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2015 Study of Economic Assumptions

Used for ASC 715 purposes

Contents

Introduction

Under the FASB Accounting Standards Codification (ASC),the sponsor of a defined benefit pension plan is required, in measuring the plan's obligations and annual expense, to use assumptions that (1) are explicit (ASC 715-30-35-42) and (2) are "consistent [with each other] to the extent that each reflects expectations of the same future economic conditions" (ASC 715-30-35-31). In general, the benefit obligation is most sensitive to the discount rate assumption; for example, a relatively small change in the discount rate (of, say, 25 basis points) could result in a change in the benefit obligation on the order of, perhaps, 2 to 4 percent.

ASC 715-30-35-43 describes the method of selecting the discount rate. The discount rate "shall reflect the rates at which the pension benefits could be effectively settled." ASC 71 5-30-35-44 notes that the discount rate should reflect the yield of a portfolio of high-quality fixed-income instruments whose coupons and maturities match projected benefit payments. However, ASC 715-30-35-1 allows the use of computational shortcuts that are expected to produce results that are not materially different from those resulting from a more detailed analysis. Because the duration of a plan's benefit obligation is affected by the plan design and by the demographic characteristics of the plan population (e.g., average age, average service, proportion of retirees), one might generally expect that plans with similar plan designs and demographics would use similar discount rates. Conversely, one might expect that plans with dissimilar plan designs or demographics may not use similar discount rates.

Of course, there may be circumstances — such as a relatively flat yield curve — in which plans with dissimilar plan designs or demographics would be able to support similar discount rates. In summary, the process an entity uses to select the discount rate should take into account the facts and circumstances specific to the plan as well as the high-quality corporate bond yield rates as of the measurement date.

ASC 715-60-35-79 and 35-80 outline similar requirements for the selection of assumptions for other postretirement employee benefit (OPEB) plans.

Companies must also disclose other economic assumptions: the expected rate of return on plan assets, the expected rate of salary increases, and the expected increase in health care costs.

Although the selection of assumptions should be specific to the individual plan, plan sponsors, as well as regulators, often compare their discount rate and other assumptions to those of other plan sponsors.

In this study, Deloitte's Human Capital service area has compiled information disclosed by many of the Fortune 500 companies in their most recent annual reports. We have focused on 287 companies that sponsor pension or other postretirement benefits in the U.S. and that have calendar fiscal years. Of these, 278 companies disclosed information about defined benefit plans. Information about OPEB (subject to ASC 715-60) was disclosed by 250 companies, including eight that disclosed only OPEB arrangements. The disclosure information also included assumptions the companies used as of the prior year, enabling us to compare changes in the assumptions from one year to the next.

