CIPFA The Chartered Institute of Public Finance & Accountancy

Report [Appendix G]

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Board	CIPFA/LASAAC
Venue	National Audit Office, 157-197 Buckingham Palace Road, Victoria, London, SW1W 9SP
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Subject	Code Development: Pension Guarantees

Purpose

To inform CIPFA-LASAAC consideration of the Code requirements in respect of pension guarantees and to request direction regarding Code specification.

1 Content of Paper

1.1 This paper includes the following sections:

2 Background
3 IAS 19 Employee Benefits (incl statutory adjustment implications)
4 IFRS 4 Insurance Contracts and IFRS 9 Financial Instruments
5 IAS 37 Provisions, Contingent Liabilities and Contingent Assets
6 Implications for Accounting Treatment
7 CIPFA/LASAAC Considerations

2 Background

2.1 Pension guarantees are generally understood as being an obligation which a local authority has entered into in which the authority undertakes to fulfil, in whole or in part, the obligation of a third party to pay pension contributions related to the third party's employees in the event that the third party fails to do so. The authority therefore guarantees that the relevant pension scheme is protected, to some extent, by the failure of the third party to pay pension contributions.

2.2 Most commonly this is understood to arise where previous local authority staff have transferred to a separate organisation under Transfer of Undertaking (Protection of Employment) (TUPE) arrangements. For example where an authority has established a subsidiary or associate to undertake activities eg leisure trusts to run sports centre.

2.3 Pensions guarantees are however expected to differ, potentially widely, in their form and content. For example the 'trigger' events for the guarantee, the extent of guarantee and any conditions attached to the guarantee may all differ. In particular as customs and practices have developed over time, the age of a pension guarantee may also affect how comparable it is to others.

2.4 It should be noted that the LGPS arrangements are generally understood to involve a 'last man standing' principle in respect of fund liabilities, whereby residual liabilities would be required to be met from participating employer contributions. Potentially this may give rise as to a question whether this is a 'pension guarantee' and whether treatment should be equivalent to specific guarantees. This paper considers that any such obligations arise from employer participation in the scheme and is addressed through the actuarial valuation and funding arrangements for employers under IAS 19.

2.5 Given the anticipated variety of specific third party guarantees it is not expected that a 'single' specified accounting treatment will be appropriate or applicable under the current accounting standards.

2.6 This has been indicated by National Audit Office (NAO) guidance for auditors in England (AGN 06/2018 paragraph 73 on) which noted that pensions guarantees may, dependent on details, fall to be treated as a:

- Insurance Contract (IFRS 4)
- Financial instrument / derivative (IFRS 9)
- Provision or contingent liability (IAS 37)

3 IAS 19 Employee Benefits

3.1 IAS 19 Employee Benefits may initially be considered inapplicable as it states (paragraph 2) "This Standard shall be applied by an employer in accounting for all employee benefits, except those to which IFRS 2 Share-based Payment applies." i.e. IAS 19 only applies to the employer of the relevant staff.

Insurance Policies in IAS 19

3.2 IAS 19 paras 46-49 include specification on an employer's treatment of insurance arrangements which guarantee / underwrite pension benefit obligations.

3.3 Where the risk is 'fully passported' the insured entity may treat the plan as a defined contribution plan.

3.4 However if the entity retains some specified legal or constructive obligations, the benefit plan is treated as a defined benefit plan. In that case such insurances may be included as 'plan assets' in determining the net liability.

3.5 IAS 19 definitions however includes "A qualifying insurance policy is an insurance policy issued by an insurer that is not a related party (as defined in IAS 24 Related Party Disclosures) of the reporting entity, if the proceeds of the policy:…..".

3.6 A footnote to the definition states: "A qualifying insurance policy is not necessarily an insurance contract, as defined in IFRS 17 Insurance Contracts."

3.7 The above suggests that

a) insurance to support benefit obligations does occur
b) if all risk is transferred the entity can treat the plan as a defined contribution plan

c) if not all risks are transferred the insurance policies could be included as plan assets in assessing the subsidiary's net liability
d) they *may* fall to be treated under IFRS 4 as insurance contracts
e) this treatment however would not appear to apply to related party situations.

Defined Benefit Plans that share risks between entities under common control

3.8 IAS 19 para "Defined benefit plans that share risks between entities under common control" (paras 40-42) may be argued to apply, dependent on interpretation especially relating to 'under common control'.

3.9 Para 40 states "Defined benefit plans that share risks between entities under common control, for example, a parent and its subsidiaries, are not multi-employer plans." Interpretation may arise as to whether this is mutually exclusive i.e. whether identification of a plan as a 'multi-employer plan' (eg LGPS) would exclude arrangements where risks are shared between entities under common control.

3.10 Common control would presumably be determined in accordance with IFRS 3 Business Combinations (paras B1-B4). This indicates that common control involves situations in which "all of the combining entities or businesses are ultimately controlled by the same party or parties". This may be interpreted to include subsidiaries but presumably would not extend to associates or joint ventures.

