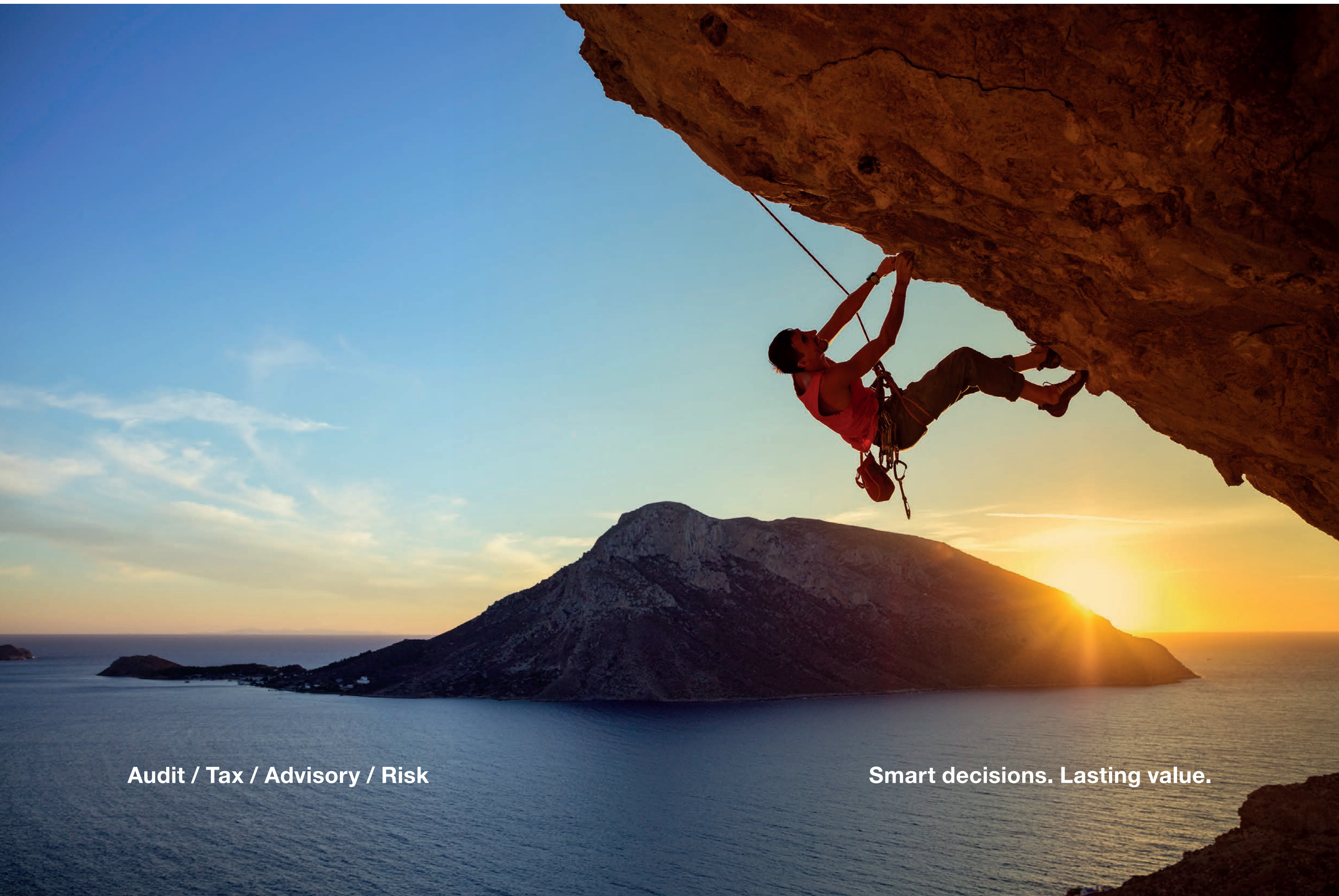
Crowe

Managing pension risks effectively

Risk management survey 2018

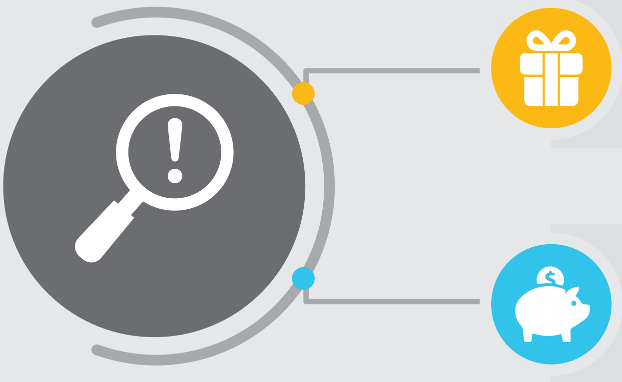


The highlights

Almost **90%** of respondents feel that **managing pension risks** has become **more challenging** in the last 12 months, primarily due to increased complexity of Defined Benefit (DB) risks and increasing numbers of Defined Contributions (DC) risks.