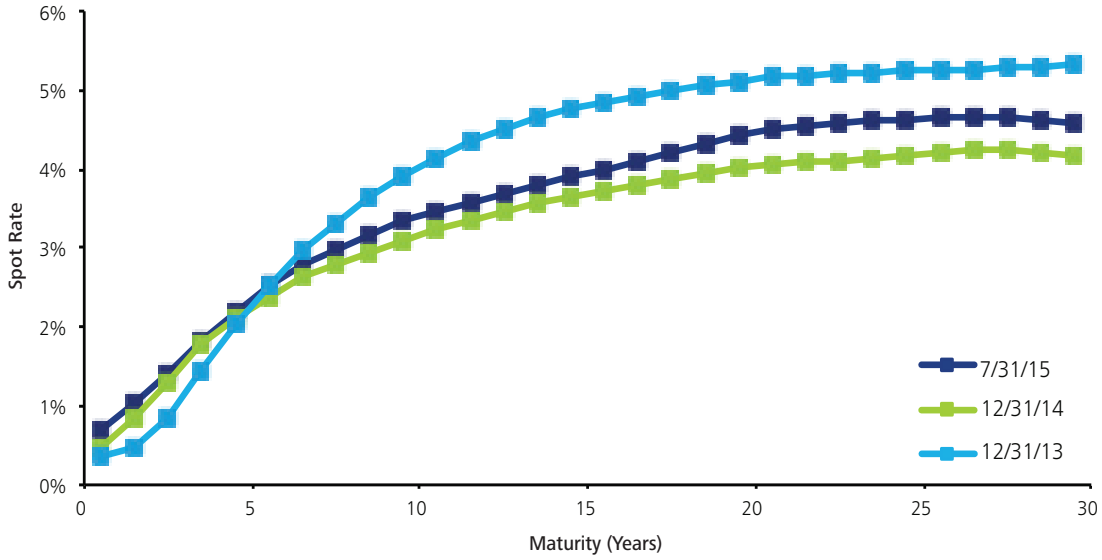
Prevailing interest rates

The SEC staff has commented about the guidance on the selection of the discount rate, noting that it believes that the term "high-quality" refers to those fixed-income instruments with at least an Aa3 rating from Moody's (or its equivalent from another rating service). Exhibit 1 shows the Citigroup Pension Discount Curve as of as of year-end 2013, year-end 2014, and July 31, 2015.

This exhibit[1] indicates that the yields at year-end 2014 are lower than at year-end 2013 for almost all maturities. However, it also shows the Citigroup Pension Discount Curve as of July 31, 2015, which indicates that rates have increased across most maturities since year-end 2014.

[1]Data from Citigroup Global Capital Markets

Exhibit 1: Citigroup Pension Discount Curve



Measurement date

Over the past several years, the rates available on corporate bonds as suggested by published indices such as Merrill Lynch U.S. Corporates Aa 15+ years, Merrill Lynch U.S. Corporates Aa/Aaa 10+ years, as well as Citigroup's (formerly Salomon's) Pension Liability Index have varied considerably. The historic yields over the past several years for these indices are plotted in Exhibit 2.

This exhibit indicates that these indices experienced decreases during 2014, and finished the year approximately 85–100 basis points lower as compared to the end of 2013. Furthermore, Exhibit 2 indicates that rates are currently (as of the end of August 2015) higher than at the end of 2014.

Exhibit 2: Corporate Bond Month-End Index Rates

Discount rate assumption

Exhibit 3 summarizes the discount rate for ASC 715-30 purposes disclosed as of December 31, 2014, and December 31, 2013. The average discount rate disclosed as of December 31, 2014, was 3.97 percent, about 80 basis points below the average discount rate disclosed by these companies at the end of 2013. Ninety-one percent of the companies included in this study were between 3.75 percent and 4.25 percent. The spread of discount rates stayed relatively constant compared to the prior year.

The FASB and SEC staffs have indicated that they expect discount rates to move with general economic trends[2]. Exhibit 4 presents the change from December 31, 2013 to December 31, 2014. The SEC staff has further indicated that it expects companies to disclose the basis for the selection of the discount rate. Companies that rely on an index to support their selection of the discount rate are further expected to provide evidence that such index is appropriate for the particular plan.

If a registrant uses published long-term bond indices as a benchmark for its assumptions, it is expected to explain how it determined that the timing and amount of cash outflows related to the bonds included in the indices matches its estimated defined benefit payments. If there are differences between the terms of the bonds and the terms of the defined benefit obligations (e.g., if the bonds are callable), the registrant is expected to explain how it adjusts for the difference. Increases to the benchmark rates should not be made unless the registrant has detailed analysis that supports the specific amount of the increase[3].

On average, discount rates decreased by around 80 basis points from December 31, 2013 to December 31, 2014. One hundred percent of companies decreased this assumption from year end 2013.

