Hot Topics in DB Pension Plans

Midwest Pension Conference
2016 fall seminar

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What we're going to cover

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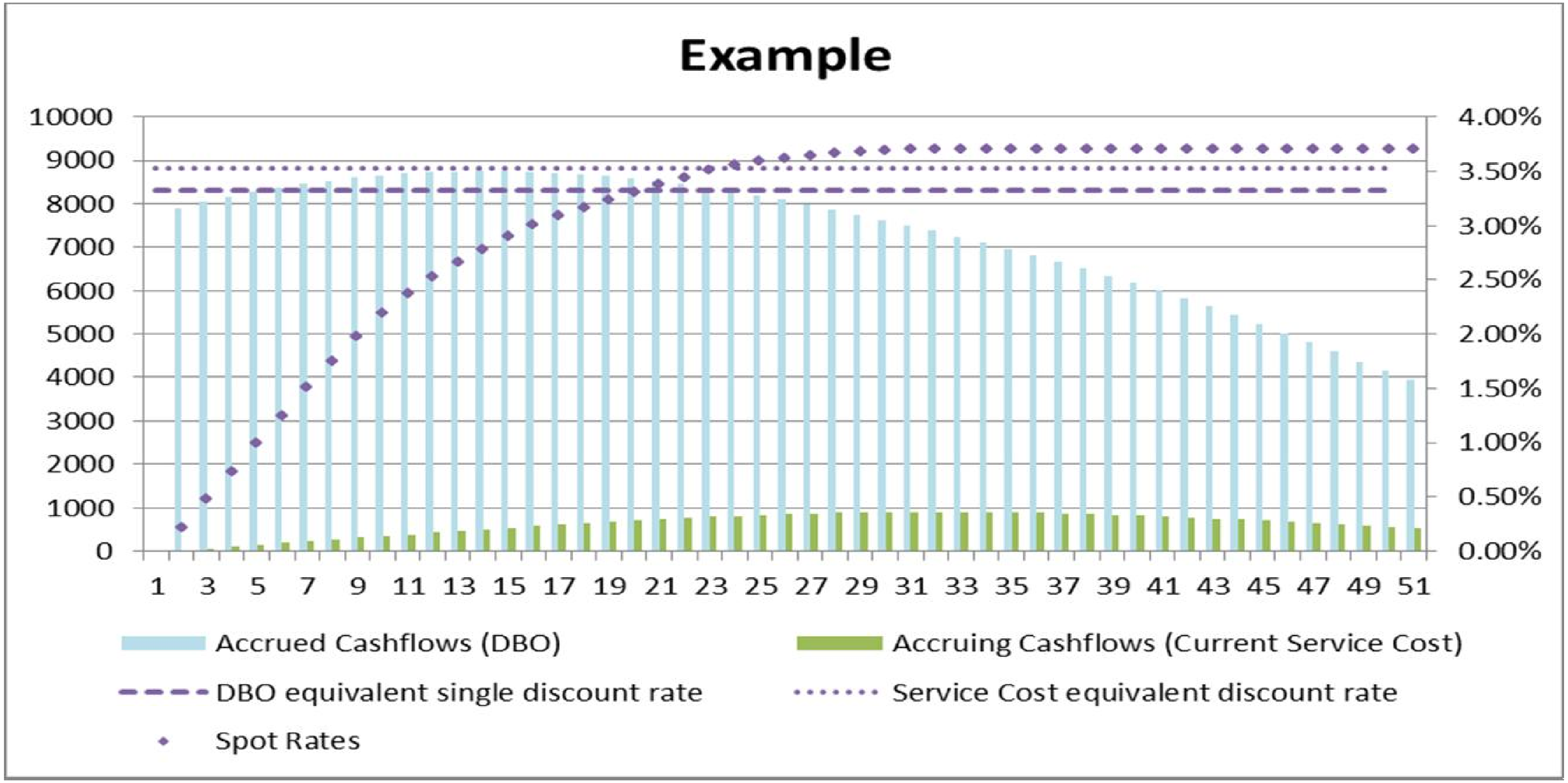
Alternatives for Measuring Service Cost and Interest Cost

Spot rate approach (also called Granular Method)

- On September 2nd, 2015, the SEC stated they will not object to registrants adopting an approach for measuring service cost and interest cost that applies individual spot rates to each year's cash flows ***when a yield curve is used to develop discount rates***.
- Applies specific spot rates along the yield curve used to measure the benefit obligation
- Discussion with SEC was specific to above facts; acceptability in other fact situations should be discussed with auditor/pre-cleared with SEC