40% of schemes (assets exceeding £1 billion) spent less than three hours in the last 12 months considering Integrated Risk Management (IRM) concepts such as risk appetite, co-dependent risks and contingency planning.

Trustees of DB schemes continue to focus primarily on managing financial risks (particularly sponsor's covenant) whereas Trustees of DC schemes are concerned with investment monitoring and members making the wrong decisions. Key risks concerning Trustees include the following:



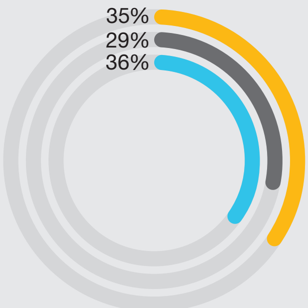
DB pension arrangements: the strength of the employer covenant, funding volatility and implementing an inappropriate investment strategy.

DC pension arrangements: poor investment performance, designing the default fund and poor communication.

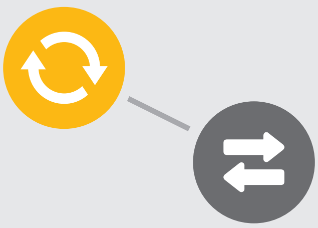
Whereas last year, many of the top risks were perceived to be equally important, employer covenant risk (for DB schemes only) is now perceived by Trustees and pension professionals as the most significant risk.

Managing pension risks effectively remains a challenge for many Trustees, particularly when it comes to ensuring that risk controls are both effective and actively managed. Despite this, respondents are confident that their current risk controls are mitigating most of their risks but less confident with risks such as **cybercrime and fraud**.

- Approximately one third **(35%)** of pension schemes (particularly the larger schemes) have appointed an independent audit firm or other third party as internal auditors to help them manage their risks.
- **29%** rely on the sponsor for resources and expertise.
- **36%** of pension arrangements who do not operate any form of internal audit function whatsoever.



A relatively small proportion of pension arrangements have actually implemented de-risking solutions such as pensioner buy-ins, longevity hedging and enhanced transfer value exercises.



30% of respondents have either not considered or chosen not to use their risk appetite when prioritising or mitigating their pension risks.

Introduction

With almost 90% of respondents telling us that they believe pension risk management has become more challenging in the last 12 months, it is perhaps worth pausing to think why this is perceived to be the case?

Yes, the number of risks and their complexity may have increased slightly, however, by no means to the extent Trustees think. It could be said that what has really changed is the mind-set of Trustees towards pension risk management.

Trustees, are now much more aware of the risks their pension scheme is facing. This is partly due to initiatives run by the Pensions Regulator (21st Century Governance, IRM) which increase the profile of risk management, but also the appearance of new risks requiring different thinking ensure Trustees better understand how risks in general can be managed.

This increased awareness has encouraged Trustees to challenge risk management practices which have been in place for many years, and recognise potential new risks at a much earlier stage in their development.

Pension risk management practices have improved considerably in recent years. However, without doubt further work needs to be done, particularly in areas such as, ensuring risk controls are effective and applicable, considering how the Trustees' risk appetite impacts their approach to managing risks and aligning key risk mitigating actions with Trustees' and sponsors' strategic goals.

Something we encourage all Trustees to consider is to keep things simple and focus on what matters. Too much of valuable Trustees' time continues to be spent focusing on risk scoring/prioritisation and not enough time is spent on discussing quality risk solutions. At the risk of over-simplifying, we would suggest Trustees should ask themselves three very simple questions at the beginning of each Trustee meeting.

01 What are the scheme's top three risks and what are we doing about them?

02 Are we within our risk appetite or tolerance parameters?

03 Are our risk controls working well?

The Trustees should then rely on their pension manager/advisors to manage the risk programme, consistent with the risk management policy, outside of the Trustee meeting and allow the Trustees to take an oversight or strategic role towards risk management going forward.

For both DB and DC schemes, risks are becoming much more scheme specific. The Trustee body's perspective on risk appetite and their approach to managing risks is reflected when presented with differing circumstances.