Exhibit 3: Discount Rates for Disclosures

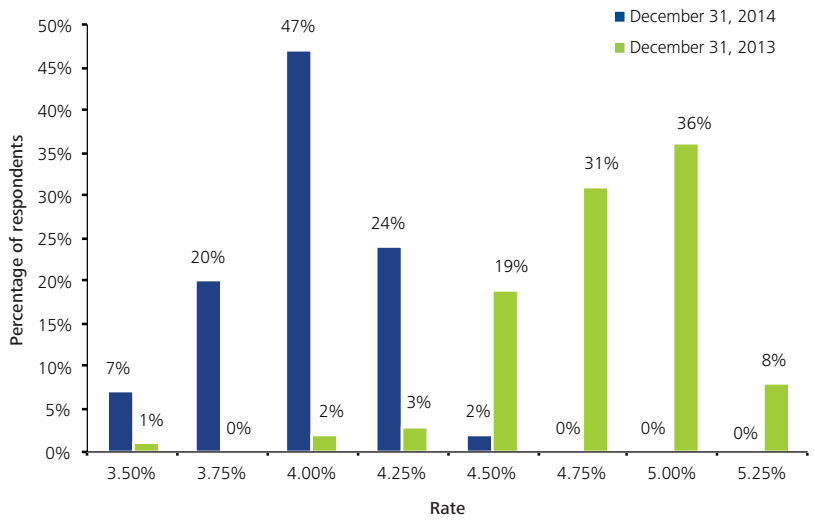
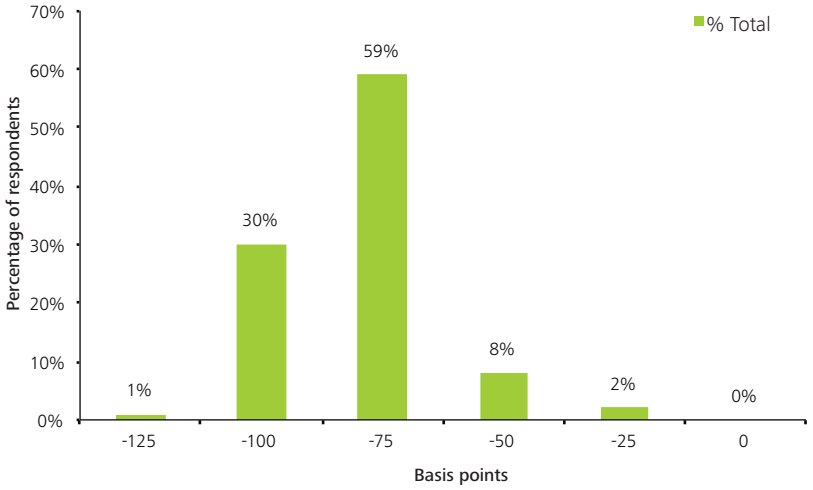


Exhibit 4: Change in Discount Rate

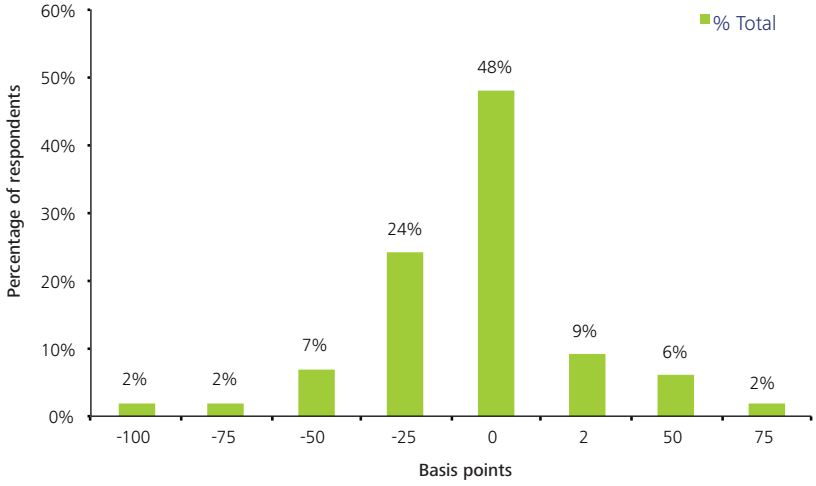


[2]ASC 715-20-S99-1 (formerly EITF Topic D-36)

[3]Cf.Section II H 1 at www.sec.gov/divisions/corpfin/acctdis030405.htm.

