Crowe

Managing pension governance and risks effectively

Risk management report 2019

Foreword

We are delighted to present our third edition of our risk management survey, which follows on from our previous surveys, and also considers the implementation of IORP II for UK pension schemes.

The Occupational Pension Schemes (Governance) (Amendment) Regulations 2018 (the Regulations) came into force in January 2019, setting out how IORP II will be implemented in UK law. The Regulations set out a framework for Trustees to demonstrate that they have an adequate and effective system of governance, which is proportionate to the complexity and risk profile of their scheme. The Pensions Regulator (the Regulator) is due to provide further guidance by issuing a code of practice on how the Regulations will be implemented by Trustees in the coming months.

Good governance is the basis of a well-run scheme. It is about having the right structure and processes in place to enable timely and effective decisions to be made by knowledgeable Trustees, in line with scheme objectives. It will also enable Trustees to demonstrate value for money. To assist the Trustees in understanding what actions they need to take, and to demonstrate that they have an effective system of governance in place, the Regulations state that an effective system of governance needs to cover how it:

1. provides for sound and prudent management of activities
2. includes an adequate and transparent organisational structure with a clear allocation and appropriate segregation of responsibilities
3. includes an effective system for ensuring transmission of information
4. includes an effective internal control system
5. ensures continuity and regularity in the performance of its activities, including the development of contingency plans
6. includes consideration of environmental, social and governance factors related to investment assets in investment decisions
7. is subject to regular internal review.

Our survey asked schemes about their existing system of governance and if this is assessed, to demonstrate that it is appropriate for their scheme and who currently performs this assessment.

To assist the Trustees in demonstrating that they have an effective system of governance in place, the Regulations also considers key functions and remuneration policies of schemes. We have asked Trustees whether they have considered this.

The level of risk that Trustees are prepared to accept in pursuit of its objectives, before action is deemed necessary to reduce the risk, is important for Trustees in order to evaluate their key risks and agree actions. Our survey asked Trustees how they incorporate risk appetite into their ongoing risk evaluation.

Cyber and IT factors were also considered and we benchmarked the top risks that Defined Benefit ('DB') and Defined Contribution ('DC') schemes are facing.

Our survey collected the views of individuals with specific responsibility for occupational Trust based DB and DC arrangements in the UK. Where relevant, we have provided respondents' views based on the size of membership of their scheme as detailed in the appendix.

This report, based on 106 responses, sets out the results of our survey. We will use this research to inform our conversations with clients as we help them to develop good governance and make smart decisions for their schemes that will have lasting value.

Judith Hetherington
Partner, Pension Funds

The highlights

Trustees of DB schemes continue to focus primarily on managing funding and covenant risks, whereas Trustees of DC schemes are concerned with ensuring that members are making the right choices at retirement.

For both types of schemes the risk of errors in the administration of the scheme is the second area of focus for Trustees.

78% of respondents confirmed that there is a formal assessment of governance in place and this is performed at least every 3 years. 70% of these respondents believe that their assessment of governance already covers the main elements of the Regulations. Therefore, when the new code of practice is issued by the Regulator, it should not have a significant impact on the majority of schemes.

It is unclear at present what the future code of practice will require from schemes in relation to key functions, namely the risk management function and the evaluation, adequacy and effectiveness of the system of governance. At present, only 53% of schemes have a specific party responsible for the evaluation, adequacy and effectiveness of the system of governance. We consider that this is currently covered by the Trustees but once the code of practice is issued, Trustees will need to consider how the requirements are covered and how this is documented.

52% of schemes have a remuneration policy for Trustees and, where there is a policy place, **only 14%** of respondents **have never reviewed the policy**.

There has been an **increase to 73%** from 50% of **schemes** that are **using risk appetite** and tolerance in analysing risks.

73%

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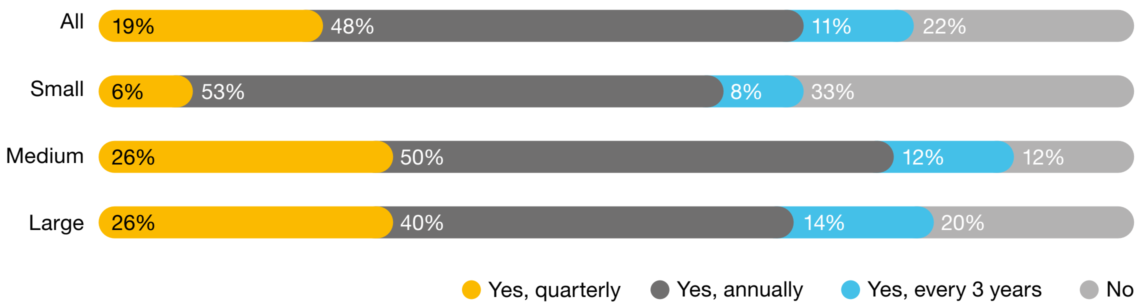
1 in 4 schemes do not have a plan in place **to respond to a cybercrime** breach. Only 33% of schemes have received cybercrime scenario-based training.

