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Effect of Fed Interest Rates and Market Results on Pension and OPEB Plans

The action by the Federal Open Market Committee to raise the short-term federal funds rate by one-quarter percent appears to have had minimal, though favorable, impact on pension discount rates thus far. But combined with disappointing investment results in 2015, plan sponsors of pension and other post-employment benefit plans will likely see higher unfunded liabilities on balance sheets as of December 31, 2015. As most plan sponsors complete year-end accounting, it may be a good time to revisit forecasts that reflect the changing dynamics that drive pension costs. Given ongoing volatility in the markets, we would also recommend sensitivity analysis be performed as part of a forecasting exercise.

Background

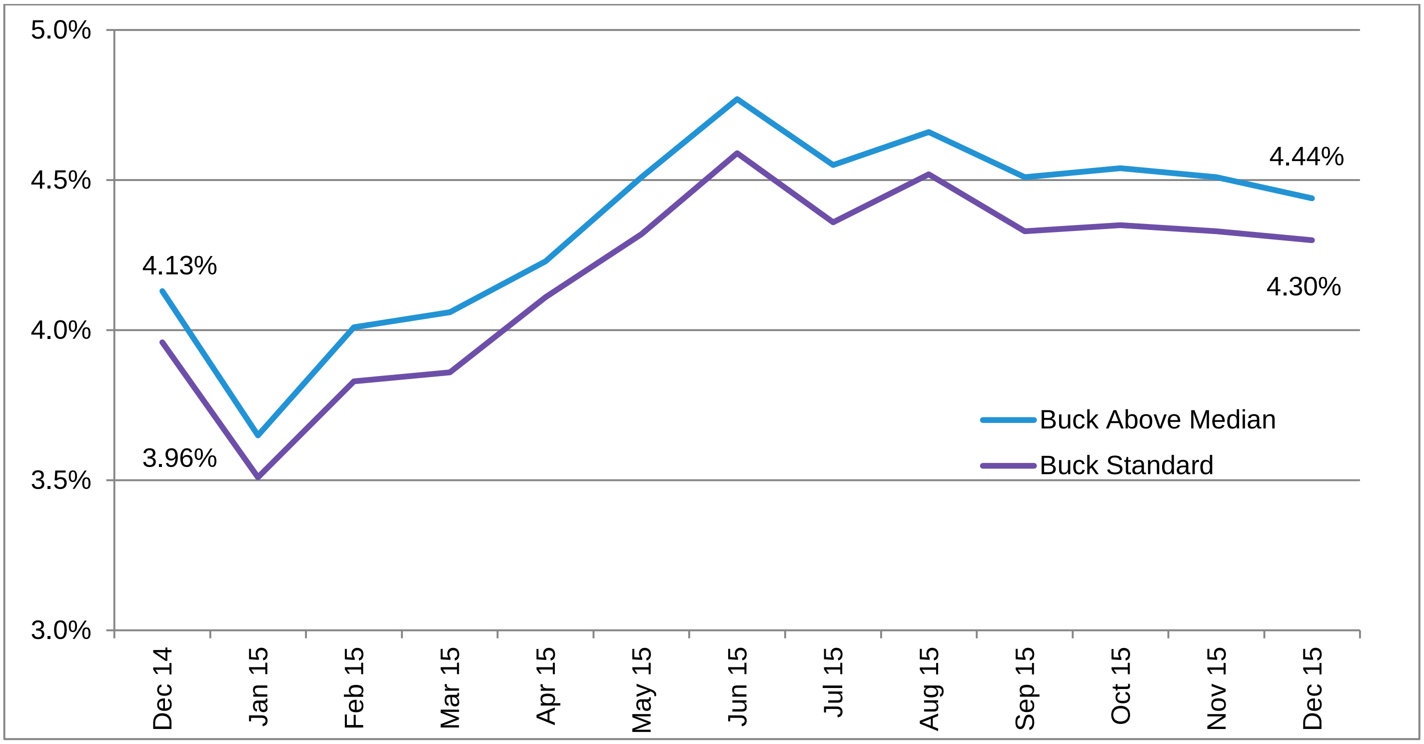
In December, the Federal Open Market Committee (FOMC), a panel of Federal Reserve officials responsible for determining monetary policy, increased the target range for the federal funds rate from 0.00%-0.25% to 0.25%-0.50%. (See our December 17, 2015 *FYI Alert.*) This was the first increase in the funds rate since the target rate was reduced to the 0.00%-0.25% range in 2008. The expectation in December was that the impact on the corporate bond market — which is used to set financial reporting discount rates for pension and other post-employment benefit plans — would be to move those rates slightly higher and thus decrease reported liabilities. Generally, however, rate changes have little short-term impact on pension funding requirements due to smoothing and corridors applied to the rates.