We also compared the discount rate disclosed for ASC 715-60 purposes with that disclosed for measuring pension liabilities in accordance with ASC 715-30. As shown in Exhibit 5, 48 percent of the companies included in this study disclosed the same discount rate for both measurements, comparable to the percentage in last year's study. Seventeen percent of companies disclosed a higher discount rate for measuring postretirement benefits than for measuring pension benefits, while 35 percent used a lower discount rate.

Exhibit 5: Difference in Discount Rate for ASC 715-60 Purposes and ASC 715-30 Purposes



Salary increase assumption

Plans that provide pay-related benefits are required to disclose the salary increase assumption underlying the measurements. Most of the companies in the study disclosed a salary increase assumption. ASC 715-30 provides relatively little guidance on the selection of the salary increase assumption. However, ASC 715-30-35-31 notes it should reflect "future changes attributed to general price levels, productivity, seniority, promotion, and other factors."

The range of assumed salary increase is fairly wide, as summarized in Exhibit 6. The average salary increase assumption disclosed as of December 31, 2014, was roughly 3.75 percent, a decrease of 6 basis points from 2013. Sixty-two percent of the companies included in this study used an assumption between 3.50 and 4.50 percent. Exhibit 7 shows the change in the salary increase assumption from December 31, 2013, to December 31, 2014. Similar to last year, between these two measurement dates, 77 percent of the companies included in this study reported no change in the salary increase assumption. Roughly 14 percent decreased this assumption.

Exhibit 6: Salary Increase Disclosures

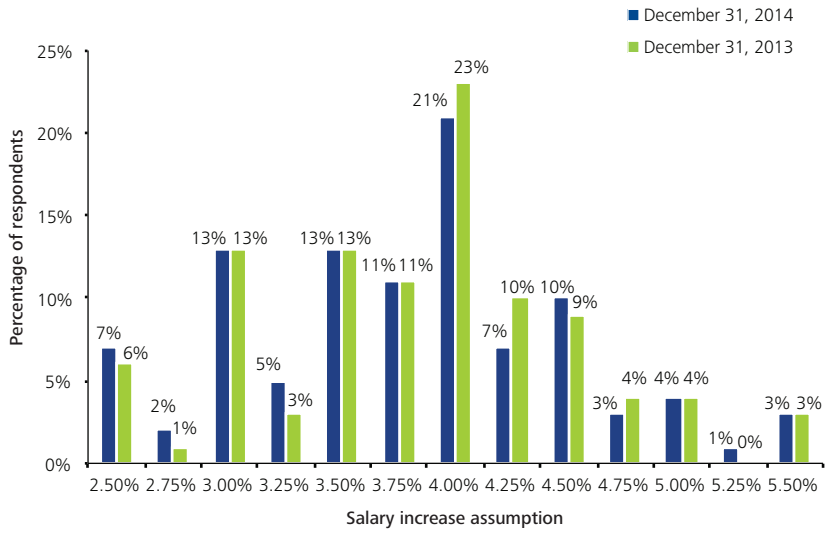
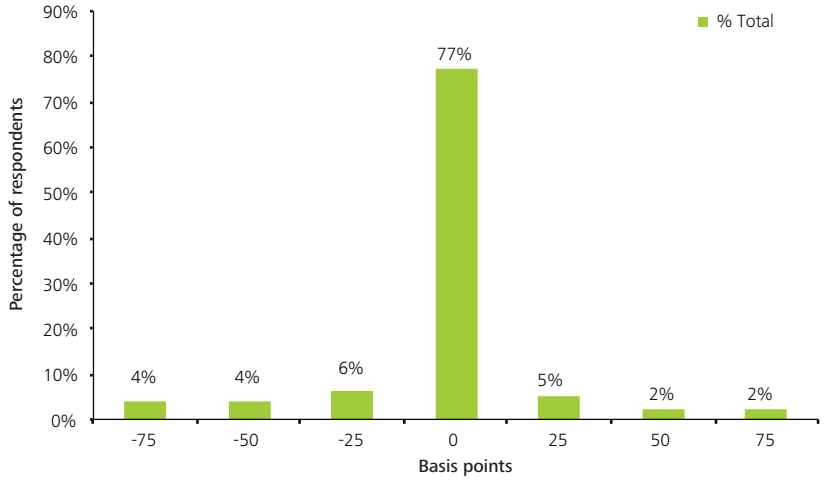