Assessment of the system of governance

The Regulations require that a scheme's system of governance should be assessed at least every three years. We asked respondents whether they have a formal assessment of governance in place of their scheme, and if so, how often this takes place:

Figure 1: Formal assessment of governance

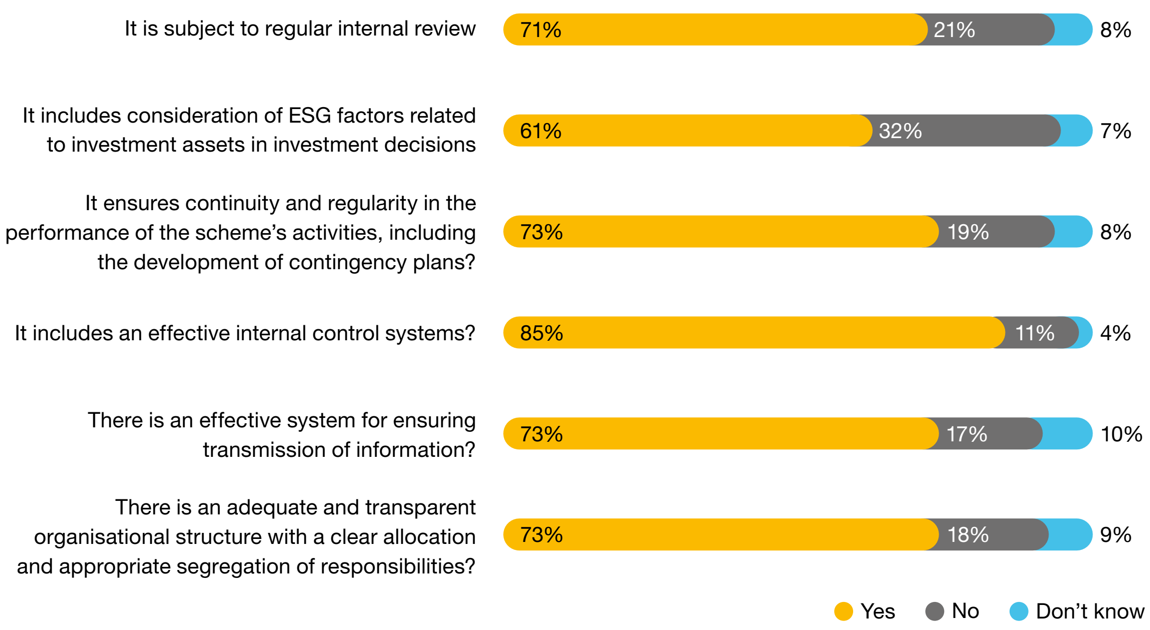


It is encouraging to see that 78% of respondents already assess the system of governance at least every 3 years. Of the remaining respondents, we would argue, based on our experience, that for a proportion of these schemes, the system of governance is assessed on a regular basis but the process is not formally documented.

We then asked what the Trustees assessment of governance covers.

Apart from the consideration of environmental, social and governance (ESG), which Trustees are currently reviewing in light of the changes required to the Statement of Investment Principles in October 2019, it is encouraging to see that over 70% of respondents consider that their current assessment of governance covers all the requirements of the Regulations.

Figure 2: What does the Trustees assessment of governance cover?



However, this does leave a number of schemes who will need to consider how they will assess whether they have an effective system of governance in place, in accordance with the Regulations.

Recognising that the scheme's assessment of their system of governance will need to be documented, we asked respondents where this is currently documented.

Figure 3: Where is the system of governance documented?*

59%
Governance policy documents

33%
Sub-committee minutes

21%
Third party agreements

26%
Internal audit reports

82%
Trustee minutes

62%
Statement of Investment Principles

86%
Risk Register

59%
Business plan

*Respondents were able to choose more than one option when answering this question.

86% and 82% of respondents confirmed that they use the risk register and Trustee minutes to document areas of the assessment of governance. The challenge for Trustees will be embedding this assessment of governance into a tri-annual process, to ensure that this assists them in achieving their overall scheme objectives and obligations, and fulfilling their duty to have an effective system of governance in place.

Who performs the assessment of governance is shown in figure 4.

Over 80% of respondents confirmed that Trustees perform the assessment of the system of governance. 70% of respondents confirmed that three or less parties cover this assessment; mainly the Trustees, secretary to Trustees and pensions manager. As the assessment will need to be completed at least every three years, Trustees have to consider whether this is an effective use of their time, and whether they should establish an effective plan to ensure the right people are covering the right areas at the right time.

