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cutting through complexity

ADVISORY

KPMG Pensions Accounting Survey in the Netherlands

2015 Year-End preview and
2014 Year-End retrospective

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Introduction

IFRS requires companies to estimate the value of their pension liability, where IAS 19 defines the assumptions for the calculation of the liability and the assets available for covering the liability. Requirements for the determination of the assumptions are provided in paragraphs 75-98, but across the actuarial advisors the interpretation and application of the requirements varies. This results in a diversity of the assumptions used, and thus company directors face a range of alternative actuarial assumptions to choose from.

In this year's KPMG Pensions Accounting Survey we take a closer look at the assumptions that companies have used to value their pension liabilities as at 2014 Year-End. In addition, we comment on some important changes in the Dutch pension environment. In this survey the companies listed on the Euronext Amsterdam stock exchange are included, and the displayed figures are based upon publicly available information. Furthermore, these companies are advised by all the major actuarial firms and, accordingly, this survey gives some insight in the market practice in the Netherlands.

Headlines

- At the Year-End 2014 the average of IAS 19 discount rates that have been applied has decreased compared to Year-End 2013. However, the applied discount rate varies per advisor and discount rate methodology. For example, following the KPMG zero coupon guidance curve, the yield for a maturity of 15 years dropped from 3.27% per Year-End 2013 to 1.56% per Year-End 2014.
- Actuarial losses arose for many of the surveyed companies during the year 2014 due to changes in the financial assumptions for the valuation of liabilities, totalling at an actuarial loss on financial assumptions and demographical assumptions of about 40 billion for all surveyed companies combined.
- On average, the value of plan assets has decreased substantially during 2014 compared to the Year-End of 2013, while the decrease in the average defined benefit obligation is smaller. This results in a lower funded status.
- A significant number of companies apply the mortality table issued by the Dutch Actuarial Association in 2014 (AG2014), in some cases including fund or sector specific adjustments. Mainly due to the adaption of this revised mortality table with lower mortality rates in the long run actuarial losses on demographic assumptions were encountered by a substantial amount of surveyed companies during the year 2014.
- The main changes in Dutch pension legislation in 2015 entail a decrease in the tax-favoured accrual rate, a cap on the tax favoured pensionable salary, and several revisions to the Dutch funding requirements with a limited IAS 19 impact (although from a benefit expense point of view generally positive).
- Over the years a trend is observed that more and more companies change the risk profile of their defined benefit pension plan such that it qualifies as a defined contribution plan under IAS 19, or that it at least does so for new participants.

Change in pension legislation

- As of 1 January 2015 the pension legislation in the Netherlands has changed. This includes, amongst other things, the following changes in the accrual of pensions:
  - The tax-favoured pension accrual rate is reduced further from 2.15% pa to 1.875% pa for a career average plan;
  - The (tax favoured) pensionable salary is capped at EUR 100,000 pa.
- Additionally, the Dutch funding requirements (Dutch: Financieel Toetsingskader, FTK) were revised in order to achieve more stability in times of financial distress. In general, the supervisory framework became more stringent and has been changed on many aspects, including the calculation of required capital, indexation provision, premium and funding ratio. Furthermore, the technical provision must be calculated based on the current risk-free interest rate term structure in combination with the Ultimate Forward Rate. The implementation of these changes in the pension plan only have a limited impact on the IAS 19 figures for companies reporting under IFRS, because in most cases the funding regime does not significantly impact the benefits and does not require direct deficit payments in relation to the funding.
- The Dutch regulator recently announced that the Ultimate Forward Rate will be reduced from 4.2% to 3.3%, and that it will be constructed as a moving average of the 20 year forward rate averaged over 120 months. Considering the 20 year forward rate over the past 10 years we expect a further decrease in the Ultimate Forward Rate. This could lead to lower funding ratios for pension funds, resulting in higher contributions that must be paid.