Exhibit 7: Change in Salary Increase Assumption



Expected return assumption

Under ASC 715-30-20, the expected long-term rate of return (i.e., expected return assumption) should reflect "the average rate of earnings expected on the funds invested or to be invested to provide for the benefits." Furthermore, ASC 715-20-50-1(d) requires that plan sponsors provide a narrative description of both a plan's actual investment policy and the basis they used to determine the overall expected long-term rate of return. As a result, companies with different asset allocations or different investment philosophies may have different long-term return assumptions.

We understand that some companies therefore engage in a process (with varying degrees of rigor) for developing the expected return assumption.

One method for determining the expected return assumption is based on a "building block" approach. In our experience, the building block approach is used by many in the investment management industry to develop capital market expectations. This approach begins with the development of a long-term level of expected inflation. The level of inflation becomes the "building block" for the development of expected returns for each of the various asset classes (i.e., the difference between real and nominal returns).

Next, companies develop an expected return on cash ("risk free" asset), typically by using 90-day Treasury bills as a proxy. Risk premiums above cash are developed as the primary determinant of expected return for the various asset classes (e.g., U.S. equities, U.S. core fixed income) included in the portfolio. Risk premiums should reflect the risk of each asset class (the riskier the asset class, the larger the risk premium).

Finally, under the building block approach, companies calculate the expected return of the total portfolio by using the asset class returns developed, taking into account the overall strategic asset allocation of the portfolio. Some companies engaging in active investment management may be able to document a premium for this strategy and may choose to incorporate a return premium to reflect their belief that active management will provide an additional incremental return. Note that management fees for actively managed investments are typically higher than passively managed products and that the premium assigned for active management should be net of additional investment management fees.

Another approach to developing the long-term rate of return assumption is to develop a consensus forecast, whereby the company gathers long-term capital market forecasts from multiple, reputable organizations in the financial services industry (such as investment consultants, investment managers, or other financial institutions). Typically, these capital market forecasts include long-term expected return assumptions for various asset classes. The company can calculate the expected return of the portfolio by "averaging" the expected return forecasts gathered by asset class and using these inputs to calculate the total expected return on the overall portfolio.

Alternatively, some companies may choose to determine the projected range of returns for the overall portfolio by using stochastic simulation. Stochastic simulation is a tool that allows the company to forecast the overall portfolio return under various potential economic environments. The inputs to the model typically include mean-variance assumptions for each asset class (which can be generated by using the building block method or consensus forecast) as well as assumptions related to future levels of inflation and interest rates. The results of the stochastic simulation will provide the company with the range of potential returns for the portfolio over a long-term horizon (although it is worth noting that the output of the analysis is largely predicated upon the assumptions).

Exhibit 8 shows the range of the expected return used in measuring pension expense for 2014 and 2013. While ASC 715-60 has a similar definition, many OPEB plans are unfunded; this assumption is not used for unfunded plans.

The average expected return was 7.10 percent for 2014 (roughly 5 basis points lower than that for 2013), with 61 percent of companies between 7.00 and 8.00 percent. Thirty-one percent were less than 7.0 percent and 8 percent were higher than 8.0 percent. As shown in Exhibit 9, compared with 2013, approximately 31 percent of companies lowered this assumption in 2014, 60 percent of the companies kept the same assumption as 2013 and the remaining 9 percent raised the assumption. Our analysis also shows that larger plans used a somewhat higher (by as much as 50 basis points on average) expected return assumption. This difference could be due to many reasons, including more aggressive asset strategies, lower expense ratios, or different investment opportunities.