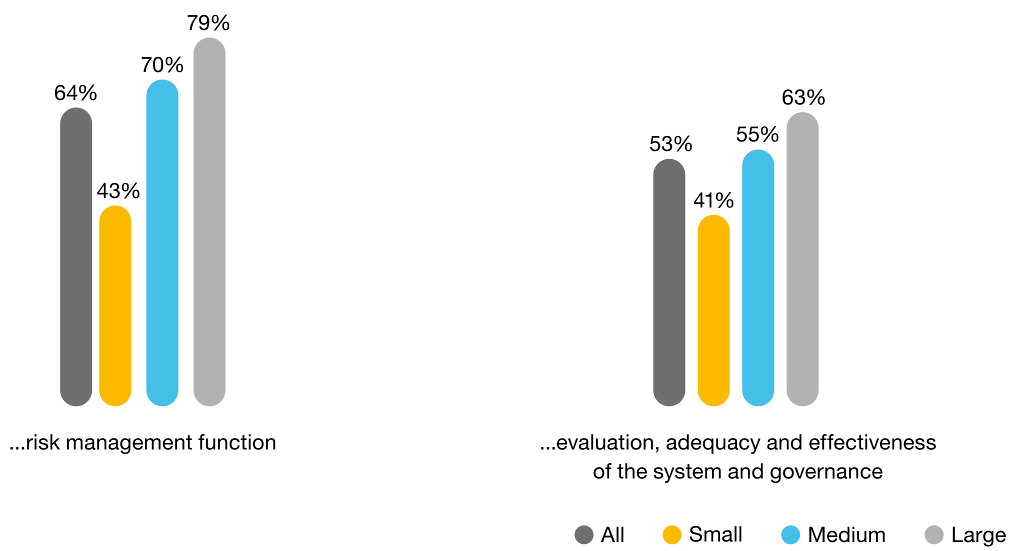
Figure 4: Who performs the assessment of the system of governance*

Key functions

The Regulations introduce the concept of key functions, specifically risk management, evaluation of the system of governance and actuarial matters.

At present the Regulations are unclear on what the nature of the key functions are and who can cover each of them. Therefore, it will be interesting to see how the Regulator clarifies this in the Code of Practice. We asked respondents about whether they have specific parties covering the risk management and the evaluation of the system of governance functions (see figure 5).

Figure 5: % of respondents confirming that there are specific parties who cover the...



It was surprising that only 64% of all respondents confirmed that there are specific parties who cover the risk-management function, as we believed that for the majority of schemes, this would be covered by the Trustees. If the code of practice clarifies that Trustees cannot cover this function, this would be a challenge for schemes.

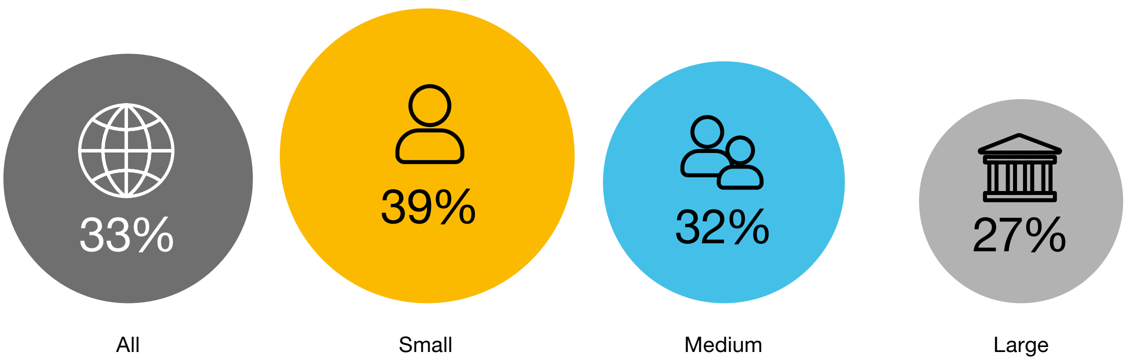
When considering the evaluation, adequacy and effectiveness of the system of governance function, only 53% confirmed there was a specific party covering this function. We anticipate once the code of practice is issued, Trustees will need to consider how this requirement is covered and how it is documented.

It is not clear under the Regulations whether the same person or organisation are able to cover both the risk-management function and the evaluation, adequacy and effectiveness of the system of governance function. We therefore asked the Trustees if they separate these functions for their scheme.

Figure 6 shows that a third of all respondents confirmed that the same party currently covers both of these functions.

Trustees will need to consider how they will address this requirement if the same individual or organisations are not able to cover both functions, with the limited resources currently available to them.

Figure 6: % confirming the same specific individuals or organisations cover both functions as shown in figure 5