3.11 IFRS 3 para B3 notes that entities under common control may include entities which do not report under IFRS.

3.12 Para 41 includes (bold added): "If there is a contractual agreement or stated policy for charging to individual group entities the net defined benefit cost for the plan as a whole measured in accordance with this Standard, the entity shall, in its separate or individual financial statements, recognise the net defined benefit cost so charged**.**"

3.13 In effect a formal agreement or policy between group members may specify how the defined benefit liability is split.

3.14 Para 41 also states "If there is no such agreement or policy, the net defined benefit cost shall be recognised in the separate or individual financial statements of the group entity that is legally the sponsoring employer for the plan**.** The other group entities shall, in their separate or individual financial statements, recognise a cost equal to their contribution payable for the period."

3.15 Arguably, where the parent has provided a guarantee, it may be treated as the sponsoring authority as it bears the risk 'by default'.

Statutory implications of interpretation

3.16 In the event that paras 40-42 are considered to apply there are specific considerations for the statutory framework since it may allow that subsidiaries would not show a pensions liability, which would be included in the parent authority liability.

3.17 This would (a) permit or require the local government statutory framework to apply to pensions liabilities for subsidiary employees and (b) increase the apparent distributable reserves of such a subsidiary. In some cases this may allow dividend payments to be made (eg to the authority).

3.18 Potentially it may be suggested that IAS 19 would not have anticipated, or was not designed to cater for, situations where public sector parents and private (or third) sector subsidiaries would report under different accounting and legislative frameworks.

3.19 Adaptation of the Code may therefore be appropriate however it is understood that at present that practices and application of the statutory framework may differ between authorities. Clarification of either accounting or statutory requirements may therefore involve transition considerations.

4 IFRS 4 Insurance Contracts and IFRS 9 Financial Instruments

4.1 IFRS 4 defines an insurance contract as "A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder." (IFRS 4 Appendix A)

4.2 Insurance risk is any risk transferred which is not financial risk. Financial risk is "The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract." (IFRS 4 Appendix A)

4.3 'Significant' insurance risk refers to the significance or extent of benefits (compensation) that *could* be payable. It is not based on or affected by the probability of the event occurring (see IFRS 4 B23).

4.4 Most relevantly para 4 (d) excludes financial guarantees from the scope of IFRS 4, unless the issuer has already determined that they are insurance contracts and has *already* applied insurance accounting to those contracts. In that event the issuer may elect to apply either the financial instrument standards or IFRS 4.

4.5 IFRS 9 Financial Instruments defines a financial guarantee contract as "A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument."

4.6 In this respect the meaning of 'debt instrument' is clearly important. IFRS standards use the term but do not appear to define it. IFRS 9 para B4.3.2 states "If the host contract is not an equity instrument and meets the definition of a financial instrument, then its economic characteristics and risks are those of a debt instrument." This would appear to indicate that a debt instrument would encompass any debtor-creditor relationship.

4.7 This may arguably be supported in principle by the fact that debtor impairments are presented as finance charges (Code 18/19 3.4.2.38), and that therefore in principle creditor / debtor relationships are financing activities in nature even if they don't include significant interest charges or constitute formal "borrowing".

4.8 It may also be noted that while the treatment of 'trade receivables' is specifically addressed, excluding *all* 'receivables' from inclusion within the term debt instrument would potentially cause application challenges regarding IFRS since it could allow differential treatment of complex or combined instruments which include elements of both a 'receivable' nature and 'financing' nature.

4.9 Additionally private sector commentary appears to refer to debt instruments as encompassing debtor-creditor relationships.

4.10 A key remaining issue is therefore determining whether the risk being transferred is 'financial risk' or 'insurance risk':

- In discussions concerning the future IFRS 17 insurance Contracts implementation the treatment of pension guarantees was raised. In particular the distinction between a 'performance bond' contract (a guarantee relating to a party performing its obligations under a contract), which would normally be classified as an insurance contract, and a 'financial guarantee' was queried.

- An IASB staff member indicated that this query has been raised regarding private sector treatment. It was suggested that the key judgement related to whether the guarantee was related to credit risk or risk arising from other events.

Financial Risk

- IFRS 7 defines credit risk as "The risk that one party to a financial instrument will cause a financial loss for the other party by failing to discharge an obligation." The reference to 'financial instrument' would, subject to rebuttal, include a debtor / creditor relationship between an employer and a pension scheme.

- Based on the definition of 'debt instrument' as including debtors (see earlier), application of the financial instrument standards would presumably lead to treatment as a financial guarantee.

- It is therefore arguable that a pension guarantee where the obligation to pay is specifically triggered by the non-payment (failure to pay) of the actual employer, may normally be anticipated to be treated as a financial guarantee

Insurance Risk

- In relation to non-financial risk the NAO guidance noted above includes (in para 76 of the guidance) an explanation that a pensions guarantee may potentially specifically be covering pensions risks, such as changes in life expectancy, the final salaries of scheme members and other actuarial variables which are not in themselves credit risks.

- In the event that payment under a pension guarantee arrangement is not triggered by a default (a failure of the employer to pay an amount which is due to the pension fund), potentially the arrangement may be anticipated to be open to treatment, dependent on the specifics of the contract, under IFRS 4 Insurance Contracts.