Developments in IAS 19

- As at June 2015 the international Accounting Standards Board (IASB) has published an Exposure Draft with proposed amendments to IAS 19 and IFRIC 14. The proposals clarify the accounting treatment for current service cost and net interest for the remaining period when a plan amendment, settlement or curtailment occurs part way through the reporting period. It is proposed that the current service cost and the net interest for the remaining period would be calculated using the actuarial assumptions applied to the remeasurement. It is further proposed that the net interest for the remaining period would be calculated based on the remeasured net defined benefit liability (or asset). The proposals further clarify the interaction between the asset ceiling and the calculation of past service cost or the gain or loss on settlement. When a plan amendment, curtailment or settlement occurs, current accounting guidance is not clear on whether the calculation of past service cost – or the gain or loss on settlement is: (a) based on the entire plan surplus or deficit; or (b) adjusted for the effect of the asset ceiling. Under the proposals, the entire plan surplus or deficit – i.e. before any adjustment for the asset ceiling – would be used. This means that past service cost – or the gain or loss on settlement – is calculated by considering the difference between the surplus (or deficit) in the plan before the event and after it.

Other trends and changes

- At the Year-End 2014 it is observed that a significant number of Dutch companies is reducing the exposure of their defined benefit plans under the IAS 19 defined benefit accounting requirements. Alternatively they have, for example, transferred their defined benefit plan in a (collective) defined contribution arrangement, or closed the current defined benefit plan for new participants. This was also observed to a certain extent in the year 2013.

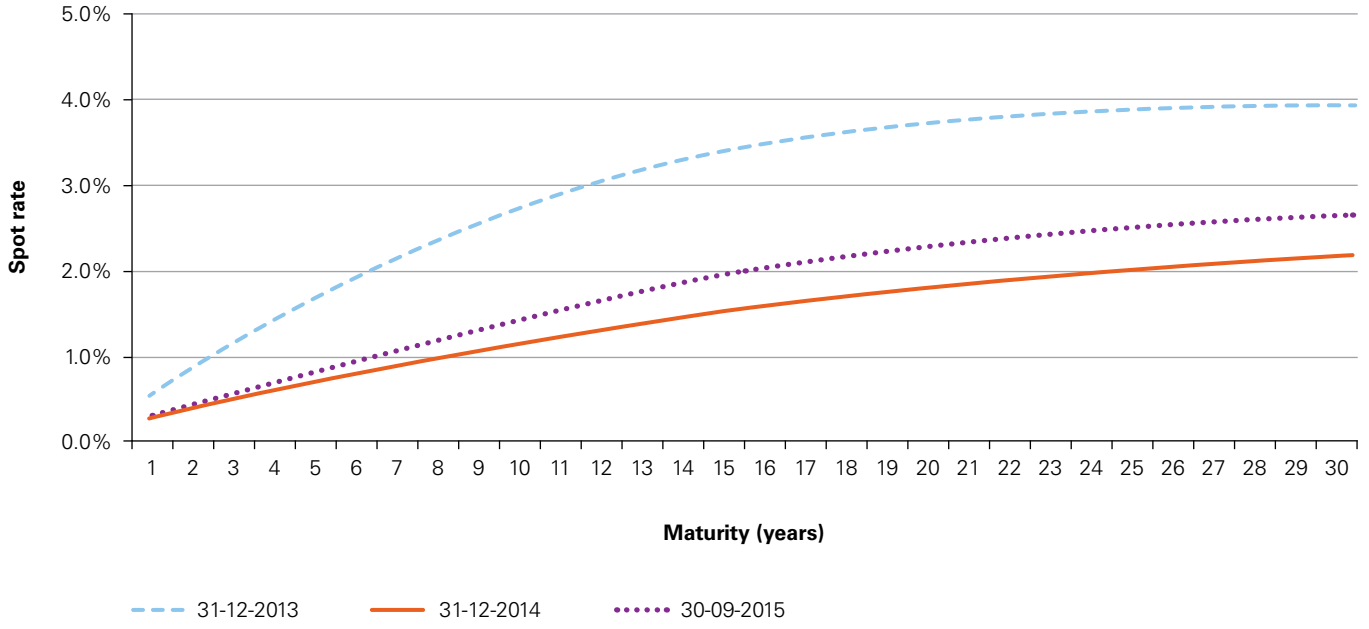
Discount rate

By discounting the estimated cash flows the defined benefit obligation is obtained. In accordance to IAS 19 (paragraph 83) the discount rate shall be determined by reference to market yields on high-quality corporate bonds at the balance sheet date. In the market it is common practice to use AA rated corporate bonds to determine the discount rate.