	Alternative Approaches to Measure SC + IC	Acceptance
Service and interest cost	Traditional approach – Apply aggregate single equivalent discount rate derived from PBO/APBO measurement	Yes
	Similar to traditional approach, but applied to smaller groupings of cash flows (e.g., actives, term vested, retirees)	Yes
Service cost	Apply individual spot rates to each year's cash flows underlying the service cost	Yes
Interest cost	Apply individual spot rates to each year's cash flows underlying the PBO/APBO	Yes
	Apply first year spot/forward rate to each year's cash flows	No

Granular Method - Application of Discount Rate Curve



Calculating the Service Cost using the single equivalent discount rate that gives the same PBO won't give the same results as applying each spot rate to each cashflow

Willis Towers Watson

Granular Method - How Does the Math Work?

Measurement of Interest Cost (illustrative using sample plan)

			Current	Proposed	Current	Proposed
A	B	C	D	E	F	G
Year	Expected cash flow (benefit payments)	Spot rate	PBO Using traditional approach = B / (1.0359^A)*	PBO Using spot rate approach = B /((1+C)^A)	Interest cost, traditional approach = D * 3.59%	Interest cost, spot rate approach = E * C
1	1,000	1%	965.34	990.10	34.66	9.90
10	1,100	3%	773.06	818.50	27.75	24.56
20	600	5%	296.34	226.14	10.64	11.31
Total			2,034.74	2,034.74	**73.05**	**45.76**

No change in PBO/APBO

Reduction in interest cost

*** 3.59% is the weighted average discount rate under the traditional approach**

Granular Method – Pros and Cons

Pros	Cons
• More precise measurement of service cost and interest cost • May reduce sum of service cost and interest cost by as much as 10 % - 20% -- *but* also reduces settlement threshold • More favorable operating income if FASB goes forward with proposal that only service cost would be recognized in operating costs • Treated as change in accounting estimate (no restatement) -- Apply at next measurement date	• Reduces gains/increases losses, resulting in higher loss amortization in future periods -- May be particularly problematic for frozen or closed plans and if settlement accounting is anticipated • May increase sum of service cost and interest cost if yield curve slopes downward • If adopt spot rate alternative, SEC expects no change back to weighted-average discount rate approach in future • Budget estimates become more complicated

Granular Method – Other Considerations

Consistency considerations

- Auditor's views differ on whether approach must be followed for all material plans where yield curve is used to develop discount rate
- Auditors views differ on whether approach can be followed for service cost or interest cost but not both
- Materiality considerations would seem to apply
  - Otherwise, pre-clearance with SEC is recommended

No change in P&L for companies immediately recognizing gains/losses (MTM)

SEC's consideration was limited to US GAAP

- We understand auditors accept spot rate approach for IAS 19 (this should be discussed with the auditor)

Granular Method - Accounting for a Change

Change in accounting estimate

Accounted for in period of change – next measurement date (interim or year end)

- Adopting this new approach cannot, in and of itself, be viewed as triggering an interim remeasurement
- Absent an interim remeasurement, service and interest cost cannot be remeasured mid-year

