Pension Plan Life-Cycle Funding Approach

Bosco L. Chan, F.S.A., F.C.I.A., F.C.A., M.Math.*

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Abstract

During its life cycle, a pension plan experiences fluctuation much like the ups and downs in the life of a human being. This paper reviews the life cycle of a typical pension plan, examines the issues relating to its funding, and proposes a new funding approach that tries to balance the various concerns. This funding approach should be flexible enough so that some of its key components can be adjusted automatically along with the maturation of a pension plan to reflect the changing concerns in funding at various stages. This funding approach is called a Pension Plan Life-Cycle Funding Approach. It is built around two key risks related to benefit security in the life cycle of a pension plan:

1. A "sudden death" situation (i.e., a plan sponsor becoming insolvent and the plan is forced to wind up), and

2. A "horrible lengthy life" situation: for example, a plan is kept ongoing but faces continual bad luck—it has experienced more losses than gains, and that makes the cost of funding the pension plan higher than anticipated.

Although legislation and regulations differ by geographic location, the fundamentals around pension plan funding are very similar. The approach presented in this paper is created with the expectation that rules and regulatory constraints can be amended in the future, if needed, to fit a sound pension plan funding approach accepted worldwide. This paper provides a high-level view of the suggested funding approach so that readers may focus on the reasoning behind this concept. Details about how this approach can be adopted in practice have been reserved for subsequent papers.