A Better Defined Benefit Contribution Policy: Contribute No Less than the Normal Cost

David T. Kausch, Ph.D., F.S.A, E.A., M.A.A.A., M.S.P.A.*

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Abstract

A frustrating aspect of pension funding rules for U.S. plan sponsors is that contribution requirements are adversely correlated with business cycles. For example, not only did plan sponsors get hit with large contribution requirements in the perfect storm of the early 2000s, but many sponsors were prohibited from contributing in the late 1990s boom because of full funding limitations.

In this paper I propose that plan sponsors be allowed to contribute the normal cost as a deductible contribution each year. In hindsight, this would have allowed plan sponsors to pay for benefits as they accrued in the late 1990s and ultimately mitigated some of the crash of the early 2000s. This change could be layered onto existing regulations or be part of a new set of regulations.

I demonstrate that a contribution policy allowing contributions to be at least equal to the normal cost will result in less volatility of contributions and improve the funded status over time. Clearly, with this outcome the proposed contribution policy would be better than the current system in the United States, where the full funding limit can restrict contributions to zero.

For comparison, this paper also considers additional proposals:

- *Current Law*—U.S. ERISA/Internal Revenue Code rules
- *Proposal 1*—Allow the normal cost to be a deductible contribution
- *Proposal 2*—Require the normal cost to be contributed each year plus a supplemental contribution if needed
- *Proposal 3*—Eliminate the full funding limitation rules
- *Proposal 4*—President's funding reform proposal.

This paper explores the range of contribution policies allowable under the above sets of rules and determines optimal contribution strategies for different objectives.

I show that adopting Proposal 1 achieves several objectives of the Society of Actuaries' (SOA's) stated funding system constraints, namely:

- Maximum flexibility for participants
- Minimal volatility of contributions for plan sponsors
- Maximum predictability of contributions for plan sponsors
- Minimal risk to shareholders
- Minimal risk to participants
- Minimal risk to guaranty agencies.

The same constraints are examined for Proposals 2–4 with mixed outcomes. Additional funding system constraints as outlined by the SOA will not be addressed.