Development of the discount rate

Compared to Year-End 2013 the discount rates have dropped substantially for all maturities in 2014. The figure below shows the differences between the discount rate curves as used by KPMG at Year-End 2013, Year-End 2014 and September 2015. The decrease for shorter maturities is limited, with a difference between December 2013 and December 2014 of 38 basis points for yields with a one year maturity, but the decrease gets more substantial as maturities increase, with the largest difference between the December 2013 and December 2014 curves of 179 basis points for maturities ranging from 21 to 24 years. For maturities longer than 24 years the difference slightly decreases again. During 2015 the discount rates recover slightly, but are still substantially below the curve per Year-End 2013 for maturities longer than one year, as can been seen in the curve of September 2015. The decrease in discount rates results in an increase in benefit obligations and actuarial losses on financial assumptions, which was also observed at most of the surveyed companies.

Zero coupon yield curves



DISCOUNT RATE

Historical and expected development of corporate AA bonds

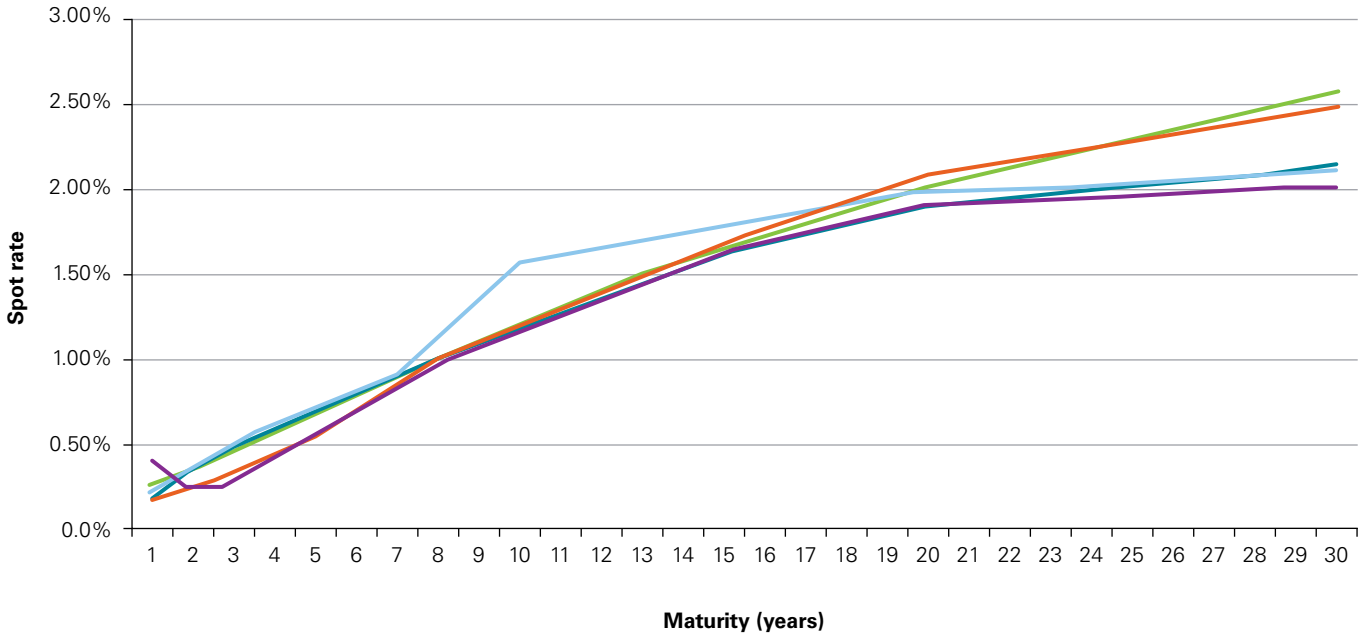
During 2014 there has been some increased movement on the AA-bond market compared to 2013, in particular during the first 9 months, resulting in lower discount rates. The graph below shows that the decrease in discount rate persists in the early months of 2015, hitting a low in March. However, spot rates are recovering from April till June. In July the spot rates have shown a small dip, resulting at a level similar to January 2015, but increase again in August. Spreads show a slight variation during 2015. The decline in discount rates can be explained by the general market situation in the Eurozone in combination with the ECB's asset purchasing programmes of covered bonds and market securities, which causes interest rates to decrease. As of 2015 still three of these asset purchasing programmes (public sector, asset-backed securities and covered bonds) are active, leading to low expectations of the interest rates in 2015.