Disclosure requirements

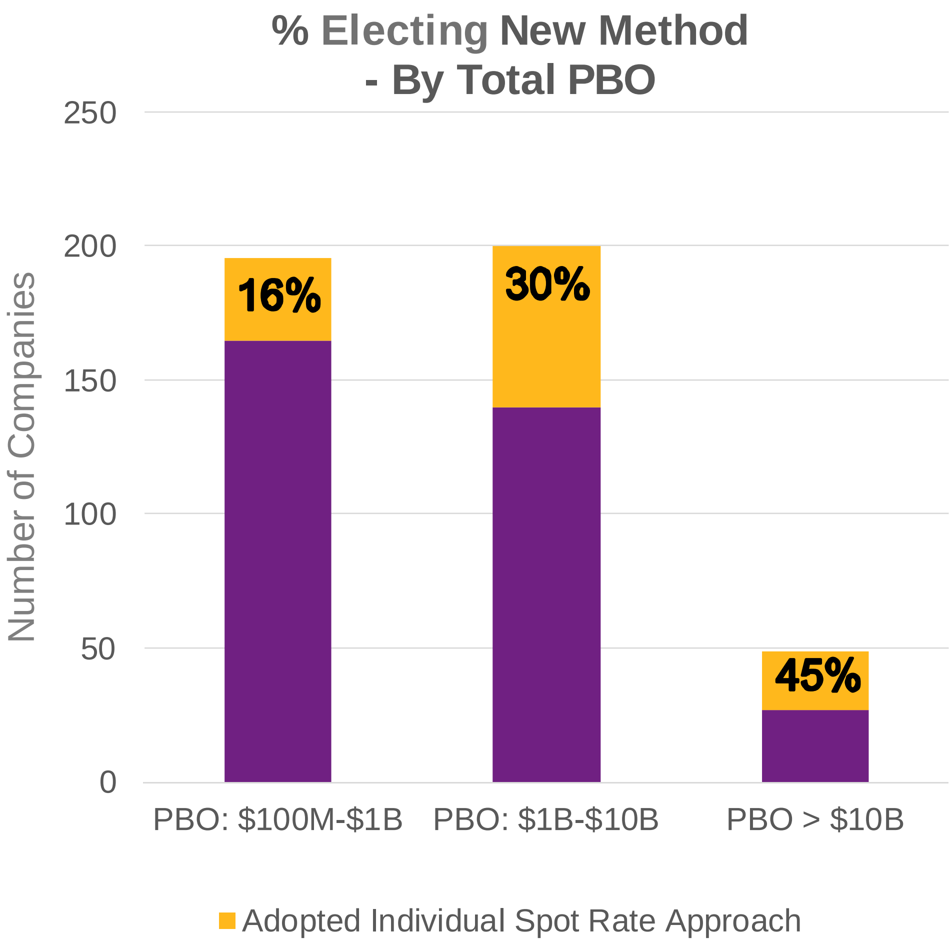
- How discount rate was developed
- How service cost and interest cost were measured
- Effect on income from continuing operations, net income and earnings per share
- Effect on future periods if expected to differ materially from current period
- MD&A disclosure, including effect on trends, non-GAAP measures

Granular Method - Companies Using Bond Matching

- Big 4 discussed a possible approach with SEC staff on May 2
  - Approach derives an implied spot rate from the selected bonds and plots a yield curve. Small amounts of bonds are purchased at all maturities so no "holes" exist for purposes of fitting a yield curve
  - In August, the SEC staff informed the Big 4 they would object to this concept due to:
    - The primary calculation supported by bond matching is the determination of PBO based on the market value of a selected bond portfolio
    - A full array of spot rates is not a direct and observable outcome derivable from that bond portfolio
- American Academy of Actuaries working group and actuarial firms has been developing and considering other alternatives
  - If supported by Big 4, other approaches likely would also have to be pre-cleared with the SEC staff
- Moving from bond matching to a yield curve approach specifically to use this alternative measure of service cost and interest cost is not allowed