5 IAS 37 Provisions, Contingent Liabilities and Contingent Assets

5.1 IAS37 para 5 states "When another Standard deals with a specific type of provision, contingent liability or contingent asset, an entity applies that Standard instead of this Standard. For example, some types of provisions are addressed in Standards on:.."

5.2 It then states, as one of the examples (e), that contracts falling under IFRS 4 Insurance Contracts are excluded.

5.3 Example (d) also excludes pension benefits under IAS 19

5.4 The fact that the example exclusions do not include IFRS 9 and specifically financial guarantees does not preclude IFRS 9 from taking precedence over IAS 37 since (as noted above) it clearly states ***when*** a different standard applies it will take precedence.

5.5 Therefore only in the event that IFRS 4 Insurance Contracts, IFRS 9 Financial Instruments or another standard are not considered to apply would the application of IAS 37 be considered.

5.6 Some commentators have suggested that pension guarantees would not fall under IAS 37 because they are executory contracts. The wording in the standard leaves room for some interpretation on this issue. It is suggested that the intention is to exclude arrangements where there is no 'net obligation' arising (ie where the net obligation = zero). The conceptual framework supports this understanding. On this basis it is suggested that the intention of the standard would be to cover guarantees where there is a 'net obligation' and that this could include obligations where no payment for the guarantee has been received. Arguments in support of this could include:

- Faithful representation
- Guarantees with no fee received could be considered to be onerous contracts

5.7 Based on the above it is suggested that IAS 37 would, in most cases, be applicable to pension guarantees provided, but only where another standard (eg IFRS 4, IFRS 9) is not considered to apply.

6 Implications for Accounting Treatment

6.1 Potentially IAS 19 may be argued to apply in some circumstances. This has implications for the operation of the statutory framework.

6.2 If IAS 19 is not considered to apply then in general terms treatment under IFRS 9, IFRS 4 or IAS 37 will all require an assessment of the probability of being called (payment being required) to be made.

6.3 IFRS 9 application would be anticipated to require an 'expected value' approach to measurement at initial recognition, with this being amortised over the term of the guarantee*. If the guarantee becomes likely to be called then IAS 37 would apply. *(*Note that if a guarantee is not 'time limited' further judgement may be required.)*

6.4 Potentially an initial estimate of the probability of settlement being required may result in the expected value of the guarantee being immaterial.

6.5 IFRS 4 would require an authority to apply a 'liability adequacy test' (para 15) or, if it does not meet the required criteria, it would be required at a minimum to recognise a liability equivalent to that which would be measured under IAS 37. For authorities the application of IAS 37 would generally be anticipated to arise.

6.6 IAS 37 requires recognition of a liability where there is an existing obligation, it is probable (eg >50%) that settlement will be required; and a reliable estimate can be made. If the 'reliable estimate' criteria is the only criteria not met, a contingent liability would be anticipated.

6.7 Generally it may be expected that recognition of an IAS 37 provision will therefore only arise if or when the actual employer of the staff has evident financial difficulties (or if any other 'trigger' event becomes evidently likely to occur); and if a reasonable estimate of the settlement can be made.

7 CIPFA/LASAAC Considerations

7.1 Pensions guarantees clearly already exist and many will be long standing.

7.2 Including additional specification or clarity in the Code may require some authorities to change their accounting treatments.

7.3 Sensitivity on any proposals may arise.

7.4 Uncertainty over the application of IAS 19 and consequently the applicability of the statutory framework may be challenged.

7.5 Given the variety of different guarantees and their precise terms, and the lack of any recognised definition of the term 'pension guarantee', it is not considered appropriate that the Code provides a definitive statement of which standard applies.

7.6 Potentially CIPFA/ LASAAC may wish to consider:

- Specifying in the Code that the requirements of IAS 19 paras 40-42 are not considered to apply to multi-employer / LGPS arrangements

- Seeking more information through the ITC before reaching a definitive decision regarding Code specification

- Noting in the minutes and/or the ITC that treatment as a financial guarantee may be the anticipated common treatment, but that this will depend on an assessment of each guarantee's specific terms and conditions. This may include potential assessment of the applicability of IAS 19 Employee Benefits.

- Adding a new paragraph in Section 7.2.9 Financial Guarantees to the effect that:

  "Where a local authority has provided a guarantee in relation to a third party's obligation to make payments to a pension scheme and this does not qualify as treatment as an employee benefit under IAS 19, such a guarantee shall be assessed, in the order indicated, to determine whether it meets the criteria for treatment:

As a financial guarantee
As an Insurance Contract under IFRS 4 Insurance Contracts
Under any other section of the Code

In the event that none of the above are considered to apply the requirements of Section 8.2 of the Code Provisions, Contingent Liabilities and Contingent Assets shall be applied."

7.7 CIPFA/LASAAC may also wish to consider whether disclosure requirements appropriately reflect, for local government, the stewardship and risk management of pension guarantees as they affect taxpayer resources.

Requested CIPFA/LASAAC Action

7.8 CIPFA/LASAAC is requested to determine whether it wishes to proceed with any, or all, of the actions noted in paragraph 7.6.