Development of 15-year spot rate

Variation in advised discount rates

The requirements for discount rates described in IAS 19 are rather principle-based, which leads to varying discount rates for the Eurozone advised by different actuarial firms. The graph below shows five discount curves as used by varying actuarial firms for the Dutch market at the Year-End 2014. The differences in these curves arise due to different applied methodologies by the actuarial firms. Differences might arise, for example, due to the usage of different AA rated corporate bonds amongst different actuarial firms to construct the curve Furthermore, the actuarial firms each use their own method of extrapolation necessary for the longer, more illiquid maturities, which also causes differences between the curves.

Zero coupon yield curves at 31 December 2014

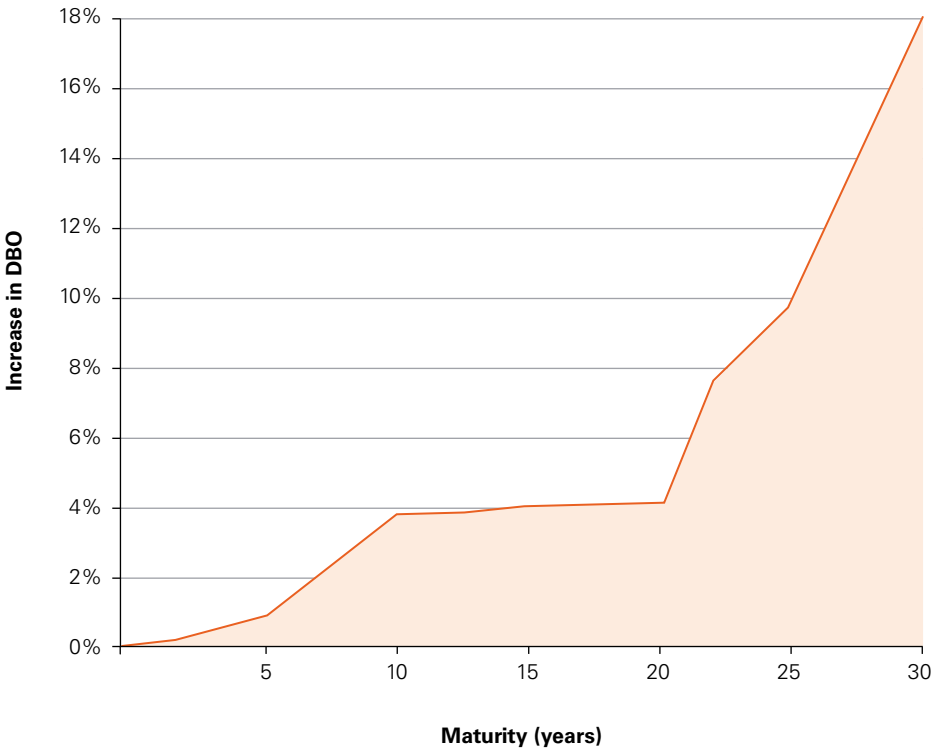


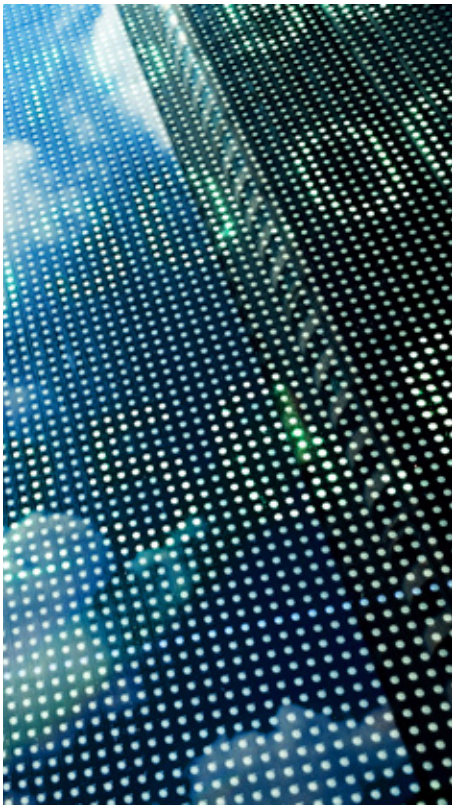
DISCOUNT RATE

The advised discount rate for a 15-year maturity varies between the different methodologies from 1.56% to 1.83%, averaging on 1.67%, which is a substantial 169 basis points lower than in 2013. The discount rates for 25-year maturities differ between 1.99% and 2.36%.

As mentioned before, the value of the defined benefit obligation is dependent on the discount rate and thus the differences between the discount rates can have a significant impact on the reported value of the defined benefit obligation. In the graph below we show this impact, comparing the estimated additional obligation to be reported when using the lowest advised discount rate to when using the highest one. For a 15-year maturity this difference between the lowest discount rate and the highest one amounts to a difference in the calculated defined benefit obligation of approximately 3.4%. This difference is smaller than the reported difference of 7.4% in the KPMG Accounting Survey of 2013.

