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STUDY:
IMPACT OF THE AMENDMENT OF THE BELGIAN PENSION LAW ON THE TREATMENT OF PENSION LIABILITIES IN IFRS ANNUAL FINANCIAL STATEMENTS

1. Context

A previous study by the FSMA[1] had stated that the IASB did not take hybrid pension plans into account when it developed IAS 19 - Employee benefits. Hybrid pension plans are pension plans that incorporate features of both defined contribution and defined benefit plans. Belgian defined contribution plans with minimum return guaranteed by law can be considered hybrid pension plans, and as a consequence, the accounting treatment of these plans in accordance with IAS 19 is problematic[2].

Prior to the change in the law in December 2015, the employer, in accordance with Article 24 of the Law of 28 April 2003[3], had to guarantee an average minimum return of 3.75 % on employee contributions and of 3.25 % on employer contributions. The minimum return guaranteed by law could be modified by Royal Decree. In the case of a change to the minimum return guaranteed by law, the new percentages would apply, from the date of that change, to reserves accrued in the past and to future contributions.

The study by the FSMA[1] showed that in practice, two methods were used for estimating the liability in relation to Belgian pension plans: a method based on the Projected Unit Credit Method (PUC method) from IAS 19 and a second, intrinsic value method.

The Law of 18 December 2015[4] amended the Law of 28 April 2003 and gave rise to a survey by the FSMA among representatives of auditors, pension funds, actuaries and insurance companies into whether their positions as regards the accounting treatment of these Belgian defined contribution pension plans with minimum return guaranteed by law had changed as a result of this amendment to the law. The survey was conducted in the first half of 2016 and was followed by further consultation.

This study aimed to draw a number of conclusions from their answers.

2. Short summary of the changes to the law on supplementary pensions which form the subject of this study

The Law of 18 December 2015 entered into effect on 1 January 2016 and amended, inter alia, the calculation of the minimum return guaranteed by law for defined contribution pension plans.

First of all, the new law no longer makes a distinction between the minimum return guaranteed by law on employee contributions and the minimum return on employer contributions. Moreover, the minimum return guaranteed by law is, from 1 January 2016, determined using a formula based on the

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1 Studies and documents No 44, Disclosures relating to Belgian “defined contribution” plans with return guaranteed by law, January 2015.

2 Amendments to IAS 19 in this respect are not planned for the immediate future. At its meeting of May 2016, the IASB decided for the time being to conduct a feasibility study on post-employment benefits that depend on asset returns. This study is to assess whether it is feasible to eliminate an inconsistency between the cash flows included in the measurement of pension benefits that depend on asset returns and the discount rate (called the ‘capped ultimate costs adjustment model’). (IASB Update, May 2016 and Agenda paper 15 as preparation for this discussion. IASB Work Plan 2017-2021 published in November 2016.)

3 Law of 28 April 2003 on supplementary pensions and on the tax regime applicable to such pensions and to certain additional social security benefits (WAP/LPC).

4 The Law of 18 December 2015 to guarantee the sustainability and social nature of supplementary pensions and to reinforce the supplementary nature in comparison to retirement pensions.

average return over 24 months from Belgian linear bonds with a term of 10 years. The interest rate is adjusted every 1st of January if it differs substantially from the previous rate of return (by 0.25 % or more). A range is also provided for, as regards the minimum return guaranteed by law, of an absolute minimum of 1.75 % and an absolute maximum of 3.75 %[5].

For contributions paid up to 31 December 2015, the previous minimum return guaranteed by law of 3.75 % on employee contributions and 3.25% on employer contributions applies, in any case, until 31 December 2015.

For pension contributions made as from 1 January 2016, the pension scheme or the pension agreement determines the method to be applied (vertical or horizontal) to capitalize the contributions in the case of a change in interest rates:

a. the horizontal approach must be applied if the pension plan is managed entirely by one or more pension institutions that guarantee a defined benefit over the whole pension plan based on the contributions paid in up to retirement age; and
b. the vertical approach must be used in all other cases.

The horizontal approach is comparable to a fixed-rate term deposit account. For the reserves accrued up to 31 December 2015, 3.25 %/3.75 % applies up to the date of exit. For new contributions, the minimum return guaranteed by law for the year always applies until the date of exit.

The vertical approach is comparable to a variable-rate savings account: For the reserves accrued up to 31 December 2015 and for new contributions, the minimum return guaranteed by law for the year applies until such time as this minimum return is amended. As stated previously, the law specifies that this minimum return may henceforth be no lower than 1.75 %.

3. Results of the survey

a. Returns guaranteed by insurance companies compared with the minimum return guaranteed by law

Study 44 by the FSMA showed that for a large majority of the companies in the sample, the pension plans are funded by contributions to an insurance company. As long as the insurance companies guaranteed a return (the 'technical interest rate') equal to or higher than the minimum return guaranteed by law, the companies argued that for such pension plans, the return risk was hedged by the insurance contract and that no pension liability should be recognized (see also paragraph 46 of IAS 19).