Exhibit 8: Expected Long-Term Rate of Return Assumption

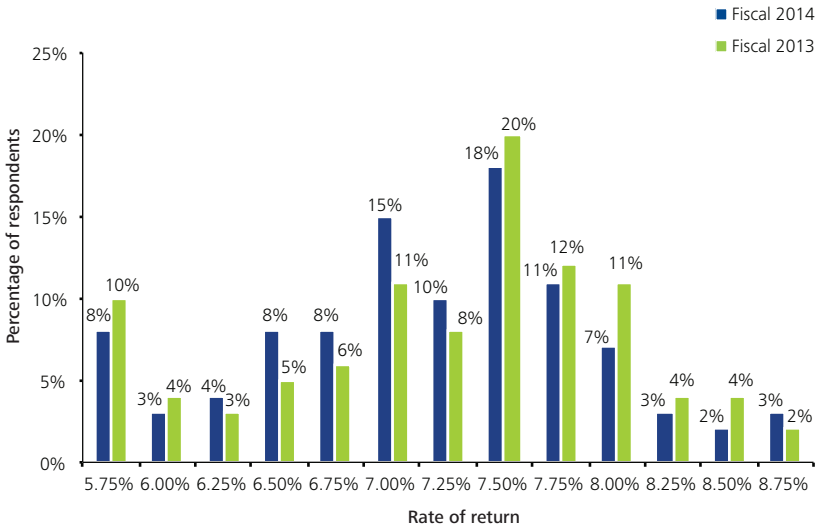
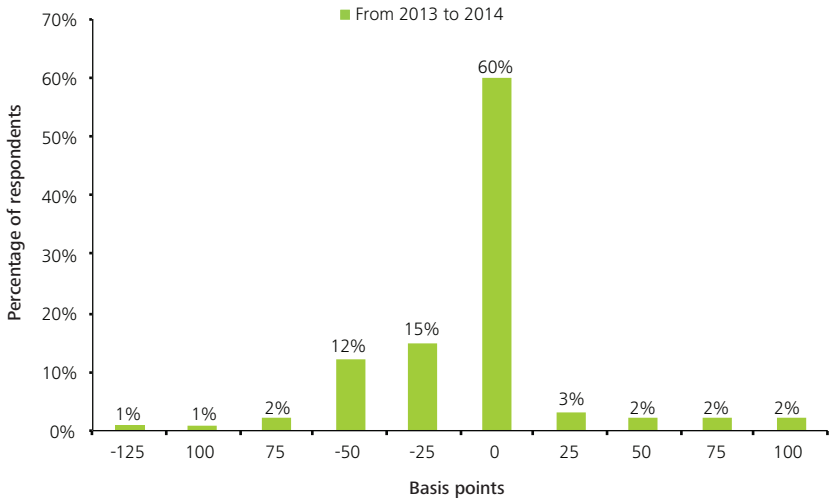


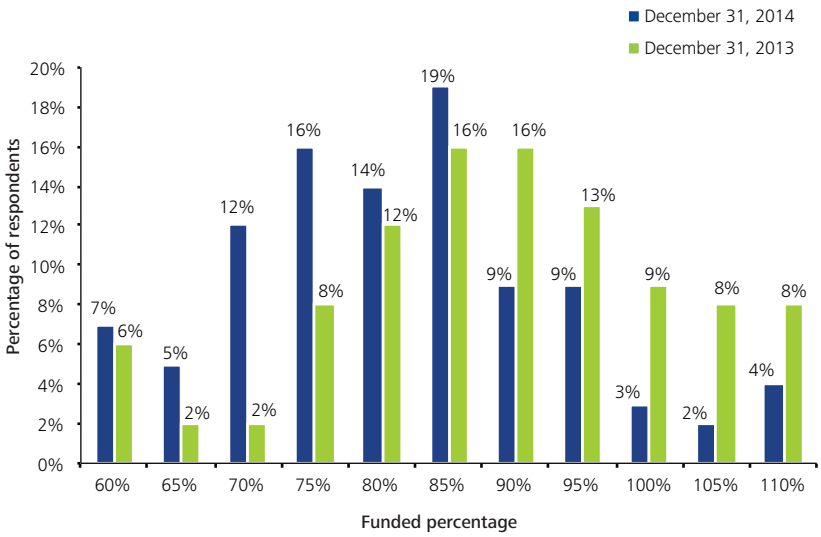
Exhibit 9: Change in Expected Long-Term Rate of Return Assumption



Funded status

Exhibit 10 shows the change in funded status (measured as the ratio of market value of assets to the projected benefit obligation) from December 31, 2013, to December 31, 2014. The funded status of the plans as of the end of 2014 averaged approximately 81 percent, a decrease of 8 percent compared to 2013. Last year, approximately 38 percent of companies had a funded status of at least 95 percent; this year, 18 percent.