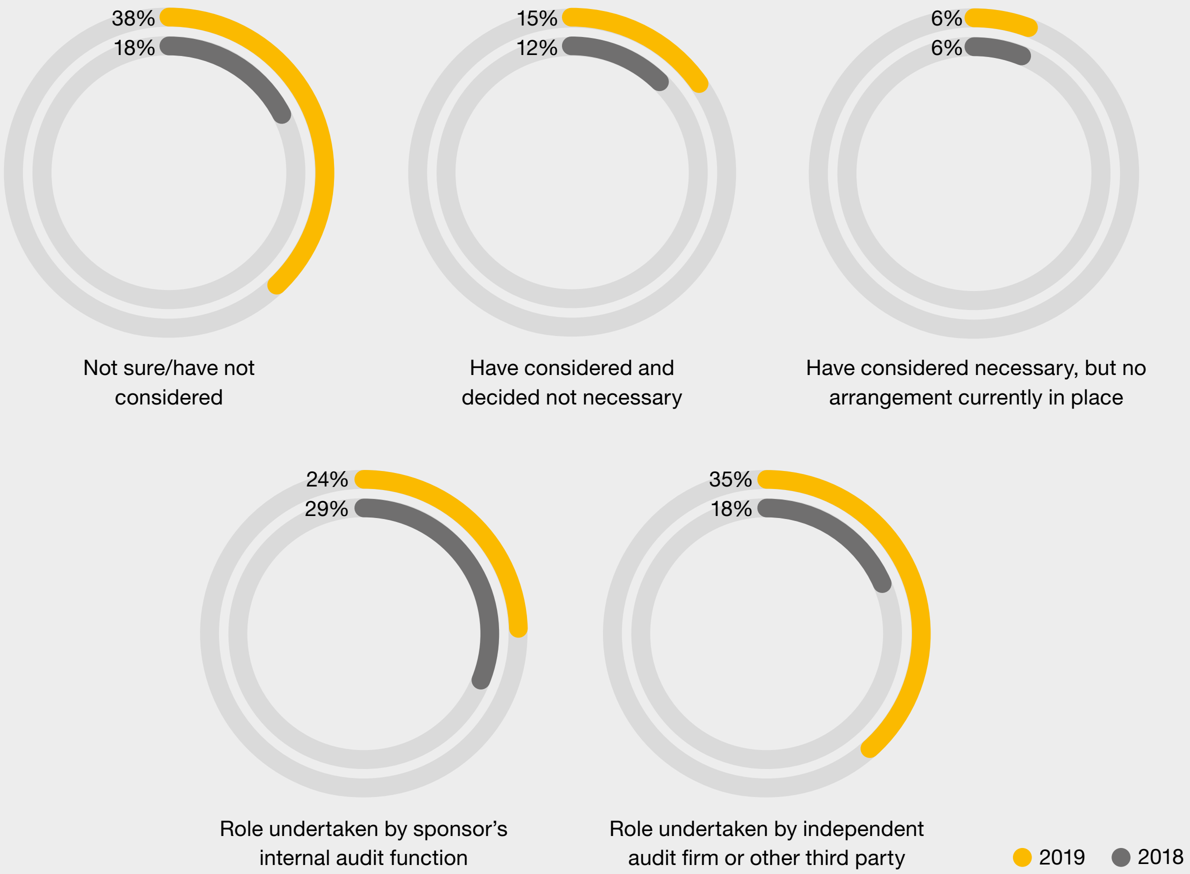
Internal audit

Recognising the possible need for an independent oversight for the assessment of scheme controls during the risk assessment, this year's survey identified the trends regarding the use of an internal audit function or specialist, to assist Trustees in their risk management practices compared to the previous year.

The results, in figure 7, highlight a shift away from using any type of internal audit function over all sizes of scheme and an increase in the number of schemes that have not considered this at all over the last 12 months.

Trustees will need to consider how they will obtain assurance over the assessment of governance, and whether an internal audit function is the right option for their scheme in light of the future requirements of the code of practice.

Figure 7: Respondents' views on who fulfils the role of internal auditor for their pension scheme



Remuneration policies

Although the Regulations state that the Code of Practice needs to cover remuneration policies, it is currently not clear what this actually means.

When respondents were asked whether they have a remuneration policy in place and how often this is reviewed, the majority of respondents confirmed that there is a remuneration policy for external parties. We would also expect that for all schemes, the costs charged by external parties are covered by the contract between the two parties.

Figure 8: Do you have a remuneration policy for:

	All	Small	Medium	Large
Trustees	52%	33%	59%	66%
Pensions manager	37%	24%	45%	42%
Administrators	66%	63%	65%	72%
Actuarial function	66%	65%	65%	66%
Other advisors	63%	62%	62%	66%

Proportion of respondents answering positively

Figure 9: How often is the remuneration policy reviewed

Size of scheme	Every year?	Every three years?	Ad hoc?	Never?
All	27%	18%	42%	14%
Small	15%	21%	47%	18%
Medium	38%	12%	32%	18%
Large	27%	21%	45%	6%

Proportion of respondents answering positively

48% do not have a remuneration policy for Trustees, and this increases to 67% of respondents in small schemes.

37% have a remuneration policy for the pension's manager, probably because the employment contract will be with the employer.

86% confirmed that they review their remuneration policies either every year, every three years or on an ad hoc basis.

It is unclear whether the code of practice will include any requirement to review remuneration policies, but we would expect this to be at the same frequency as the own-risk assessment requirements.

We speculate that the remuneration policy will need to consider the quality of service that the scheme receives, and whether this provides value to members and the scheme. The cheapest contract does not always provide value for money.

Risk appetite and tolerance

As reported in 2018, the Regulator suggests that Trustees should consider their risk appetite and tolerance for risks, when determining potential risk prioritisation and mitigation techniques.

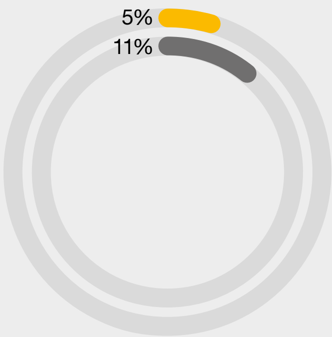
This may be extended to cover the assessment of the system of governance and therefore, we have summarised the movements since last year's survey on the progress that Trustees have made in relation to this (see figure 10).

