

IAS 19: Change to discount rate method

Extract, IFRS® Discussion Group Report on the Meeting – September 23, 2020

One actuarial assumption that has a material effect to the defined benefit obligation is the discount rate. The current discount rate method developed by the Canadian Institute of Actuaries (CIA method) was established in 2016.¹ The market turbulence brought by the COVID-19 pandemic has highlighted some vulnerabilities with the current method. To overcome these challenges, the CIA proposes a new recommended method to calculate the discount rate.

The Group discussed some accounting implications to provide inputs to the CIA's new recommended methodology considerations.

Discount rate guidance in IAS 19 Employee Benefits

Paragraphs 83 and 86 of IAS 19 provide the following guidance on selecting the market yield and estimating the discount rate for longer maturities:

- 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. For currencies for which there is no deep market in such high-quality corporate bonds, the market yields (at the end of the reporting period) on government bonds denominated in that currency 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.
- 86 In some cases, there may be no deep market in bonds with a sufficiently long maturity to match the estimated maturity of all the benefit payments. In such cases, an entity uses current market rates of the appropriate term to discount shorter-term payments, and estimates the discount rate for longer maturities by extrapolating current market rates along the yield curve. The total present value of a defined benefit obligation is unlikely to be particularly sensitive to the discount rate applied to the portion of benefits that is payable beyond the final maturity of the available corporate or government bonds.

[emphasis added.]

IAS 19 does not define high quality corporate bonds. AA or AAA rated corporate bonds have been used in practice to determine the discount rate. Due to the long term nature of pension payments, extrapolation from the market curve is necessary to match the estimated maturity of the benefit payments that will be incurred far in the future.

1 The CIA method represents one approach for establishing the discount rate, other methodologies may be applied by actuaries.

Current CIA Method and its challenges

Established in 2016, the current CIA method relies only on high-quality bonds, such as AA rated corporate bonds and Canadian provincial and federal government bonds.

The long maturity discount rates are extrapolated using the AA rated corporate bond curve by maintaining the ratio of “X/Y”:

X= spread between corporate AA bonds with five to ten years maturity over the government of Canada yield curve

Y= spread between provincial bonds with five to ten years maturity over the government of Canada yield curve

The above ratio of spreads is used to individually adjust provincial bonds in the long term (10+ years) to create synthetic corporate AA bonds.

The Canadian bond market and recent market turbulence from COVID-19 have created some challenges in applying the current CIA method, such as:

- a) A decreasing number of AA-rated corporate bonds in Canada since 2009.
- b) Currently, excluding hospital and university bonds and transportation bonds, there are no AA-rated corporate bonds with a maturity over 10 years in Canada.
- c) Market turbulence in March 2020 has caused a significant widening of spreads, causing the synthetic corporate AA curve to exceed the actual corporate A curve. To resolve this counterintuitive result, the synthetic corporate AA curve has been adjusted to not exceed the actual corporate A curve since March 2020.

Proposed CIA Method

The proposed CIA method introduces a “corridor approach” to ensure that the synthetic corporate AA curve stays in between the corporate A curve and provincial bond curve. Because the corporate A curve is not considered “high quality” in practice, it is not used directly to calculate the discount rate. Instead, it is used to indirectly extract market information in estimating the corporate AA curve.

The CIA is considering several technical and modelling decisions such as the definitions of “A” and “AA”, “corporate”, and “mid-term”. Back testing is also being performed by the CIA.

Accounting considerations for the proposed CIA Method

A few of the accounting considerations for the proposed CIA method include:

1. Are only AA or higher rated bonds considered as “high quality corporate bonds” when applying guidance in IAS 19?

In its November 2013 [agenda decision](#), the IFRS Interpretations Committee (IFRIC) observed that “IAS 19 does not specify how to determine the market yield on HQCB [high quality corporate bonds], and in particular what grade of bonds should be designated as high quality. The Interpretations Committee considers that an entity should take into account the guidance in

paragraphs 84 and 85 of IAS 19 (2011) in determining what corporate bonds can be considered to be HQCB.”

In addition, IFRIC noted that “high quality” as used in paragraph 83 of IAS 19 reflects an absolute concept of credit quality and not a concept of credit quality that is relative to a given population of corporate bonds. Therefore, the concept of what is high quality should not change over time.

2. Is it acceptable to use market information contained in A rated bonds as one of the inputs used to extrapolate the AA curve?
3. Should an average or best rating be used to determine an A or AA rating?
 - In practice, best rating has been used historically and reflects that at least one recognized rating agency considers the bond to be of that quality.
4. Should certain segments such as ports and airports be excluded when constructing the yield curve?
 - Ports and airports have been excluded historically when constructing the corporate bond yield curve under the CIA method as some think they are quasi-government.
5. Should the change in the CIA method be accounted as a change in estimate or a change in accounting policy?

The Group’s Discussion

The Group provided the following inputs to the five questions listed above:

1. Are only AA or higher rated bonds considered as “high quality corporate bonds” when applying guidance in IAS 19?

Group members commented that although IAS 19 does not specify what grade of bonds should be designated as “high quality”, in practice, it includes only AA or higher rated bonds. They further noted that as described in the November 2013 IFRIC [agenda decision](#), “high quality” reflects an absolute concept of credit quality and not a concept of credit quality that is relative to a given population of corporate bonds. Therefore, they thought that the decreasing number of AA-rated corporate bonds in Canada should not cause a change in current practice as to what grade of corporate bonds should be considered as high quality.

2. Is it acceptable to use market information contained in A rate bonds?

Given that A rated bonds are only used to indirectly extract market information and are not directly used to derive the discount rates, Group members thought it is acceptable to use market information contained in them.

3. Should an average or best rating be used to determine A or AA rating?

Group members thought that it is important to have consistency in determining bond ratings. Therefore, the reason for a change in practice should be clearly explained.

4. Should certain segments such as ports and airports be excluded when constructing the yield curve?

Group members thought that the rationale of considering ports and airports as quasi-government agencies and excluding these entities when constructing the corporate bond yield curve, should be clearly articulated. One Group member commented that the reason for exclusion should not simply be predicated on the typically low yield of these bonds as this rationale alone is not sufficient. In addition, such rationale being the only reason for exclusion would inappropriately bias, based on yield, the population of bonds used in the model.

5. Should the change in CIA method be accounted as a change in estimate or a change in accounting policy?

Group members thought that the proposed CIA method is refining the current method to derive a better estimate based on updated market information. Therefore, they thought the change should be accounted for as a change in estimate.

Overall, Group members highlighted that an entity should apply the model used consistently and any changes made to the model used should be supported and documented in the context of IAS 19's best estimate requirements.

The purpose of the discussion is to provide inputs to the CIA's proposed method. No further action was recommended to the AcSB.