Overhauling Minimum Funding Requirements[1]
A Not-So-Radical Proposal

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[1] The views expressed in this paper are solely those of the author and do not represent an official position of his employer or the Society of Actuaries.

Abstract

The contribution smoothing vehicles embedded in the U.S. pension minimum funding requirements can be summarized as follows: assets are allowed to be smoothed, liabilities are smoothed by using smoothed interest rate assumptions, and gains and losses in the unfunded accrued liability are further smoothed by amortizing them over five years. Finally, just as "smoothing" seems to be a major theme of the system, the deficit reduction contribution (DRC) trumps all prior smoothing with its volatility-increasing override. Having a funding system that smoothes input parameters (assets and liabilities) as well as outputs (gains and losses to the unfunded) gives plan sponsors only indirect incentives to manage the true economic state of the plan. The DRC override, though partially effective at increasing the level of plan funding, introduces tremendous contribution volatility into the system despite being based on indirect asset and liability measures of the true economic state of the plan. The challenge this paper tackles is to fix the minimum funding requirements so they balance the need for a healthy funding level with contribution stability and predictability. Rather than suggest patches to the current system, this paper develops a completely new set of minimum funding requirements. This proposal is "not so radical" because it retains the normal cost–plus–amortizations structure of the current system, but it overhauls everything else. The DRC is eliminated, the amortization system is revolutionized, and both assets and liabilities are marked to market. The paper discusses how this system—with several other deviations from the current system—could have significantly lower contribution volatility and earlier contribution predictability while still maintaining a stronger funding level. Although there is no perfect solution to pension funding issues, this system would encourage plan sponsors to manage the true economic state of the plan without imposing excessive contribution amounts or volatility, and it would balance the competing needs of the primary stakeholders in the pension system: plan sponsors, participants, taxpayers, the Pension Benefit Guaranty Corporation (PBGC), and society as a whole.