



AMERICAN ACADEMY *of* ACTUARIES

Risk Management and Public Plan Retirement Systems

Prepared by the Public Plans Practices Task Force

American Academy of Actuaries

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Overview:

The Public Plans Practices Task Force appointed by the American Academy of Actuaries board of directors delivered the following report to the board at its fall 2010 meeting. Over the previous two years, the task force examined the complex challenges facing public sector retirement plans, which in many cases have fallen significantly behind their own targets for funding pension promises. With the national economy in distress, and state and local governments facing major budget challenges, public retirement plans are under greater scrutiny than ever. This report is an examination of the issues affecting public sector retirement plans for state and local government employees.

The task force determined that retirement programs benefit from comprehensive risk management, that wider adoption of this approach should be encouraged, and that the actuarial profession should assist by developing additional tools for its application. This report therefore focuses on the need for a risk reporting and governance framework for public pension plans. It is purposely aimed at professionals operating in this arena and outlines a value added process to plans and their advisors, leaving open the choice of specific procedures. We hope and expect that this report will guide the development and application of many risk management tools and methods.

Summary & Recommendation

The report recommends that the American Academy of Actuaries' Board of Directors encourage and coordinate the development of a risk evaluation, management, and reporting framework for public pension plans.

Enterprise risk management (ERM) is a rapidly evolving discipline that is adding value in many fields. The task force believes that the application of ERM techniques to public retirement systems would be highly beneficial. There are, however, a number of practical difficulties

hindering their application. Chief among those difficulties is the lack of a generally accepted framework for the evaluation, management, and reporting of risk in public retirement systems.

This report is not an undertaking to judge the appropriateness of risk taking in a pension plan. Rather, it provides a starting point for the development of a framework for actuaries and stakeholders to analyze and communicate the implications of risk taking to facilitate discussions with and between stakeholders. With a fully developed risk management framework, actuaries will be better able to help stakeholders understand the value of benefits, how risk-taking strategies affect the expected cost to employees and taxpayers (current and future generations), and the downside risk and upside potential to any risk-taking strategy.

The recommendation is based on the following findings:

I. *There is a need for sound risk evaluation and management in public pension plans. Concerns about the potentially precarious financing of state governments and their pension plans need to be addressed through proactive risk management.*

II. *While the financial risks faced by private and public plans are the same, the operational and governance differences heighten the need for a risk management process in public plans to strengthen the ability to balance (1) the fulfilling of the promise of deferred compensation to retiring employees with (2) the need to maintain reasonable workforce compensation (pay and benefits) and (3) reasonable tax assessment.*

III. *A risk-focused reporting and governance requirement will add value by addressing three topics:*

1. Structural incentives leading to moral hazards.
2. The level of risk and potential range of consequences inherent in the system.
3. Possible stresses that could adversely affect the plan members or taxpayers and steps to follow should those stresses occur.

This report and the framework it recommends is intended to help policymakers assess and implement changes to improve the understanding and successful long-term management of public sector retirement policies and promises. A better understanding of how these risks are being addressed serves the public interest and will contribute to the day when pensions are a less controversial aspect of civic governance.

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