Yields on corporate bonds rated AA or higher determine the appropriate discount rate under accounting standards for both U.S. GAAP and international accounting under IFRS.

Discount Rates Increase During 2015

Earlier this month, we published the Buck Yield Curves as of December 31, 2015. Based on the cash flows from ten model plans, single equivalent discount rates are up approximately 30 to 35 basis points as compared to December 31, 2014. (See chart below.) Plans with materially longer or shorter benefit payment durations may see slightly different impacts. As shown in the chart, the Buck Above Median Curve generally has resulted in anticipated discount rates 15 to 20 basis points higher than the Buck Standard Curve.

Volume 39 | Issue 06 | January 15, 2016



The action by the FOMC to raise the short-term federal funds rate by one-quarter percent appears to have had minimal impact on pension discount rates thus far. The Fed's action directly impacts the discount rates associated with short-term, risk-free yields (i.e., increasing the short end of the yield curve), but does not necessarily impact corporate bonds to the same degree, nor does it have a material effect on the longer end of the yield curve.

2015 Investment Results

Asset returns generally lagged behind expectations during 2015. The following table shows actual 2015 benchmark returns, for selected key asset classes. So even with the decrease in liabilities that some plans will enjoy due to the slightly higher discount rates, asset values that did not keep pace with discount rates or expected returns may lead to higher unfunded liabilities on balance sheets.

Asset Class	Benchmark	2015 Return	Asset Class	Benchmark	2015 Return
US Large Cap	Russell 1000	0.92%	Aggregate Bonds	Barclays Aggregate	0.55%
US Small Cap	Russell 2000	(4.41%)	Long Gov/Credit	Barclays LT G/C	(3.30%)
REITs	NAREIT Equity	3.20%	Inflation-Linked Bonds	Barclays US TIPS	(1.44%)
World Ex-US	MSCI ACWI Ex-US	(5.25%)	High Yield	Barclays US Corp HY	(4.47%)
Emerging Mkts	MSCI Emerging	(14.60%)	Cash	Citigroup 90-Day T-Bills	0.03%

Volume 39 | Issue 06 | January 15, 2016

What To Do

It is always important to have sound projections of a plan's expected cost. Plan sponsors should consider updating the deterministic or stochastic projections used to forecast the position of the plan for the following reasons:

- Changes in discount rates from December 31, 2014 to December 31, 2015 may reduce the accounting liability for a typical pension plan by about 4%, depending on the plan's liability duration. This will typically also decrease the plan's annual pension expense.
- Asset performance was different than expected in 2015 — and perhaps different than forecast even at mid-2015. Projections should be adjusted for this, and perhaps also for the sharp stock selloff early in 2016.

Plan sponsors may also consider performing scenario analyses that reflect different views of the future due to the ongoing volatility of the markets. For example:

- A scenario where the U.S. economy remains strong and interest rates continue to rise
- Scenarios where equities underperform expectations, reflecting both lower and higher inflation and interest environments

Plan sponsors that have adopted (or are considering adopting) the alternative Individual Spot Rate method for determining pension cost should also consider scenarios that reflect different shapes of the yield curve. For example, recent Fed actions that have increased short-term interest rates are expected to flatten the yield curve, which might lessen the effect and benefit of moving to this alternative approach. That said, it seems many plan sponsors have adopted or are strongly considering adopting this approach.

In Closing

Plan sponsors may wish to consult with their actuary or investment advisor about the effect of these changes in the economic landscape on their benefit plan liabilities and consider updating projections for their plans.

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