Granular Method – Prevalence: Fortune 1000

Based on Fiscal Year-end 2015 Financial Statements

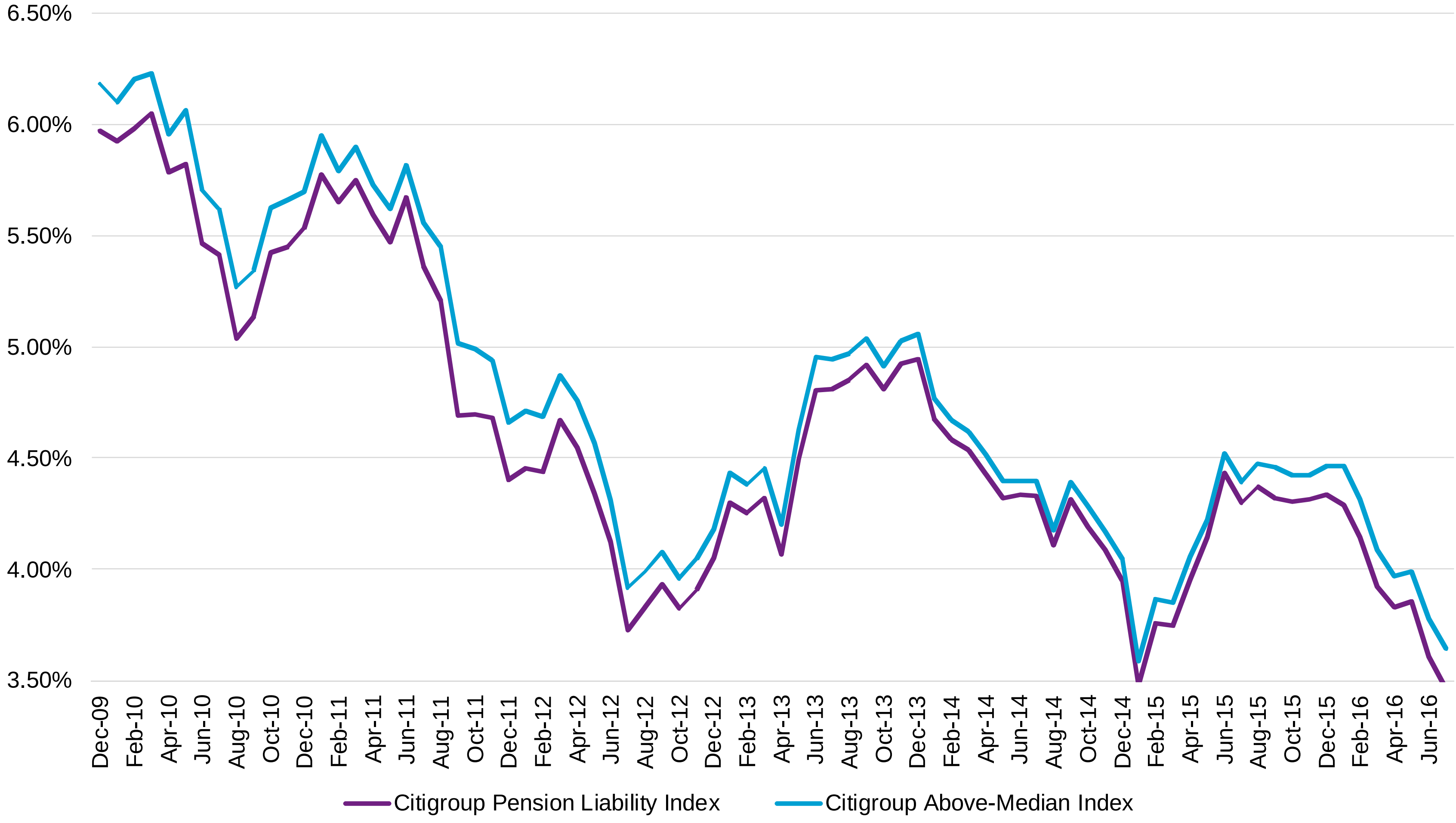


Summary

- Of 445* Fortune 1000 companies, reporting pension liabilities in fiscal year-end 2015 statements (with PBOs > $100M), **25%** elected the individual spot rate approach