Top 10 Defined Benefit (DB) pension risks

Looking firstly at DB risks (see table 1), consistently with last year's results, financial risks dominate the top of the table. Whereas the top risks last year were broadly equal in importance, it is a very different message this year. Employer covenant concerns is easily the biggest risk concerning respondents (less so for larger schemes). In fact almost 40% of respondents rated this as their primary concern.

Although the importance score for cyber risk has remained constant in the last 12 months, it has dropped down the table in terms of priority; mainly due to increased concerns relating to the quality of DB administration. Its risk importance score has almost doubled in the last year.

The only significant difference in views between small and large schemes relates to:

- **smaller schemes** (less than £100 million assets) tend to focus almost exclusively on financial risks
- **medium sized schemes** (£100 million to £1 billion assets) were very concerned regarding sponsor covenant risks
- **larger schemes** (greater than £1 billion assets) rated administration concerns before investment risks.

Table 1: Top 10 risks facing DB pension arrangements

1	Employer covenant	3.10
2	Funding volatility	2.05
3	Inappropriate investment strategy	1.68
4	Investment under-performance	1.62
5	Administration	1.12
6	Meeting regulatory/compliance requirements	0.82
7	IT/cyber risk	0.80
8	Sponsor/Trustee relationship	0.80
9	Trustee capabilities/governance	0.58
10	Quality of risk management	0.58

The importance score, which has a maximum score of five, measures how important that risk is perceived to be by respondents.

Top 10 Defined Contribution (DC) pension risks

For DC schemes, concerns were focused on poor investment performance, the design of their default fund and risks associated with poor communications (see table 2).

Poor investment performance and setting the right default fund or investment strategy are perceived to be the top two DC risks, closely followed by the risk of poor communications. The importance score for poor investment performance has increased by 60% in the last 12 months, whereas the scores for the other two risks have remained fairly constant.

Similarly to DB schemes, there was some variation in scoring depending on both the size and type of DC scheme.

- Larger DC schemes were concerned with the quality of communication and meeting regulatory and compliance requirements.
- DC only schemes were concerned with regulatory compliance and cyber risk.
- Hybrid (i.e. DB and DC) schemes were more concerned with risks associated with poor communication and the design of the default funds.

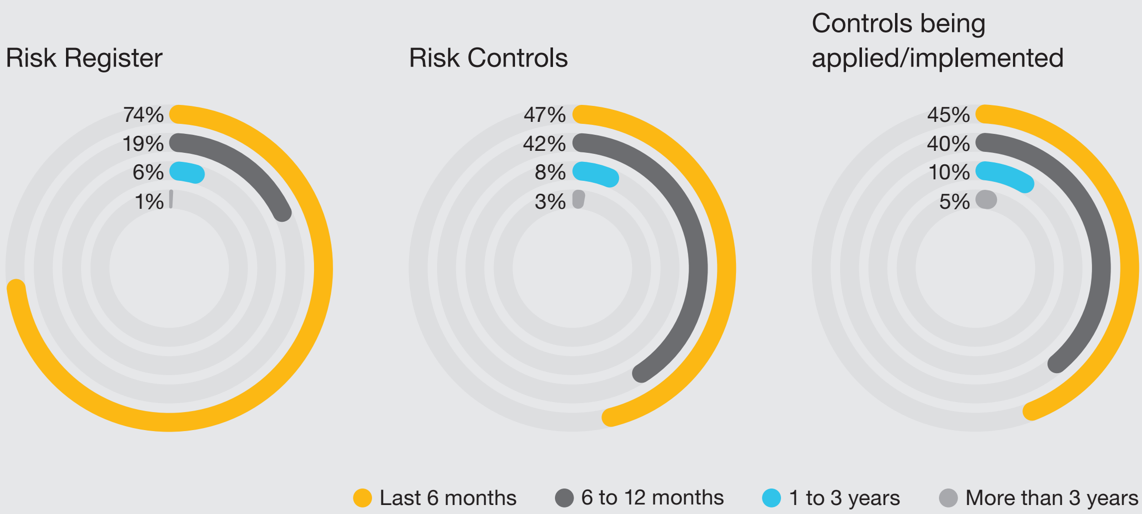
Table 2: Top 10 risks facing DC pension arrangements

		Importance score
1	Poor investment performance	2.18
2	Design of default fund/inappropriate investment strategy	2.05
3	Poor communications	1.97
4	Inappropriate decision making by members	1.51
5	Meeting regulatory/compliance requirements	1.46
6	Administration	1.23
7	IT/cyber risk	1.18
8	Fraud/scams	1.03
9	Inadequate controls	0.69
10	Quality of risk management	0.51

Managing pension risks effectively

How proactively are Trustees managing their pension risks and controls?
We asked respondents to confirm how frequently Trustees reviewed the appropriateness and effectiveness of their risk register and risk controls (sometimes called 'controls' or 'control mechanisms').