It is encouraging to see that there has been an increase from 50% of schemes to 73% of schemes using risk appetite and tolerance.

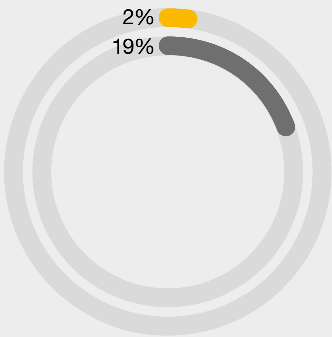
When analysing the responses between the sizes of scheme based on membership, there is an expected difference in using risk appetite/tolerance concepts between the larger schemes and smaller schemes.

For the smaller schemes it would seem that following the Regulator's suggestions, a generic statement was put in place, to ensure that the scheme is covered, but these are not actually used in practice. This is probably due to limited resources or time to enable the Trustees to use these concepts effectively.

Figure 10: Has your Trustee body discussed topics such as the Trustees' Appetite or Tolerance for risk?

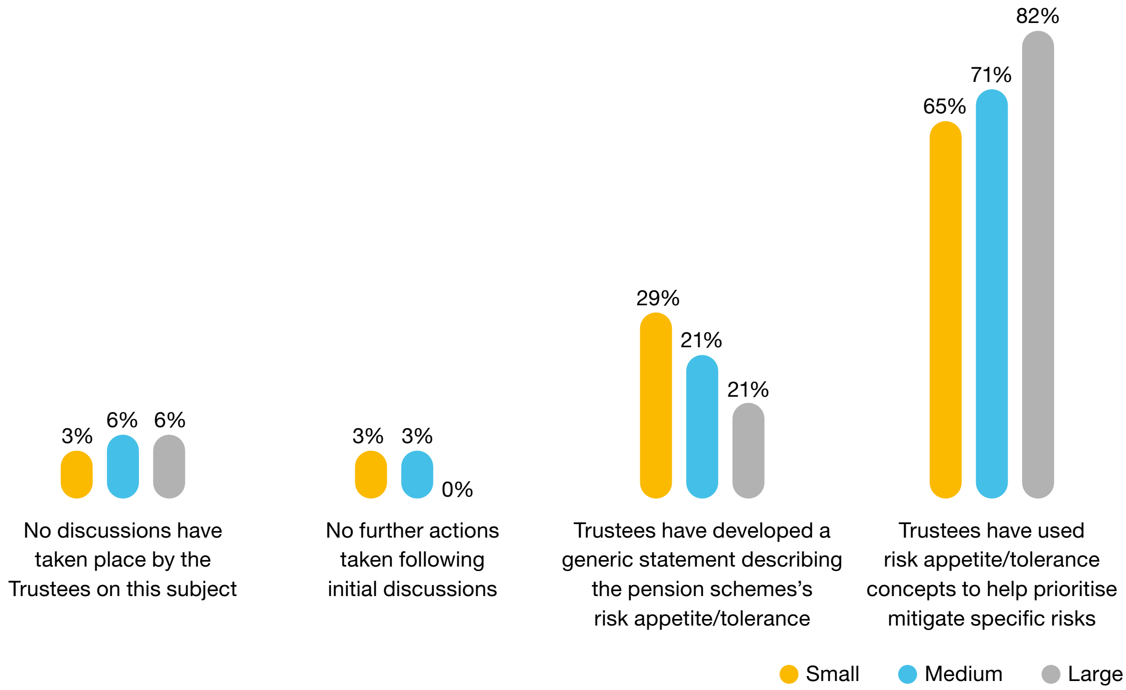


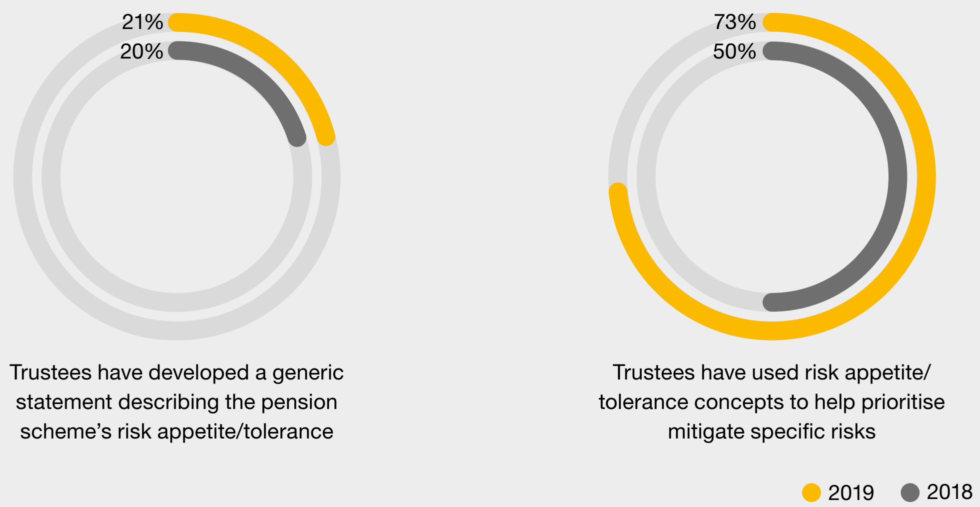
No discussions have taken place by the Trustees on this subject



No further action taken following initial discussions

Figure 11: Has your Trustee body discussed topics such as the Trustees' Appetite or Tolerance for risk?