- Actual % likely higher since some may first disclose with 2016 cost

*Includes companies with fiscal year ends from 9/27/2015 through 1/3/2016

Capital Market Update – Citigroup Pension Liability Index Rates



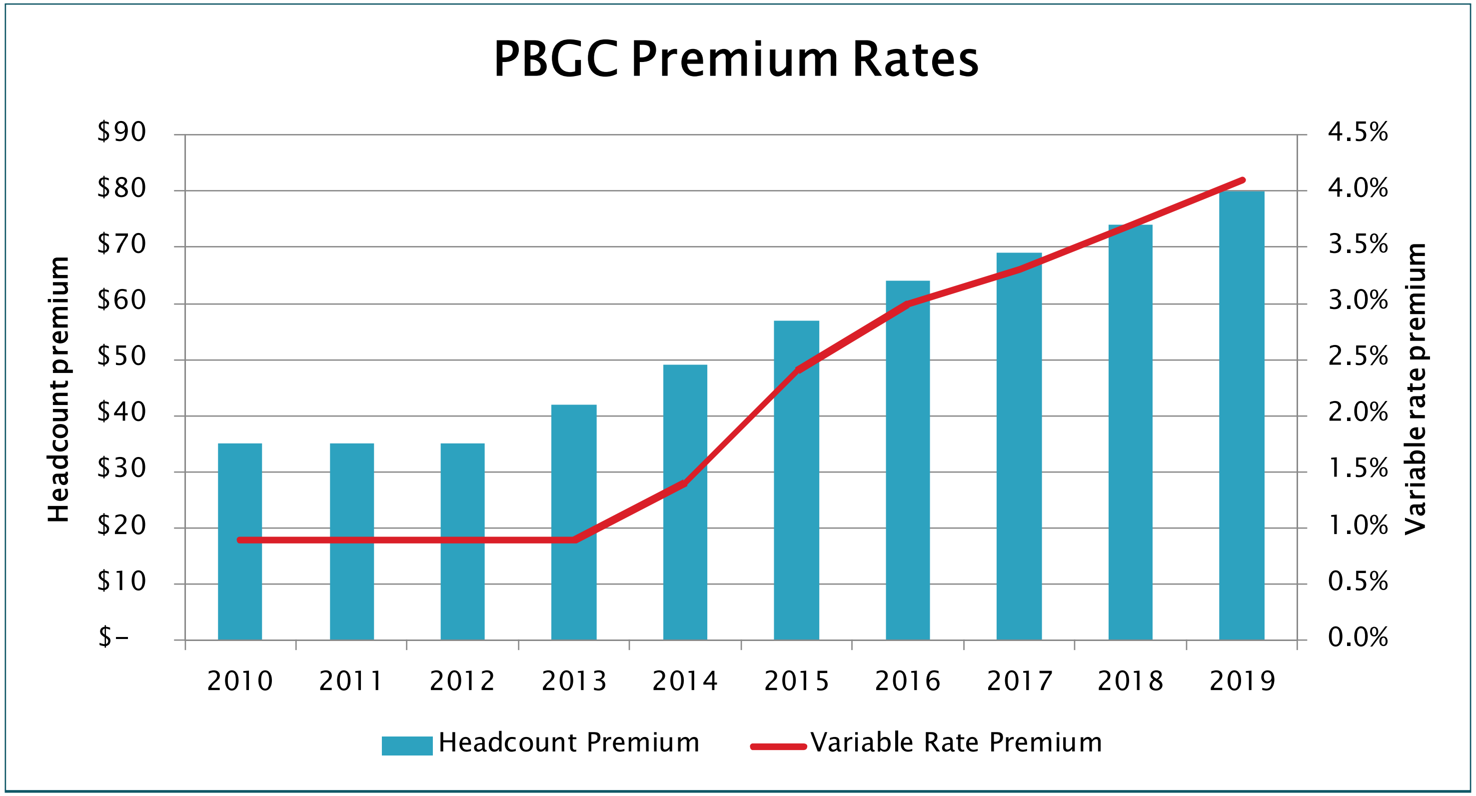
Capital Market Update - Asset Values and Interest Rates