Figure 1: How frequently pension risks (and their controls) are being reviewed



It is encouraging to see a large proportion of pension Trustees have reviewed their pension risks in the last six months, particularly their risk register. However, despite reviewing risks within the risk register, risk controls are much less likely to be reviewed. For example, 16% of large pension arrangements have not reviewed their controls during the last year.

We believe the results from our survey suggest a more positive picture than reality. Trustees might think they are reviewing their controls regularly but is the review in sufficient detail to make the results meaningful? In our view, Trustees should occasionally undertake 'deep dives' into specific risks (and their controls), particularly those non-traditional risks (such as cybercrime) which require a different approach.

Identifying areas for improvement regarding controls

Recognising that Trustees are not formally reviewing their controls as frequently (or in as much detail) as they perhaps should be, our focus turned to Trustee perception regarding the adequacy of controls in managing specific pension risks.

Figure 2 and 3 describe respondents' views regarding how effective their controls are in mitigating DB and DC risks.

Defined Benefit arrangements

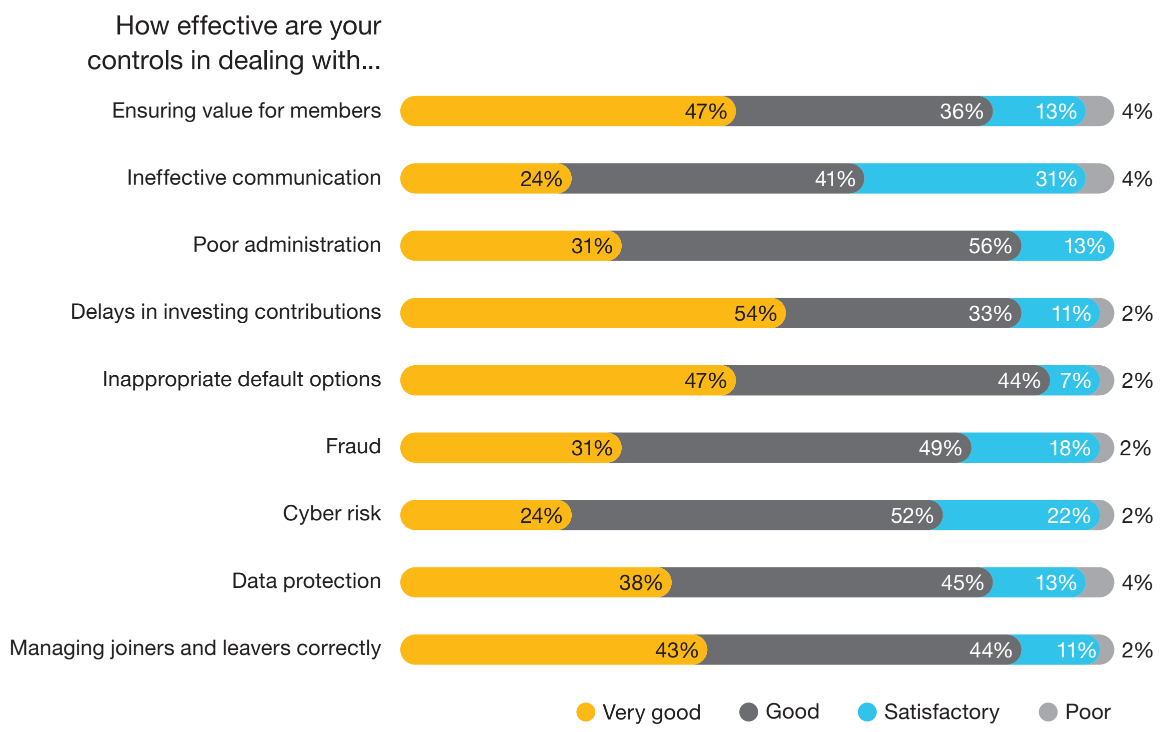
With the exception of cyber risk and arguably fraud, respondents across all groups are very confident that the control mechanisms targeting specific risks are working very well. Large numbers of respondents believe their controls are good or very good.

Figure 2: Effectiveness of risk controls in mitigating DB risk

Defined Contribution arrangements

Trustees feel they are dealing with most risks reasonably well, although perhaps less positive than Trustees responsible for DB pension arrangements. However, they have concerns regarding the controls typically associated with mitigating ineffective communications and, to a lesser extent, cyber risks.