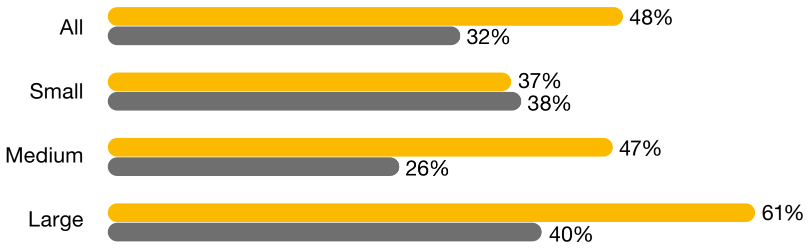




Cyber and technology

Technology and cyber risk has remained in the top 10 risks for pensions schemes over the last three years. Regarding cybercrime, the Trustees have…

...met the Cyber Essentials plus standard



...identified the key operations, IT systems and information flows vulnerable to cybercrime

...a plan in place to respond to a cybercrime breach

It is encouraging that across schemes of all sizes, the awareness and considerations of cyber and technology risks have increased. This is especially evident in the medium size schemes, where it is obvious this has been high on Trustees' agenda over the last year. However, it is concerning that there are still one in four schemes that do not have a plan in place to respond to a cybercrime breach. More than 50% do not meet the cyber essentials plus standard, which the Regulator recommends is adopted for managing potential cybercrime issues.

Figure 12 and 13 show that work is still to be done, with over 25% of schemes still not having assessed the vulnerability of their third party suppliers. This drops to over 30% for smaller schemes, where it is more likely that greater reliance is placed on external parties.

Although more Trustees now have a plan in place in case of a cybercrime breach, we would question whether Trustees are aware of how these plans would work in practice, as under 34% of schemes have actually received scenario based training.

Figure 12: Assessment of third party suppliers

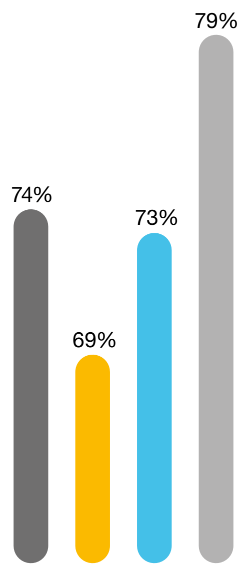
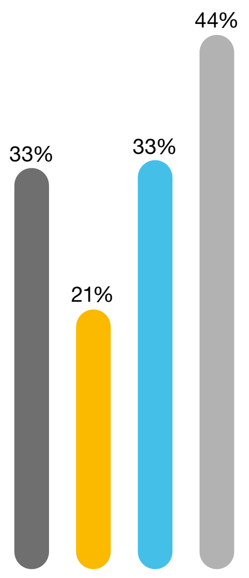


Figure 13: Received scenario based training



DB top pension risks trends

Figure 14: DB top pension risks trends

	2017	2018	2019
1st	Funding volatility	Employer covenant ↑	Employer covenant →
2nd	Employer covenant	Funding volatility ↓	Funding volatility →
3rd	Investment under-performance	Investment under-performance →	Inappropriate investment strategy ↑
4th	Inappropriate investment strategy	Inappropriate investment strategy →	Investment under-performance ↓
5th	IT/Cyber risk	Administration ↑	Administration →
6th	Trustee capabilities/ governance	Meeting regulatory/ compliance requirements ↑	IT/Cyber risk ↑
7th	Administration	IT/Cyber risk ↓	Trustee capabilities/ governance ↑
8th	Meeting regulatory/ compliance requirements	Sponsor/Trustee relationship ↑	Sponsor/Trustee relationship →
9th	Sponsor/Trustee relationship	Trustee capabilities/ governance ↓	Fraud/scams ↑
10th	Quality risk management	Quality risk management →	Meeting regulatory/ compliance requirements ↓
11th	Fraud/scams	Fraud/scams →	Quality risk management ↓

As in previous years, financial risks dominate the top risks facing DB schemes, with the only change being 'investment underperformance' overtaking 'inappropriate investment strategy' in the rankings.

Trustees and advisors have spent a significant amount of time over the last five years putting an investment strategy in place covering, de-risking and the growth portfolio. The concern now is that this does not deliver.

Other trends show 'frauds and scams' entering the top 10 risks for the first time, probably due to the well published issues over the last year. 'Meeting regulatory/ compliance requirements' has dropped from sixth biggest risk to 10th as there have not been major changes for DB schemes this year. We would expect this to change in 2020, following the announcement by the Regulator that they will be combining their codes of practices.