Several insurance companies have, since 2013, lowered their technical interest rate to a level below the minimum return guaranteed by law. As a result, it is possible that companies will have to make up any shortfall between the technical interest rate and the minimum return guaranteed by law.

Even after the lowering of the minimum return guaranteed by law as a result of the change in the law, our survey shows that the technical interest rates are for the most part lower than the minimum return guaranteed by law. It can therefore be supposed that the companies responsible for achieving the

[5] As of 1 January 2016, the minimum guaranteed return both for employer and employee contributions was lowered to 1.75 %.

minimum return guaranteed by law have not always hedged, or fully hedged, their return risk with an insurance contract.

b. Method to be applied for measuring the pension liability

There is no longer any debate as to the classification of Belgian pension plans with a minimum return guaranteed by law. These plans must be classified as defined benefit plans (and not as defined contribution plans).

For the treatment of defined benefit plans, IAS 19 imposes the use of the Projected Unit Credit Method (the PUC method) to measure the defined benefit obligation.

Strict application of the PUC method to the Belgian situation was in the past regarded as problematic by most of those concerned, as explained in the previous study. In the absence of an IFRS that specifically applies to a transaction, other event or condition, management must use its judgement in developing and applying an accounting policy (paragraph 10 of IAS 8 - Accounting Policies, Changes in Accounting Estimates and Errors).

The previous study showed that only 15 % of the surveyed companies applied a method based on the PUC method under IAS 19. The large majority of listed companies applied the intrinsic value approach. Following the latter method, the pension liability to be recognized is based on the sum of the positive differences between the minimum reserve guaranteed by law on the calculation date (calculated by capitalizing past contributions at the minimum guaranteed return up to the calculation date) and the actual accrued reserve (reserve calculated by capitalizing past contributions at the technical interest rate, taking profit-sharing into account, up to the calculation date).

As a result of the change in the pension law, all audit firms surveyed and the majority of the other parties consulted now appear to be of the opinion that a **method more in line with the PUC method** is now possible because:

- the horizontal method must be applied for most insured pension plans. Following this method, the minimum return guaranteed by law applies until the date of exit. For most insured plans, the accumulated past contributions can therefore be projected at the minimum return guaranteed by law up to the exit date in order to determine the company's minimum obligation;
- the minimum return guaranteed by law is clearly defined on the basis of the market interest rate with a set absolute minimum (1.75 %). For plans to which the vertical method applies, a reasonable projection can be made given that changes in the minimum return guaranteed by law are linked to the market interest rate. There is therefore less inconsistency between the discount rate and the minimum return guaranteed by law.

Most respondents state that this method can also be applied to pension plans to which the vertical method applies, given that the minimum return guaranteed by law is now more closely in line with market interest rates. One party consulted states that there is no change to the method to be used for such pension plans and that the intrinsic value approach can continue to be used.

c. A method in line with the PUC method for the treatment of Belgian pension plans with minimum return guaranteed by law

Even after the change in the law, strictly applying IAS 19 to Belgian pension plans with a minimum return guaranteed by law continues to be problematic. For example, a projection of the pension based on the expected return and discounting of this projection against market yields on high-quality corporate bonds, give a counter-intuitive result: the higher the expected rate of return, the higher the obligation, while the company's risk as regards the minimum return guaranteed by law is reduced. In other words, insurance contracts with a higher technical interest rate lead to a higher present value of the defined benefit obligation than insurance contracts with a lower interest rate, while the company can only be obliged to insure the minimum return guaranteed by law.

Given that a specific accounting policy does not exist for such hybrid plans in IFRS, management should, as specified in paragraph 10 of IAS 8, use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable and takes into account the specific characteristics and materiality of the pension plans granted. In making that judgement, companies must take into account the IFRS requirements for similar and equivalent matters as well as the provisions of the Framework. This basis for financial reporting should be disclosed, and consistently applied, in the financial statements.

Most respondents state that a method based on the PUC method is now possible. IAS 19 requires the present value of the defined benefit obligation as calculated by the PUC method to be compared with the fair value of the plan assets. Plan assets include assets held by a pension fund and qualifying insurance contracts. From the survey, it appears that there are differences in position as regards:

a) Adjusting the present value of the defined benefit obligation to take account of the fact that the participant is entitled to the contributions plus the minimum return guaranteed by law or the contributions plus the actual return, whichever is the highest. Certain respondents first calculate the present value of the defined benefit obligation based on the minimum return guaranteed by law and compare it with the accrued reserves on the calculation date. Others determine the defined benefit obligation immediately on the basis of the highest of the minimum return guaranteed by law and the technical interest rate. A more elaborate method takes into account the possibility that the employees may exit the plan early, as a result of which the return guaranteed by law (but not the technical interest rate) falls to 0 %; and
b) Estimating the fair value of the insurance contracts. From the survey it seems that the respondents either use the accrued reserves on the calculation date or a projection and a discounting of these accrued reserves.