Impact on DBO of minimum versus maximum discount rates



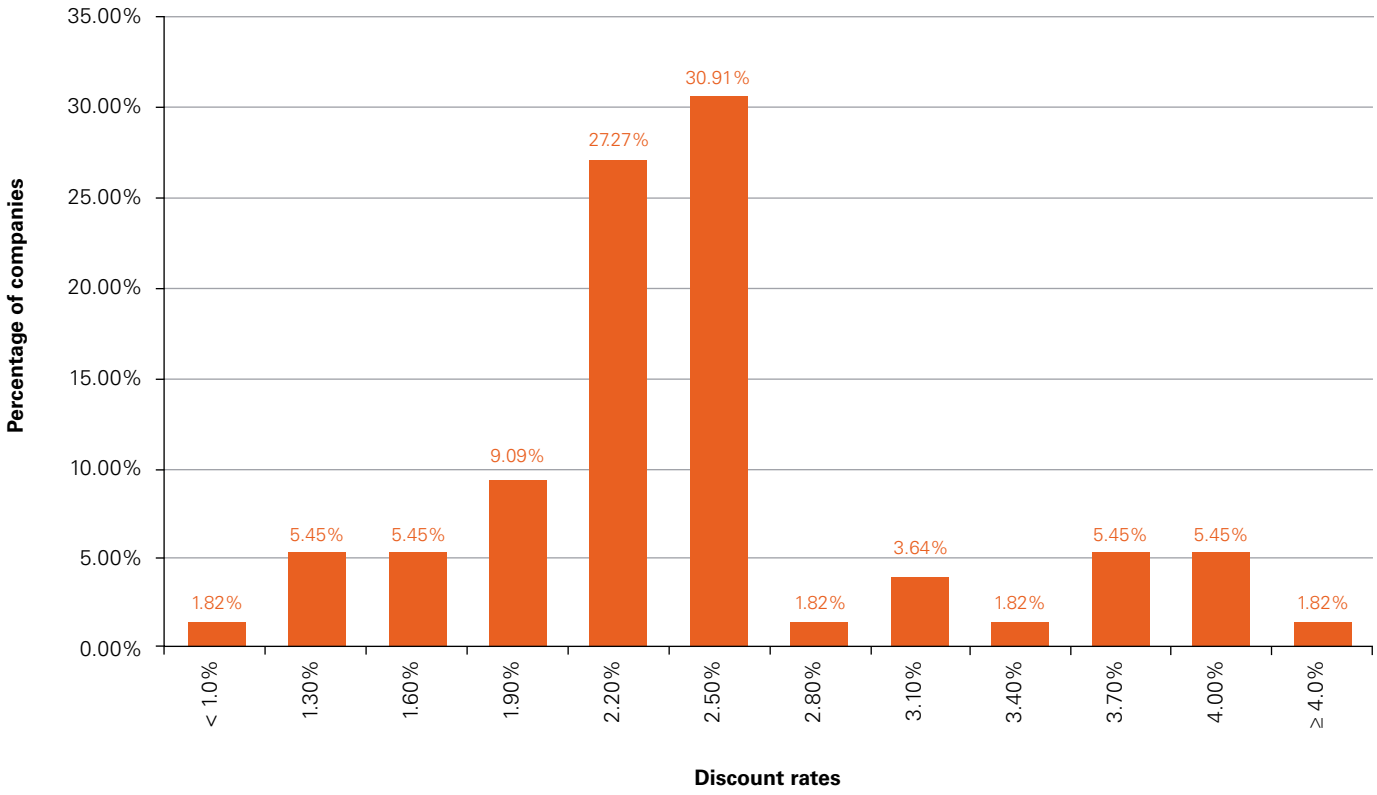


Discount rates applied by listed companies

The graph below displays the discount rates applied by the listed companies over the year 2014.

The discount rates applied in 2014 by the surveyed companies range from 0.90% to 4.29% with an average of 2.26%, where more than 50% of the listed companies uses a discount rate between 2.20% and 2.80%. Compared to 2013 the average discount rate decreased with 139 basis points. This sharp decline was expected, as described in the Accounting Survey of last year, due to the observed decline in interest rates till September 2014.