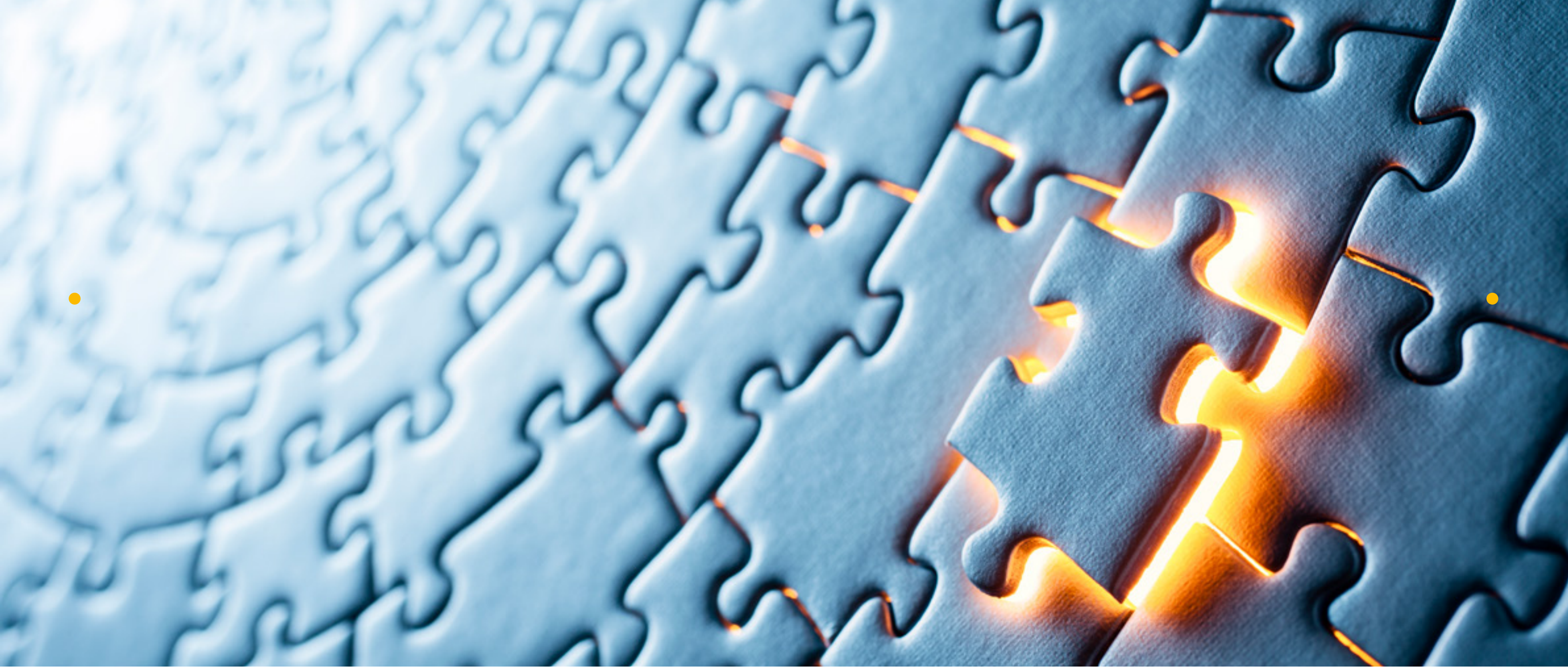
The difference in views between small and large schemes based on membership

- **Smaller schemes** (less than 1,000 members) had 'administration' above 'inappropriate investment strategy' and 'Fraud/scams' ranked as the seventh biggest risk compared to 10th for the larger schemes.
- **Medium schemes** (between 1,000 to 9,999 members) had 'meeting regulatory/compliance' ranked as seventh compared to 10th for the other scheme categories.
- **Large schemes** (greater than 10,000 members) ranked Trustee capabilities as fifth, three places higher than the other two scheme categories.

DC top pension risks trends

Figure 15: DC top pension risks trends

	2017	2018	2019
1st	Delivering 'Value for Members'	Investment performance monitoring ↑	Inappropriate decision making by members at retirement ↑
2nd	Design of default fund	Design of default fund →	Design of default fund →
3rd	Poor communications	Delivering 'Value for Members' ↓	Delivering 'Value for Members' →
4th	IT/Cyber risk	Poor communications ↓	Member administration & record-keeping ↑
5th	Investment performance monitoring	Inappropriate decision making by members at retirement ↑	Meeting regulatory/ compliance requirements ↑
6th	Member administration & record-keeping	Meeting regulatory/ compliance requirements ↑	Poor communications ↓
7th	Inappropriate decision making by members at retirement	Member administration & record-keeping ↓	IT/Cyber risk ↑
8th	Meeting regulatory/ compliance requirements	IT/Cyber risk ↓	Trustee capabilities/ governance ↑
9th	Fraud/scams	Fraud/scams →	Investment performance monitoring ↓
10th	Trustee capabilities/ governance	Inadequate Controls ↑	Fraud/scams ↓
11th	Receiving contributions on time	Trustee capabilities/ governance ↓	Receiving contributions on time ↑
12th	Inadequate Controls	Receiving contributions on time ↓	Inadequate Controls ↓



For DC schemes in 2017 and 2018, the top two risks were seen as the 'design of the defaults fund' and 'delivering value for members'. However, this year, these risks have been overtaken by 'inappropriate decision making by members at retirement'.