Figure 3: Effectiveness of risk controls in mitigating DC risks



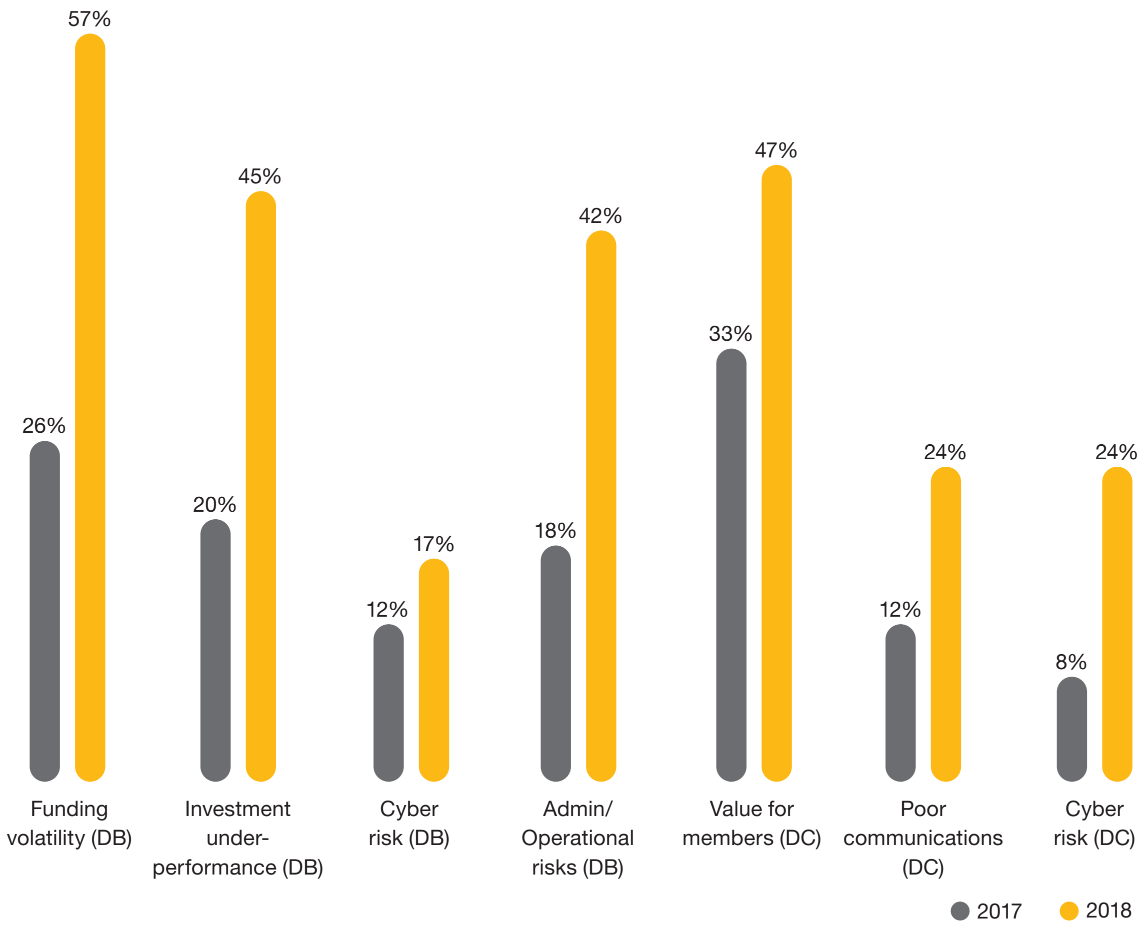
Comparison with last year's results

We decided to analyse if Trustees' confidence in controls was a developing trend or have Trustees always been confident in the ability of their controls to mitigate their pension risks? We compared the responses from our 2018 survey with those we received from respondents who completed a similar question in our 2017 survey. The comparison for a selection of key risks is summarised in the figure 4.

Trustee confidence in their risk controls has increased dramatically in all of the risks highlighted above during the last 12 months. We are unclear at this stage why Trustees feel more confident today but this increase in confidence levels could be one of the reasons why Trustees do not review the controls as frequently or in sufficient detail.