Exhibit 10: Funded Status Percentage



Health care cost trend rate assumptions

ASC 715-60-35-99 describes the health care cost trend assumption as representing "the expected annual rates of change in the cost of health care benefits… for each year from the measurement date until the end of the period in which benefits are expected to be paid." ASC 715-60-35-100 notes that "health care cost trend rates may be assumed to continue at the present level for the near term, or increase for a period of time, and then grade down over time to an estimated health care cost trend rate ultimately expected to prevail."

As of December 31, 2014, 82 percent of the companies disclosed an initial health care cost trend assumption of between seven percent and eight percent. The average initial trend rate was 6.97 percent, down from the 7.22 percent disclosed for the prior year. A comparison of the current and prior year is shown in Exhibit 11.

Thirty-six percent of the companies used the same rate as the prior year (as shown in Exhibit 12). Two percent used a higher initial trend, and the remaining plans disclosed a lower trend assumption. Eight percent decrease their initial rate by 100 basis points or more.

Exhibit 11: Initial Health Trend Assumption

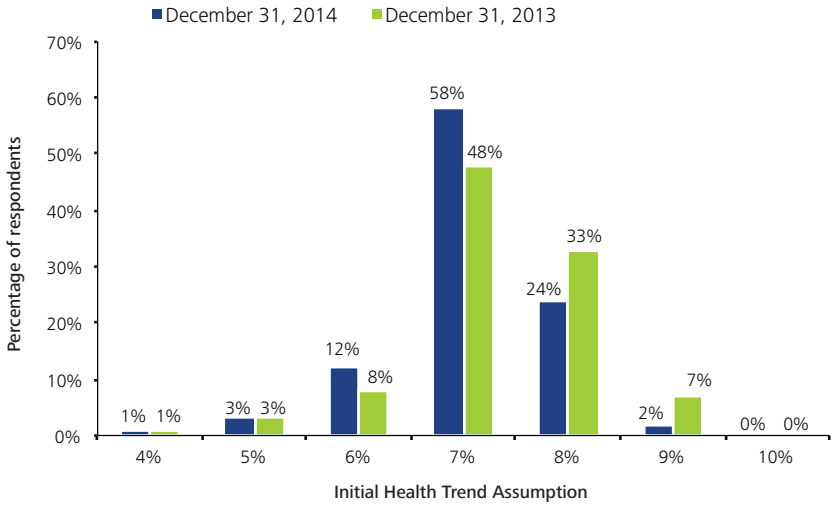


Exhibit 12: Change in Initial Health Trend Assumption

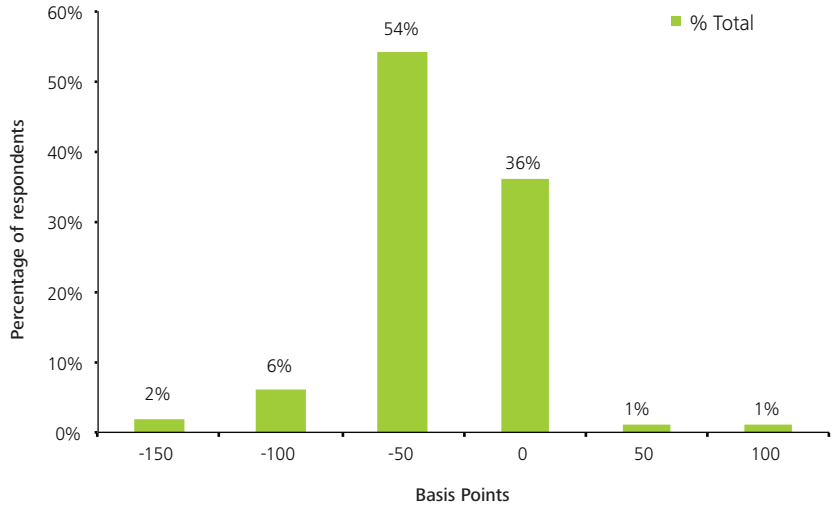


Exhibit 13 summarizes the ultimate health care cost trend disclosed as of December 31, 2014. At the end of 2014, the average ultimate health care cost trend rate was roughly 4.80 percent, slightly lower than that disclosed at the end of the prior year.

Exhibit 14 compares the difference between the initial and ultimate trends at year-end 2014 compared with year-end 2013. Over the year, on average this difference narrowed slightly from 2013 to 2014 (from 238 basis points in 2010 to 217 basis points in 2014).

Exhibit 13: Ultimate Health Trend Assumption

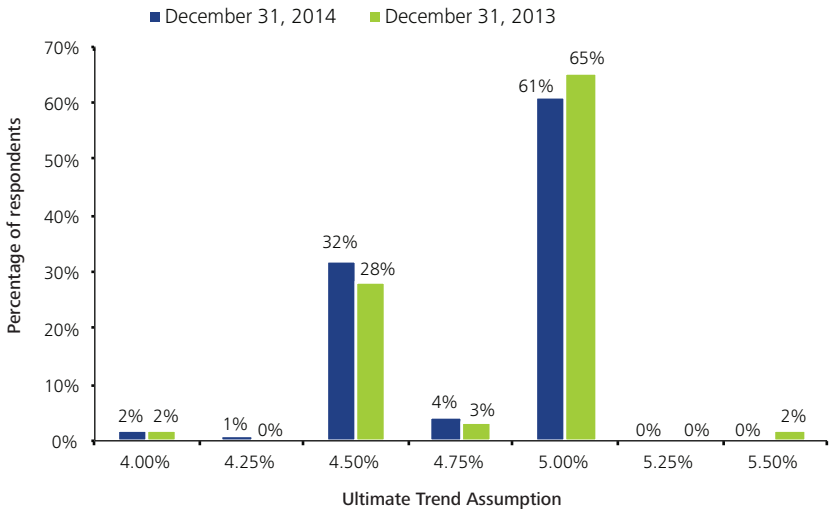
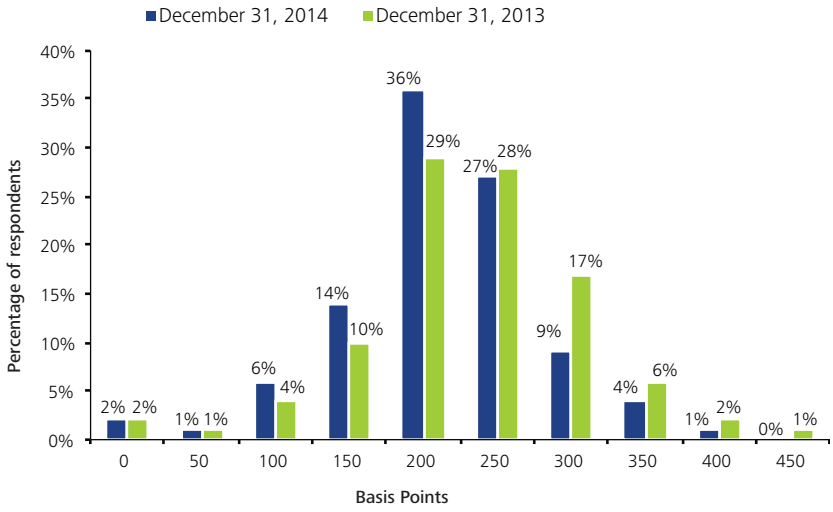


Exhibit 14: Difference Between Initial and Ultimate Health Trends



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