We know that Trustees spent a significant amount of resources in 2017 and 2018 to enable them to fulfill the DC Chair's Statements requirements. Now the focus seems to have shifted, to ensure that members are making the right decision for their circumstances.

The 'investment performance monitoring' risk score, which increased by 60% in 2018, fell by more than 50% over the last 12 months. We believe that this is because Trustees now have the systems in place to provide them with accurate and timely information on performance.

Other trends show 'member administration and record-keeping' rising to the fourth largest risk.

The difference in views between small and large schemes based on membership

- **Smaller schemes** (less than 1,000 members) had 'design of default fund' as the top risk and 'meeting regulatory and compliance' as second risk. 'Fraud and scams' was the fourth top ranked risk compared to 10th for the larger schemes.
- **Medium schemes** (between 1,000 to 9,999 members) had 'member administration and record keeping' as the top risk compared to fifth for the other scheme categories.
- **Large schemes** (greater than 10,000 members) ranked 'Poor communications' as fourth, three places higher than the other two scheme categories.

Conclusion

Our findings clearly demonstrate that the majority of schemes already have many of the requirements of the Regulations covered through their existing processes. However, there will be work to be done. Here are six areas that Trustees may want to consider:

1

Whether the existing assessment of governance covers the requirements of the Regulations and consider how this is formally documented.

2

How to use risk appetite/tolerance concepts as part of the assessment of the system of governance. As schemes have limited resources, this will ensure schemes establish and operate an effective system of governance.

3. Whether the right people are performing the assessment of the system of governance as this will need to be completed every three years.

4. Whether the remuneration policies consider the quality of service that the scheme receives and whether this provides value to members and the scheme.

5. How they will obtain assurance over the assessment of governance which includes demonstrating that effective internal controls are in place. Trustees may wish to consider whether an internal audit function is the right option for their scheme.

6. The pension scheme’s potential vulnerability of their third party suppliers to cybercrime should be a priority. Additionally, the Trustees need to know that they have a plan in place to respond to a cybercrime breach and that it is fit for purpose.

How Crowe can help

Trustee effectiveness

The success of pension schemes in providing the best possible outcomes for members will be enhanced by an effective Trustee Board.

This means that we need to understand what skills, expertise, experience and personalities are on the Trustee board, to enable us to provide you with constructive feedback so that you can drive the scheme forward to meet its objectives.

We also need to understand your structures and processes which support your decision making.

Risk assessment

With the expanding regulatory requirements on Trustees to take ownership of risk management of their schemes, having good systems in place is vital to ensure compliance.

We help and support Trustees by evaluating pension scheme governance arrangements, including risk management, policies and practices.

This will lead to good decision making and good member outcomes.

Internal audit/assurance

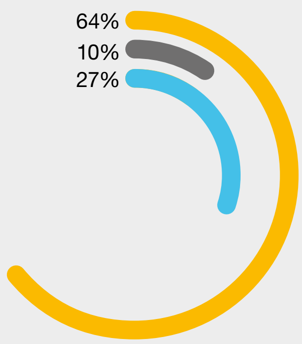
Our internal audit approach is delivered through co-sourcing, outsourcing or a combination of these approaches.

Our pensions internal audit service provides assurance that appropriate policies, procedures and controls are in place to mitigate key pension scheme risks as part of good scheme governance and supports the latest ‘21st Century Trusteeship’ initiative and Codes of Practice issued by the Pensions Regulator.

Appendix: Summary of participants

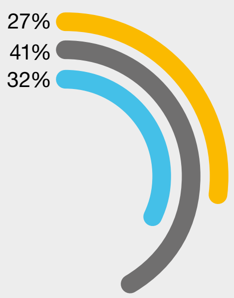
In total, we had 106 responses to our survey, covering a broad range of occupational Trust based pension schemes in the UK. The breakdown by type of pension scheme, size by net assets and members can be found below.

Type of pension arrangement



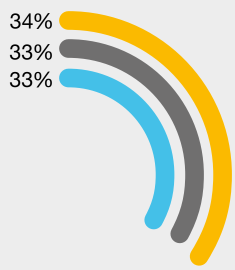
- Trust based DB
- Trust based DC
- Hybrid (i.e. both DB and DC)

Size of pension arrangement



- Less than £100m assets
- £100m –£1,000m assets
- More than £1,000m assets

Type of pension arrangement



- Less than 1,000 members
- 1,000–9,999 members
- More than 10,000 members

Start the conversation

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About Us

Crowe UK is a national audit, tax, advisory and risk firm with global reach and local expertise. We are an independent member of Crowe Global, the eighth largest accounting network in the world. With exceptional knowledge of the business environment, our professionals share one commitment, to deliver excellence.

We are trusted by thousands of clients for our specialist advice, our ability to make smart decisions and our readiness to provide lasting value. Our broad technical expertise and deep market knowledge means we are well placed to offer insight and pragmatic advice to all the organisations and individuals with whom we work. Close working relationships are at the heart of our effective service delivery.

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