Figure 4: The effectiveness of risk controls in mitigating risks – comparison of 2017 and 2018 figures

The proportion of respondents who rated their risk controls 'very good'



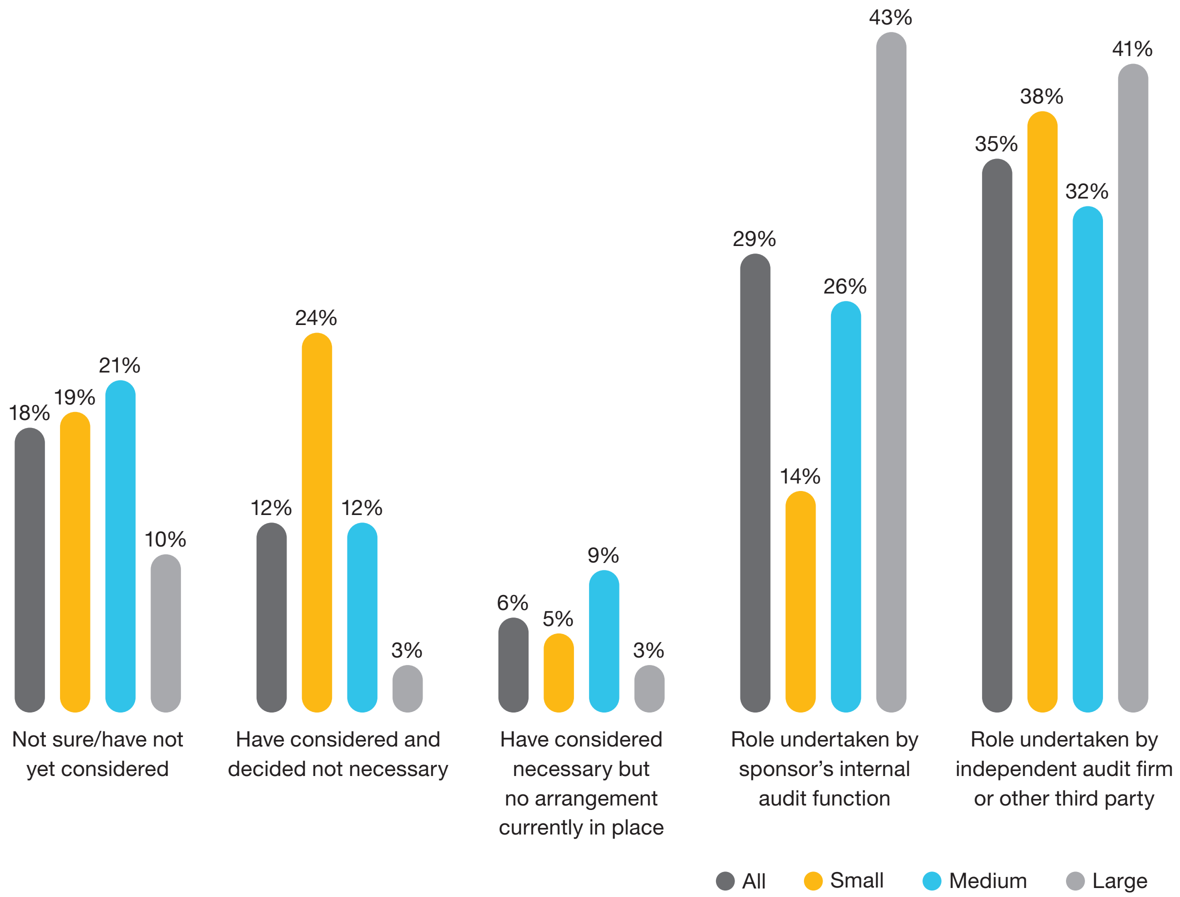
Internal audit assignments to support pension risk management

Recognising the increasing importance of independent oversight capabilities in managing pension risk, this year's survey identified views of Trustees regarding the use of an internal audit function or specialist to assist them with their risk management practices.

The chart below reflects respondents' views (split by size of scheme). 32% to 41% of pension arrangements (depending on size) have appointed an external third party to fulfil their internal audit requirements. Just under half of the remaining respondents make use of the principal employer's internal audit or business assurance function to support them, leaving 36% of pension arrangements with no internal audit function support at all.

Figure 5: The use of internal audit to help manage risks

Who fulfills the role of internal auditor for your pension scheme?



Responding to specific risk issues

De-risking solutions

There is a fundamental difference between managing risks on an ongoing basis and removing risks via de-risking projects, with the latter approach picking up most of the headlines in the press. In reality, as table 3 demonstrates, there have not been as many de-risking projects taking place as you would expect.

With the exception of managing investments consistently with their scheme's liability profile, the number of pension arrangements actively reducing their risks through these types of arrangements is relatively small, although continuing to grow. There is little differentiation by scheme size but longevity hedging is more popular for medium sized schemes compared to the other two categories.