Discount rates at 31 December 2014



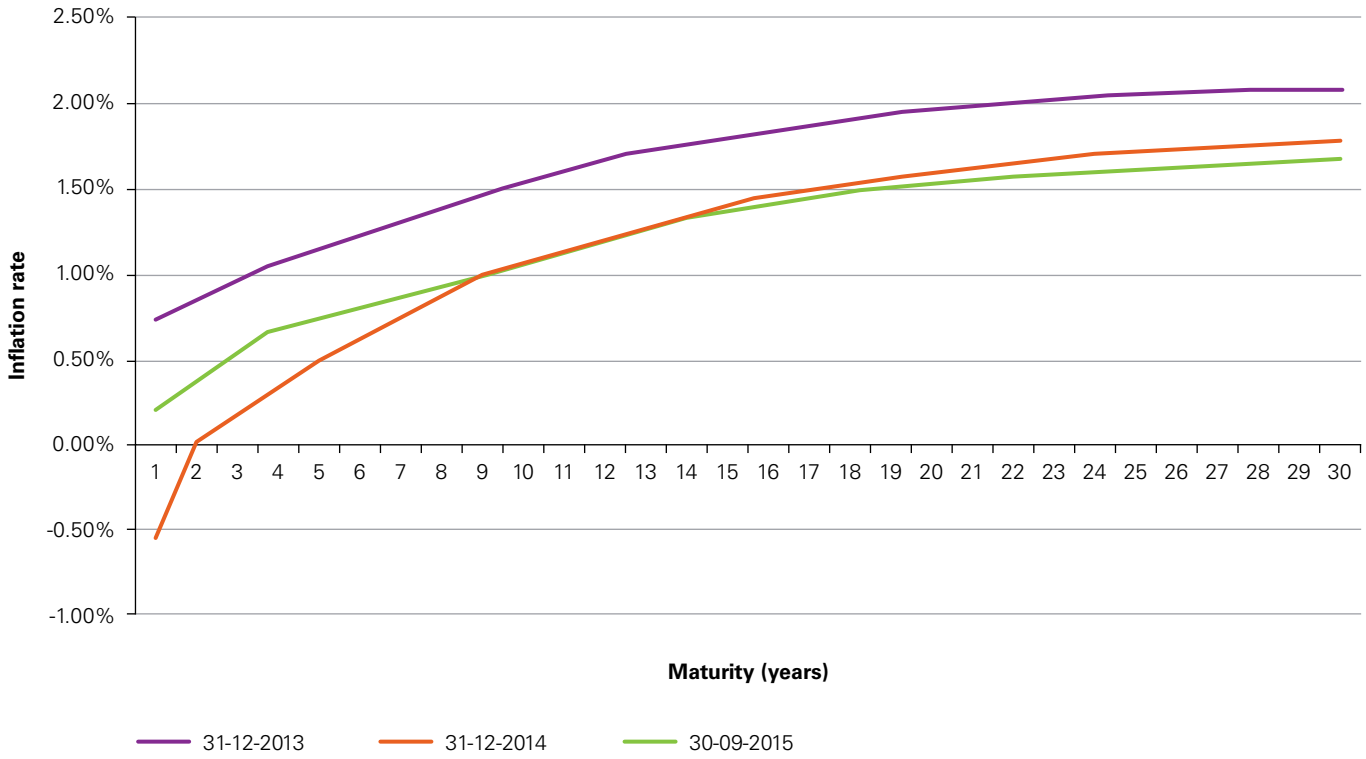
Inflation rate

The graph below shows three term structures for inflation (inflation curve implied by the Euro swap) at Year-End 2013 and 2014, as well as at the end of September 2015. As one can see in the graph, the swap implied inflation has decreased from Year-End 2013 till Year-End 2014, with the steepest decrease for shorter maturities, even hitting negative values for very short maturities at the end of 2014. In 2015 the rates show some increase, especially for the shorter maturities. For the longer maturities the rates drop slightly below those per Year-End 2014.

Inflation rates used at Year-End 2014

The average inflation rate assumed over 2014 by the listed companies is 1.5%. At the Year-End 2013 the average assumed inflation rate was 1.5% as well. Many companies follow the ECB long-term inflation rate expectation of 2%, which has not changed in 2014. However, the graph below suggests that the 2014 inflation rate is lower than the rate in 2013.

Euro swap implied inflation



Life expectancy

We observe that a significant number of surveyed companies have adapted the AG2014 mortality table, which was introduced by the Dutch Actuarial Association in September 2014. Some of them apply fund or sector specific adjustments to this table. A commonly used adjustment to the table is the "ervaringssterfte pensioenen 2" adjustment, or ES-P2 for short, which is based on observations of the Dutch Association of Insurers. We've added the tables below to illustrate the effect of this adjustment on the mortality figures. As one can see from these tables, life expectancy increases for both males and females when using the ES-P2 adjustment, with the strongest effect for males.

Life expectancy based on AG2014 without adjustments

	Males			Females		
age	2014	2039	2064	2014	2039	2064
0	89.9	92.4	94.1	92.2	94.5	96.1
25	62.4	65.3	67.5	65.1	67.7	69.6
45	40.2	43.6	46.2	43.2	46.1	48.4
65	19.7	22.9	25.5	22.8	25.6	27.8
85	5.8	6.9	7.9	6.8	8.0	9.2