As a result of these different positions, it is all the more important that companies clearly specify in their financial statements the basis used for material plans. In any case, the suggested methods are more in line with the PUC method (and therefore the IFRS requirements) than with the intrinsic value approach.

Present value of the defined benefit obligation

The PUC method requires a reliable estimate of the final costs to the company of the pension plan (IAS 19.57). The final costs of Belgian pension plans with minimum return guaranteed by law will consist of the contributions plus the return on these contributions, which must at least be equal to the minimum return guaranteed by law.

The respondents that had developed a method went on the principle that an estimate of the defined benefit obligation based on the <u>minimum returns guaranteed by law</u> best reflects the current situation. This means:

1. Estimating the minimum guaranteed benefit on retirement date by projecting the legally guaranteed minimum reserve on the calculation date (past contributions and past minimum

returns guaranteed by law) using the minimum return guaranteed by law (potentially taking into account the possibility that the employee may exit the plan); and

2. Discounting that benefit on the basis of market yields on high-quality corporate bonds;

A strict application of the PUC method as described by IAS 19 requires the use of the best estimate and not the minimum estimate of the defined benefit obligation. However, as can be seen from the answers received, the minimum return guaranteed by law is used to estimate the future benefit. As previously explained, the use of an expected return that is higher than the minimum return guaranteed by law leads to contradictory results.

To avoid underestimating the present value of the pension liability by using the minimum return guaranteed by law, an estimate is also made of the actual benefit expected on exit. If this latter amount is greater than the amount obtained based on the minimum return guaranteed by law, this is the amount used to determine the present value of the defined benefit obligation.

It came out of the survey that there are different methods to estimate the actual expected benefit for the purposes of determining the defined benefit obligation when a pension plan is financed through an insurance plan.

1. The accrued reserves (past premiums plus the technical interest rate and profit share up to the calculation date). This amount takes no account of the fact that the technical interest rates apply up to the date of exit.
2. The highest of the accrued reserves and the minimum reserve guaranteed by law on the calculation date (past premiums plus the minimum returns guaranteed by law up to the calculation date). This amount is the amount that is to be paid to the participant upon exit on the calculation date.
3. The actual accrued reserves projected against the technical interest rate and discounted on the basis of market yields on high-quality corporate bonds.

In certain cases, account is taken of the possibility of exiting the plan, as a result of which the minimum return guaranteed by law falls to 0 %. Different estimates of the expected benefit are then combined on the basis of the probability of each potential circumstance.

Given that there is a diverse range of methods for estimating the present value of the defined benefit obligation, it is all the more important that readers of the financial statements be informed of the measurement of the defined benefit obligation in the summary of the accounting policies.

Fair value of an insurance contract

The answers show that three different methods are used for estimating the fair value of an insurance contract:

1. The actual accrued reserves: Past contributions plus the actual returns awarded up to the calculation date. This amount does not take into account the fact that the technical interest rates apply up to the end date of the contract.
2. The projection of accrued reserves using the different rates that the insurance company guaranteed, discounted on the basis of market yields on high-quality corporate bonds. In this case, the entity deems paragraph 115 of IAS 19 to apply. According to this paragraph, the fair value of a reimbursement right arising from an insurance contract, which exactly matches the amount and timing of some or all of the benefits payable under the defined benefit plan, is

deemed to be the present value of the related obligation. Certain respondents are of the opinion that this paragraph should be applied given that the benefits are paid by the insurance companies, as a result of which there is an exact match between the insurance contract and some of the benefits payable under the plan.

3. The projection of the accrued reserve using the different rates that the insurance company guaranteed, discounted at a discount rate that takes into account the specific risk of the insurance company.

Given that there is a diverse range of methods for estimating plan assets, readers of the financial statements should be informed on the measurement of the plan assets in the summary of the accounting policies.

4. Conclusion

- The returns guaranteed by the insurance companies (the 'technical interest rates') are in most cases lower than or equal to the minimum return guaranteed by law. As a result, the companies in some cases have not fully hedged their return risk through an insurance contract.
- Strict application of the PUC method can lead to contradictory results and remains problematic. This is why it is necessary for companies with material plans to provide a clear disclosure and justification for the policies used and to consistently apply these policies.
- Most respondents are of the opinion that the application of a method close to the PUC method provides a true and fair view of Belgian pension liabilities with minimum return guaranteed by law. An evolution towards a method that is more closely in line with the method prescribed by IAS 19 is seen as positive by the FSMA.
- There are differences in the estimation of the present value of the defined benefit obligation and the estimation of the fair value of an insurance contract. It is therefore important that a company with material plans clearly explain in the summary of the accounting policies how on the one hand the present value of the defined benefit obligation and on the other hand the fair value of the plan assets is determined.