Funding Reform: Future Directions

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I reviewed two funding reform proposals: the first developed by Jeremy Gold and the second by Mercer actuaries Ethan Kra and Donald Fuerst. The Gold proposal calls for plan sponsors to fully fund their plans at all points in time after a transition period. The Mercer proposal calls for a more moderate approach, whereby plan sponsors would address any unfunded liabilities over a period of years. The Mercer proposal also calls for the volatility of year-to-year contribution requirements to be mitigated through use of a volatility corridor (e.g., changes in contribution amounts would not exceed 2 percent of liability).

Rationale for Advance Funding

To address the appropriateness of different levels of contribution requirements, I believe it is important to go back to basic principles: what is the rationale for prefunding? Sponsors fund their plans primarily for the following reasons:

- Pension benefits are payable over extremely long periods of time, with payments delayed as much as 60 years after benefits are accrued. Over such long periods, substantial business changes can be expected; some companies will fail. Promises of deferred compensation to employees should not rely on the employer's future viability.
- Advance funding helps to spread the financial burden of plan sponsorship appropriately over different generations of shareholders.
- Investment return accumulated within a pension trust receives favorable (deferred) tax treatment.

Without full funding of pension benefits, some benefits will not be paid upon plan termination. Funding these deficits puts a burden on the Pension Benefit Guaranty Corporation (PBGC), and therefore on other plan sponsors who must pay PBGC premiums, as well as on plan participants who may lose some of their expected pension benefits.

Given the plan termination experience of recent years, it seems obvious that there must be some limit on how much pension-related instability society is willing to tolerate. But there also appears to be a limit on how much benefit security plan sponsors are willing and able to pay for. An effective process toward funding reform must recognize and balance these conflicting viewpoints.

Issues Related to Cash Contributions

Cash requirements seem by far the most critical determinant of the financial burden of running a pension plan. (A shortage of available cash flow versus cash commitments is the typical rationale for bankruptcy; it is hard to imagine a plan sponsor going bankrupt as a result of an accounting adjustment.) Absent contribution requirements, at least some plan sponsors would not advance fund their plans at all, preferring to employ all their available capital in their businesses. Requiring some level of advance contributions limits plan sponsors' financial flexibility, but does so for an important public policy reason: to ensure a level of benefit security when companies fail.

Given that advance funding is necessary, plan sponsors uniformly state a preference for relatively stable and predictable contribution amounts. Volatility is perceived to have a cost, particularly when the variation in required contributions is negatively correlated to the economy's—and even more critically, the company's—business cycle.

Requiring that plans maintain a fully funded position at all points in time presumes that plan sponsors are willing to accept the responsibility—and the added cost—for providing absolute benefit security. This is far from clear, for the following reasons:

- Such a funding approach entails forfeiting what has been traditionally viewed as the financial advantage related to the sponsorship of a long-term benefit commitment—the ability to invest for the long term and weather the impact of short-term volatility.
- This volatility in contribution requirements resulting from a mark-to-market/full funding approach would be viewed as extremely burdensome.
- Options available to fully mitigate the volatility of contribution requirements would add extremely significant cost and likely make defined benefit plans seem uneconomic: that is, the higher cost would outweigh the perceived value of benefits in the eyes of both employers and employees.

This type of funding system would also create an imbalance, in that sponsors would be forced to pay for any deficits that arise as a result of unfavorable capital market conditions while not being able to access the surplus funds that accumulate during more favorable times.

The costs related to contribution volatility can be viewed in two ways:

1. the degree of expected year-to-year contribution volatility given a typical asset strategy
2. the increase in expected cost over time under a highly matched asset/liability strategy.

In forecasts developed for a benchmark plan funded with a typical 60-40 asset strategy, it was found that a requirement to maintain full funding based on mark-to-market measurements for assets and liabilities would entail annual contributions that potentially reach as high as 35 percent of payroll, and year-to-year changes in contribution amounts that regularly hit 20 percent of payroll. A more smoothed contribution methodology, on the other hand, entailed maximum annual contributions in the range of 15–20 percent of payroll, and year-to-year changes that topped off at about 8 percent of payroll.

The cost attached to an asset-matching strategy designed to mitigate this volatility is also very significant. As an example, the present value of a benefit payable 40 years in the future was found to more than *double* if funded using an all-bond strategy as compared to an effectively diversified 60-40 investment approach.

The Situation for Plan Sponsors

As the regulatory environment for defined benefit plans is currently structured, it seems obvious that plan sponsors do not bear the burden of fully securing plan benefits at all points in time, regardless of economic conditions or business results. With respect to their unfunded benefit promises, plan sponsors may well view their situation as one that includes the following offsets to their liability for unfunded benefit amounts: (1) a put to the PBGC, (2) a secondary put to plan participants, and (3) an absolute limit based on the level of equity in the company.

If there were no PBGC, and shareholders were forced to bear unlimited responsibility for paying benefits regardless of the financial viability—or value of equity — in the company, then full funding of all plan benefits at all points in the business cycle might seem the reasonable response. Even in this situation, given economic realities it seems obvious that fewer plan sponsors would be willing to either bear this risk or pay the cost of mitigating it, and thus the level of defined benefit plan sponsorship would likely decline.

Finding a Workable Balance

Since the cost of providing absolute benefit security is so high, it seems critical to arrive at a reasonable and economically efficient compromise solution. This should be one that balances the added costs placed on plan sponsors with the level of improvement in benefit security for plan participants.

Such a system likely calls for the following:

- A funding target set to 100 percent of a market-based measure of solvency liability.
- At least some smoothing of results over time, to reduce volatility and mute the connection of contribution requirements to the business cycle.
- Some ability to advance fund in good times and draw down those prepayments under adverse business conditions.
- Some ability to reap the potential benefits of favorable investment performance, that is, when asset values greatly exceed amounts needed to pay benefit obligations.

The bottom line is that any reasonable solution has to incorporate a realistic view of what plan sponsors are committed to provide, and what they are willing to pay for it. A connection needs to be drawn between the added costs and the resultant benefits. A decision to impose higher costs on employers should not be based purely on economic theory without considering the real-world implications.

Critiquing the Mercer Funding Proposal

Under the Mercer proposal, assets and liabilities would be marked to market. This effectively improves the transparency in reported funded status results and facilitates the effective use of asset/liability strategies.

Under Mercer's funding approach, the average funded status of pension plans would be expected to improve dramatically compared to expectations under current law. This means that benefit claims transferred to the PBGC by failing employers would be greatly reduced. The proposed approach also remains sensitive to the financial constraints and objectives of plan sponsors, in that contribution requirements would be relatively stable and predictable.

The less favorable attributes of the Mercer proposal involve the tradeoff between minimizing the level of required contributions versus minimizing the volatility of these contribution requirements. Prioritizing the latter instead of the former, as the Mercer approach does, implies that in many cases contributions would continue to be required even for plans that have attained a significant surplus position.

Some plan sponsors might prefer to bear the burden of more significant contribution volatility rather than be forced to continue funding their plans under these circumstances. This is especially true when you consider that for many large defined benefit plan sponsors the amount of assets and liabilities entailed by their pension plans equals or exceeds the entire market capitalization of their companies. Given this, one might conclude that the decision to continue contributing to a fully funded plan is one that is best left voluntary.

Another issue with respect to the Mercer approach is the high resulting correlation between the level of funding requirements and the market cycle. Although the dollar response to capital market change is dampened on a year-to-year basis, other smoothing approaches may be more effective at muting this linkage.