	August 31, 2016 Index Value/Bond Yield	YTD 2016 Return/Change	2015 Return/Change
Assets Returns[1]			
S&P 500	4,120.2	7.81%	1.38%
Russell 2000	1,761.9	10.24%	(2.90)%
MSCI EAFE	4,879.2	1.03%	(0.81)%
Barclays Aggregate	2,037.7	5.84%	0.55%
Barclays Long Treasury	3,854.9	16.57%	(1.21)%
Barclays Long US Credit	3,898.6	17.66%	(4.56)%
Bond Yields			
Merrill Lynch 10+[1]	3.46%	92 basis point drop	40 basis point increase
Merrill Lynch 15+[1]	3.48%	93 basis point drop	40 basis point increase
Citigroup Pension Liability Index	3.46%	88 basis point drop	39 basis point increase
Citigroup Above Median Index	3.61%	86 basis point drop	42 basis point increase

[1] Sources for returns and yields are Bloomberg and Barclays Live

PBGC update

- Government continues to use PBGC as a "revenue raiser": premiums climbing and becoming significant administrative cost.



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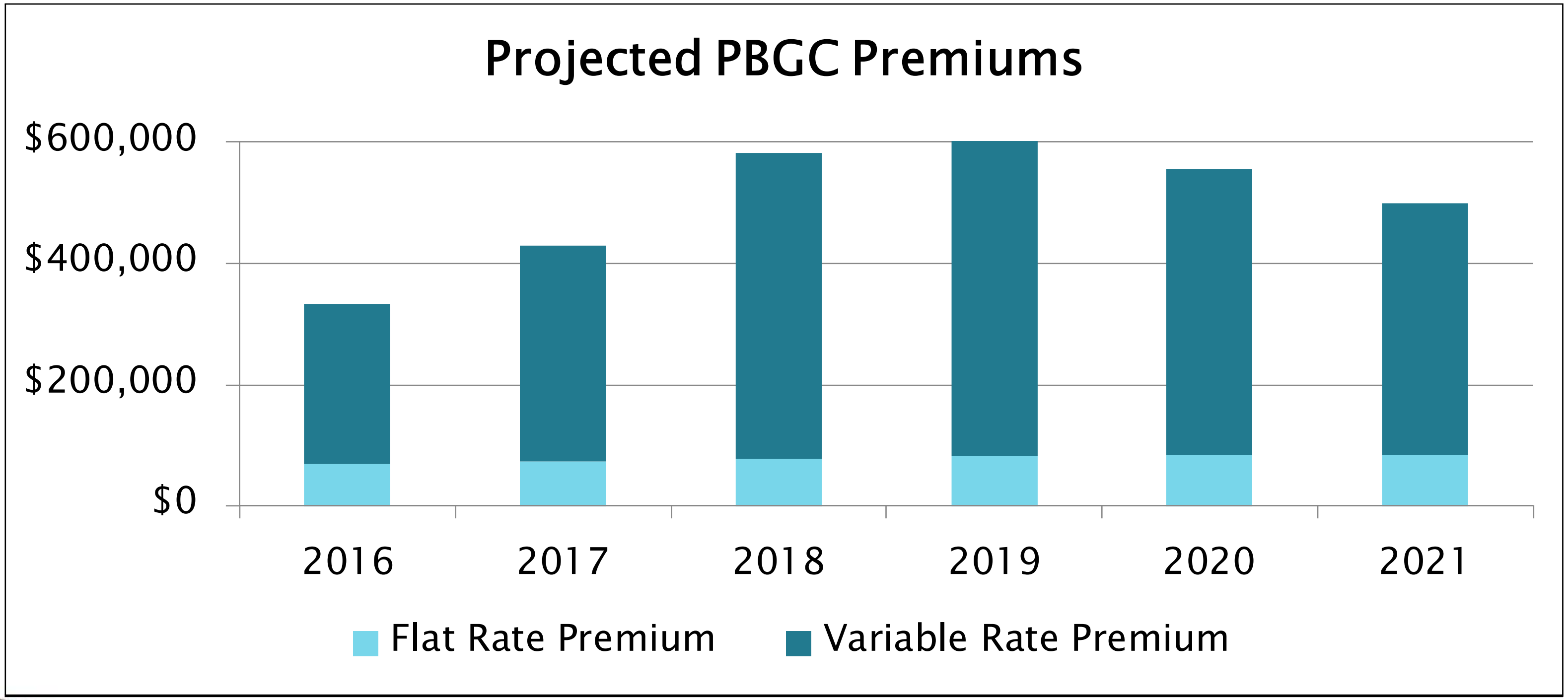
PBGC update

- Sample plan with 1000 participants and annual $1.2M funding policy
- "100% funded" on IRS minimum basis; 75% funded on PBGC basis
- Premiums have already tripled in the past four years



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Pension risk transfer activity

- Lump sums and annuity purchases are still hot

- Plan termination is becoming a realistic option
  - Focus on net opportunity cost of retaining plan vs. cost to fund and terminate
  - Option of borrowing to terminate

- Knowns, unknowns, and volatility
  - Interest rates are VERY low; for how long?
  - Assets are still volatile
  - Mortality assumptions for lump sums, funding, and PBGC are likely changing … at some point … soon(?)

Nondiscrimination testing relief

- Plans closed to new entrants will eventually fail testing because remaining DB population tends to become "concentrated" with HCEs
- Can aggregate DB and DC plans to pass testing IF provide minimum "gateway" benefit (~7.5% of pay)
- Previous relief applied to 2013-2016 if could pass testing in 2013
- New relief:
  - Can ignore gateway requirement if DB can pass testing on standalone basis for 5 years after freeze
  - Aggregated plans still need to pass nondiscrimination tests; just get free pass on gateway requirement

Prescribed mortality changes

- Prescribed mortality assumptions used for minimum funding, PBGC premiums, and lump sum payments.
- Longer lifespans = higher liabilities/costs
- Could save $ on PRT lump sums if paid before prescribed assumptions change
- No 2017 update, so let's bet on 2018

Public sector update

- Public sector pensions are front page news because usually less well-funded than private sector plans

- Ongoing debate whether solvency liability or ongoing funding liability is best measure

- Example:
  - Funding liability (7.5%) = $100M; Assets = $80M; Unfunded = $20M
  - Solvency liability (2.5%) = $190M; Assets = $80M; Unfunded = $110M
  - Gross liability increases 90%
  - Unfunded liability increases 450%

Other good stuff

- Schedule H, Line 4L
  - Question asks "Have all benefits been paid to plan participants"
  - Unannounced change to the 2015 Form 5500 instructions clarify that this question would also apply to terminated participants over age 70 ½ who should have received a benefit, but have not
    - IRS guidance in August indicated participants could be excluded where reasonable efforts were made to locate the participants
    - Recommend discussing with legal counsel how to answer
- SOA Mortality – The Retirement Plans Experience Committee of the SOA may release another mortality update similar to the MP-2015 update last fall (most likely after October 15, 2016 though)

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