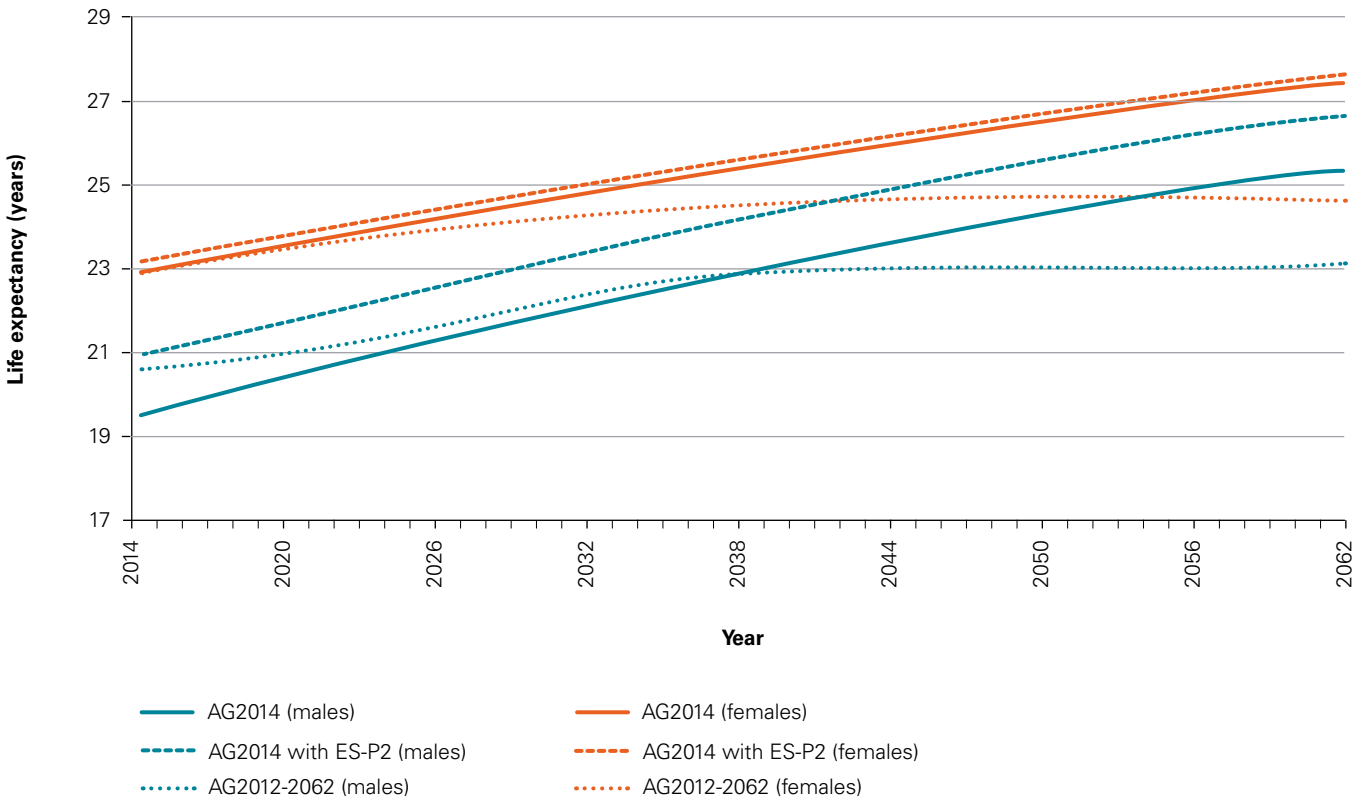
Life expectancy based on AG2014 with the ES-P2 adjustment

	Males			Females		
age	2014	2039	2064	2014	2039	2064
0	91.5	93.4	94.8	93.0	95.0	96.5
25	64.2	66.6	68.5	65.8	68.2	70.1
45	42.1	45.0	47.2	43.9	46.7	48.8
65	21.2	24.0	26.3	23.3	26.0	28.2
85	6.2	7.2	8.2	7.1	8.3	9.5

LIFE EXPECTANCY

In last year's survey we reported that the life expectancy of 65 years old males had slightly decreased with respect to the AG2012-2062 mortality table. In the figure below, which displays the effect of the ES-P2 adjustments on the AG2014 mortality table for 65 years olds, we can see that the life expectancy of a 65 years old male is adjusted upwards when using the ES-P2 adjustment, resulting in a higher life expectancy than when using the AG2012-2062 mortality table (without any adjustments applied to it). The figure below also illustrates that in general life expectancy of 65 years olds is increased when one uses the ES-P2 adjustment on the AG2014 mortality table, but that the effect for males is stronger than for females.

Life expectancy of 65-year olds



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