In terms of how successful de-risking projects had been, most respondents were positive with Trustees typically pleased with the results. Longevity hedging and pension buy-in exercises were typically perceived to be the most successful projects, particularly in relation to large pension funds. Enhanced transfer value member exercises were least successful, particularly by smaller pension schemes.

Table 3: Risk reducing solutions for DB pension arrangements

	Proportion of respondents who have implemented de-risking solution(s) in the last two years			
Pensioner buy-out/buy-in	23%	26%	22%	22%
Aligning investments with liability profile	85%	84%	86%	83%
Longevity hedging	25%	11%	36%	13%
Enhanced transfer value exercise	14%	11%	16%	13%
Benefit adjustment exercises (PIE)	15%	16%	12%	22%

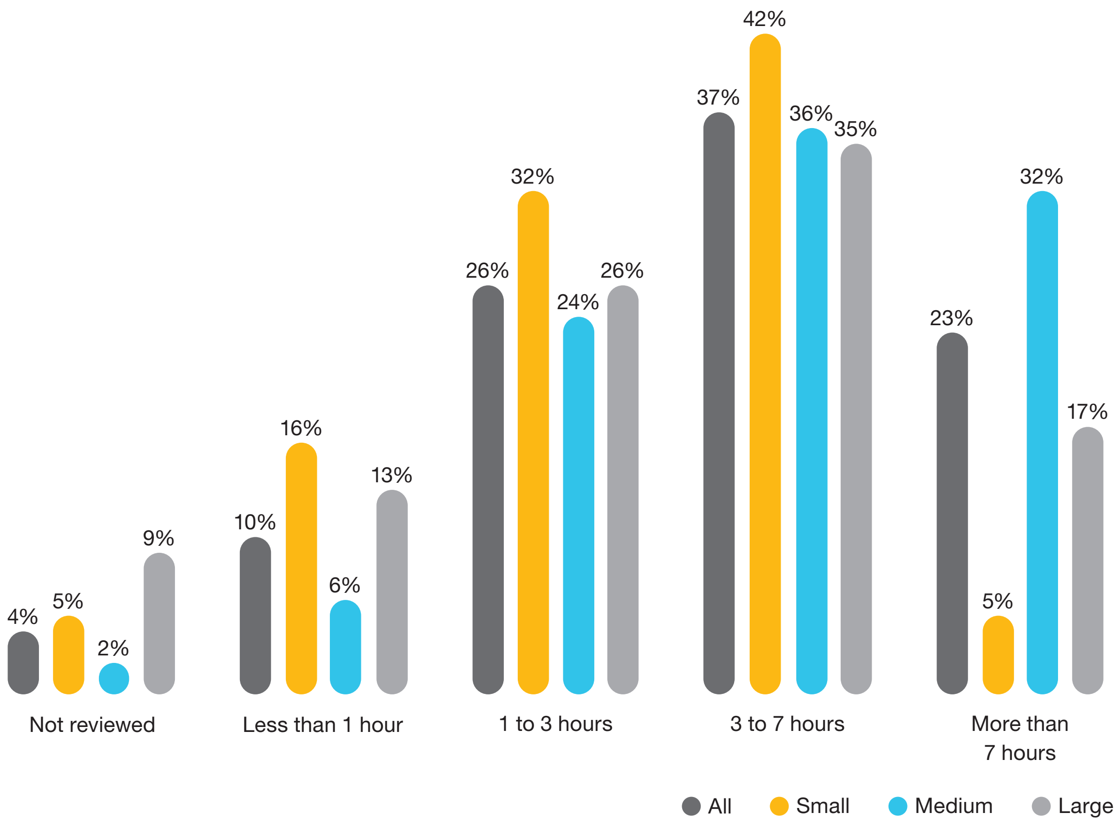
Integrated Risk Management and risk appetite

IRM is obviously a new topic which Trustees are grappling with and results from our survey highlight that most pension arrangements are taking IRM seriously. Figure 6 shows that 60% of pension schemes are spending more than three hours each year considering IRM and related topics. However, of concern is the 14% of pension arrangements who have spent less than one hour on this subject in the last 12 months, including the 22% of large DB pension arrangements.

Perhaps reflecting their concerns regarding employer covenant, medium sized schemes tend to assess IRM implications in more detail than other pension arrangements.

