistency is considered the over-riding objective so that only one option is to be allowed for the setting of discount rates, the better option would be to restrict the choice to sovereign yields. I assume that the resultant increase in liabilities would not be appreciated by corporate sponsors around the world and so the more pragmatic option has been taken by the IASB. Overall, I accept the restriction to high quality corporate bond yields for schemes sponsored by private sector entities.

Public Sector Schemes

As an actuarial advisor to public sector schemes, I am more concerned with the use of "high quality" corporate bond yields for the purpose of discounting liability cash flows backed by government sponsors. As noted above, I believe that the conceptually correct approach in these circumstances is to base the discount rate on sovereign yields. Presumably this argument was supported by the AASB through their inclusion of paragraph Aus78.1 in AASB 119 and their tentative decision in ED 187 to retain it.

Whilst the level of liabilities and service cost would be lower if the discount rate was based on corporate yields, I believe that outcome to be conceptually incorrect and misleading to a reader of the financial statements. The difference in the value of liabilities between a private sector and public sector scheme with identical benefits is entirely appropriate. The higher value of the public sector liability reflects the greater likelihood that its cash flows will eventually be paid. Consequently, the removal of Aus78.1 on the grounds of "greater consistency" would actually produce an inappropriate outcome.

Another consequence of the arguments above is that the distinction between "for profit" and "not for profit" public sector entities is not relevant for the purpose of setting an appropriate discount rate, The key point is the standing of the public sector employer sponsor. If the sponsor can be assumed to guarantee the benefit payments in all practical economic circumstances, then the sovereign bond yield should be used, independent of the profit

[1] I note that IAS 39 states that "The best evidence of fair value is quoted prices in an active market." Whilst it is debateable whether corporate bond market were "active" at all times during the GFC, quoted yields would generally be the starting point.

intention of the entity. However, given that AASB 119 will soon be subject to comprehensive review, I do not support any change to Aus78.1 at this time regarding this issue.

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