conversation with James J. McKeogh

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Actuary James J. McKeogh, FCA, FSA, MAAA, believes that multiemployer pension plan trustees who are trying to assess plan risks need a measurement similar to the passer rating, which considers multiple aspects of an NFL quarterback's performance. Instead of looking solely at one risk, a risk rating that McKeogh has been developing considers several factors to help determine a plan's ability to pay benefits to participants over time. McKeogh, who is the founder of The McKeogh Company in West Conshohocken, Pennsylvania, discussed the benefits of the rating with Editor Kathy Bergstrom, CEBS.

How do most multiemployer pension plans define and measure risk?

Most multiemployer plans do not have a specific definition of overall risk. Rather, trustees may discuss risk in terms of such things as volatility of investment returns as presented in the investment consultant's report. Actuarial reports mention *longevity risk* (people living longer than expected) and *maturity risk* (when a plan has a high ratio of pensioners to active participants). Other risks that are discussed at trustee meetings include shrinking contribution bases, net cash flow, etc.

Another measure of risk is the zone status established by the Pension Protection Act of 2006. Plans are now color-coded, with "green zone" plans being called "safe" and other colors indicating whether a plan is "endangered" or "critical." But that is a broad characterization of plans.

What are the challenges or shortcomings of these approaches?

The biggest shortcoming of each of these approaches is the prospect of false signals—both false negatives and false positives. For example, a plan's net cash flow is usually defined as contributions less the sum of benefits and administrative expenses. Cash flow can be either positive, which is "good," or negative, which is "bad." The problem is that the measure ignores investment income, and it ignores a plan's assets and liabilities. Focusing on the cash flow can create false negatives.

Pension plans typically have a large reserve of assets, which provides investment income. That investment income has to be part of the equation. Assets and liabilities are important because a plan might have assets exceeding its liabilities and may not need any cash coming in.

I have seen reports where the actuaries will note that the plan is in the green zone and, therefore, it is safe. That is oversimplifying because it's not where the plan is at any point in time but where it's headed. If it is 80% funded and otherwise classified as a green zone plan but projected to be 70% funded in five years, that is not good. Conversely, a red zone plan can actually be rather healthy.

The false signals are dangerous and overly simplistic. Further, there is no quantitative measure. Are all green zone plans safe? Are some riskier than others? Can a red zone plan be less risky than some green zone plans?

What alternatives do you suggest?

We are experimenting with a measure that borrows concepts from sports analytics. The measure, which we call the *multiemployer pension plan risk rating,* takes a plan's assets, liabilities, contributions and current costs and blends them into one statistic. It reveals the increase, if any, in employer contributions that would be required after a year in which the investment return for nonmatched plan assets (i.e., assets not matched to specific liabilities) was negative 20%. The required increase is defined as the increase necessary to get the plan to 100% funded

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status in ten years. For this purpose, we define *current costs* as the cost of the benefits being accrued in a given year plus administrative expenses. The rating projects whether a plan can ride out an investment storm and, if it cannot, how much more in contributions it will need to avoid reducing benefits.

For example, if a plan's rating were 50, it would need to increase contributions by 50% to reach full funding in ten years after a 20% investment loss. A risk rating of zero would mean the plan is projected to be 100% funded in ten years with no contribution increase or benefit reduction even after a 20% negative return in one year. The lower the score, the better the risk profile of the plan. I should note that the use of a 20% investment loss for developing the rating is somewhat arbitrary. It is meant to test a plan with a "shock" loss comparable to that in 2008 when the average pension plan lost about 25%.

Our rating is somewhat akin to the quarterback passer rating, which combines pass attempts, pass completions, total passing yards, touchdowns and interceptions into one statistic. The number itself is meaningless but, if you rank everybody, it gets pretty close to identifying the quarterbacks who are better passers. With this pension risk rating, a plan can see how it is performing over time and how it performs compared with other plans.

Why might this be a better way to measure risk?

There are at least three reasons:

1. It is based on the major goal of a pension plan—to accumulate sufficient assets to pay benefits when due. It is a high-level goal and should be foremost in the mind of every trustee.
2. It is quantitative. If the answer to the question is that a 50% increase in contributions would be needed, then the plan has a better risk posture than one that would need a 100% increase. In our look at multiemployer plans, there are a number of plans that do not need any increase at all.
3. It can be compared with other plans at a given point in time, with itself over time, and before and after a given transaction. For example, if two pension funds want to merge, it would help them understand what they are getting into.

The rating also helps avoid the false signals. For example, in our analysis of the Form 5500 database using the risk rating, we found a red zone plan in the top (least risky) quartile. We questioned why it was there. On further review, we found out that the plan subsequently was certified in the green zone. This plan's rehabilitation plan had worked, and the plan had emerged from critical status. Our statistic, in my opinion, was a better indicator of that plan's risk profile than its PPA zone status.

How could multiemployer pension plan trustees use this risk rating to evaluate and strengthen their plans?

The risk rating gives them a better picture of what the risk is. It focuses trustees on the right thing. Plans stand on their heads not to go into the red zone, but that is not the primary goal. Once a consistent measure is established, then trustees can start discussing the management of risk. Using this risk rating, our analysis shows that at least three approaches can improve a plan's risk posture:

- **Improve the funded percentage.** Some plans have already built an excess of assets over liabilities. These plans have a cushion to absorb bad investment results.
- **Increase the contributions that would be in excess of what we have called the current cost.** This is like a household that socks away a portion of any increase in income, like a pay raise, to save for that proverbial rainy day.
- **Match a portion of plan assets to plan liabilities.** This technique is known variously as *asset-liability matching, liability-driven investing* and *immunization*. This is what insurance companies do when they sell group annuities—They get a single sum and construct a portfolio such that assets match the liabilities. We have one client that recently matched assets for a portion of its liabilities—those of the plan's pensioners age 65 and older. They effectively shrunk the plan's exposure to risk and simultaneously addressed the maturity risk.

We believe this risk rating could be a meaningful tool for plans to evaluate their ability to absorb adverse experiences related to the funding of their legacy liability. We hope it will stimulate more discussion about specific strategies to help multiemployer pension trustees and professionals identify and manage the risks associated with these plans.

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