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How to **Stop the Insanity!**

by Jeremy Gold

At the 2002 Enrolled Actuaries Meeting, Donald Segal and Tonya Manning asked ERISA authorities to "Stop the Insanity." In the authors' response to comments on our article "Reinventing Pension Actuarial Science," Larry Bader and I have said that funding rules require societal, or political, judgments. In this article, I try to identify and delimit the public's interest in defined benefit plan funding. Thus, for the time being, I put aside the pursuit of a new theory of pension actuarial science in favor of a practical proposal to Stop the Insanity.

As Segal and Manning have documented, 29 years of ERISA have resulted in a chaotic deluge of overlapping, often contradictory, measurements and restrictions designed to regulate the funding of qualified defined benefit plans for U.S. employees. We may understand such rules as the expression of the public's interest in what otherwise would be a matter of private contracts between employers and employees. Although the public interest in these matters is legitimate, we can do the public will in a fashion that will Stop the Insanity.

Public interest in the funding of private defined benefit plans comprises two issues:

- Funding should be sufficient to secure promises that have been made by employers and earned by employees – i.e., accrued benefits, measured at market values.

- Tax-deductible contributions should be limited. Such limitation may also be defined in relation to the market value of accrued benefits.

The public does not have an interest in:

- Patterns of contributions over time, although this may be important to plan sponsors and their constituents.

- Normal costs.

- Gain and loss amortization.

- Past service costs and amortizations.

- Interest on liabilities.

- Expected returns on assets.

I believe that the six bullets above, the basics of the traditional actuarial funding processes that underlie ERISA, contribute to the Segal-Manning Insanity. Pre-ERISA, these components helped the actuary rationalize the sponsor contribution budgeting process. When the public chose to intervene, it framed the problem in terms of these components and attempted to control funding outcomes by controlling these inputs. Much of the insanity arose in response to undesirable outcomes. Thus, for example, the PBGC saw the need to define and measure the Current Liability after plans that met ERISA's minimum funding rules failed to achieve adequate funding levels.

My Sane proposal defines two simple limits: a minimum (sufficiency level) below which contributions are required and a maximum (excess level) above which no contributions are allowed. Between these

levels, the public has no interest and plan funding is entirely discretionary. Actuaries may design funding schemes therein, employers may negotiate with employees and their representatives therein, stockholders and lenders may argue with management therein. The public does not care.

My proposal is the ultimate safe harbor. Within the harbor, actuaries and plan sponsors may use the elemental actuarial building blocks much as a sailor uses the tiller and the positions of sails to guide a boat. As long as the boat neither runs aground nor heads out to the open sea, the Coast Guard can rest easy.

The public must choose its measures of sufficiency and excess very carefully. Although setting the levels will be inherently political, the liability measure should be financially sound, transparent and objective. Discounting the cash flows implied by benefit accruals to date at the Treasury yield curve meets these tests. Once set, the measures should be administered with minimal discretion and subjected to minimal political interference. Most of the political debate should be focused on setting the heights of the lower (sufficient) and upper (excessive) bars, each defined in terms of the ratio of market-valued assets to the objective liability measure.

Suppose, and I really mean this as an example and not as a recommendation, that the lower bar is set at 100 percent and that any shortfall must be one-third funded currently. The shortfall has no history and no amortization schedule. If the plan is $3 million short, the sponsor must fund $1 million currently regardless of whether it was underfunded or overfunded last year. There is no schedule for the other $2 million. If the plan remains underfunded next year, the sponsor must contribute one-third of the shortfall determined at that time. I would expect PBGC premiums to be collected from all qualified plans with a basic per-capita amount for plans that are sufficiently funded and increased amounts for plans in shortfall. Shortfall plans might be further restricted from making benefit-increasing amendments.

The tradeoff for the rigorous attack on poorly funded plans is the freedom offered to the great majority of well-funded plans. This combination should provide substantial incentive to sponsors to manage the asset/liability positions of their plans prudently as well as to exercise caution in granting benefit increases.

Suppose, again as an example not a recommendation, the upper bar is set at 150 percent. The sponsor of a plan that is $1 million short of this ceiling would be permitted to contribute and deduct $1 million if it desired. From the public perspective, it seems to me that plans funded above the upper bar should be free to recoup such excess funding without excise taxes and without strings on the redeployment of such monies (after payment of appropriate income taxes). The IRS may want to limit this practice for companies that appear to be taking undue advantage.

The initial bar-setting process may be as technically complicated and as political as the public will choose to demand/tolerate. Congress will be the arena for the bar-setting process; the regulatory agencies will administer that which Congress devises. Congress might choose to assign authority for lower-bar issues to the DOL and the PBGC and upper-bar issues to the IRS.

An example of a technical, complicating issue that lies within the initial process: those who share my financial economics perspective may want the lower bar to be set to recognize the nature of the plan's asset/liability mismatch. Plans invested in a liability-matching fashion might have a lower bar set at 95 percent, while poorly matched plans might face a bar set at 115 percent.

A second example: if Congress is concerned about tax losses attributable to excessive inside build-up as well as excessive contributions, they may wish to define an upper-upper bar above which funds would be mandatorily reverted and taxed. Congress may also deem it necessary to limit tax deductions for small plans that principally serve as tax shelters for owner-employees or other narrow groups.

I have tried to suggest a practical response to the Segal-Manning plea for sanity. The success of such a simplification scheme requires that:

- The basis for liability measurement be scientific, objective and market-oriented. The thumb should be off the scale with respect to measurement.
- Setting the levels of the lower and upper bars should be as simple as possible, but no more so.

Looking beyond the immediate and practical, I hope that the inner harbor will provide substantial room for pension actuarial science to evolve, free of much of the regulation that has stunted its growth over the last three decades. We really do need to revisit and revitalize our science. ◆

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