Figure 6: Time spent by Trustees considering IRM related issues in the last 12 months

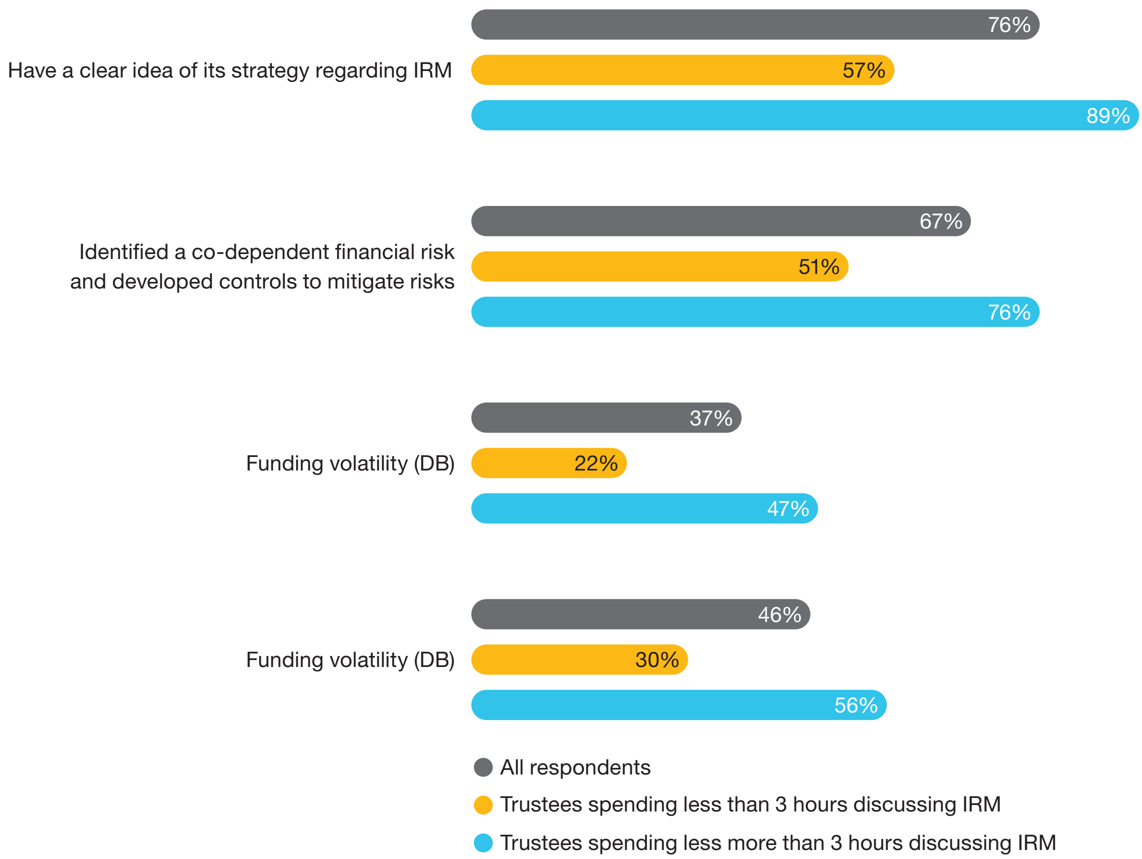
How long did you consider IRM in the last year?



When we explored how successful Trustees were in identifying specific ‘outputs’ as in figure 7.

Figure 7: Typical ‘outputs’ from IRM discussions by Trustees

Following IRM discussions, Trustees...



Our research highlights two findings.

1. Trustees generally still have some work to do in terms of their IRM discussions to identify the key requirements set out by the Pensions Regulator, particularly in the areas of contingency planning and documenting decisions.

2. There is a clear correlation between positive outcomes and time spent discussing IRM, with those organisations spending more than three hours considering IRM being much clearer, or being more comfortable with IRM outputs.

Defining and applying risk appetite when prioritising and mitigating risks

The Pension Regulator suggests that, as part of IRM discussions, Trustees should consider their risk appetite and tolerance for risks, when determining potential risk prioritisation and mitigation techniques.

We asked respondents to tell us if Trustees had discussed these topics and if so, how was the information used by the Trustees.

30% of pension arrangements are not actively using risk appetite and tolerance to help them mitigate their risks, this includes 13% of large organisations. Of those who do, it is encouraging to see that most are actively considering these concepts on a risk by risk basis when mitigating specific risks.

Table 4: The use of risk appetite and tolerance levels in risk management discussions

	No discussions have taken place by the Trustees on this subject	No further action taken following initial discussions	Trustees have developed a generic statement describing the pension scheme's risk appetite/tolerance	Trustees have used risk appetite/ tolerance concepts to help prioritise/ mitigate specific risks
Proportion of respondents	11%	19%	20%	50%

Cyber risk management

Cybercrime and data protection were seen as the fastest growing pension risks in our survey in 2017. Since then, the Pension Regulator has issued guidance on cybercrime.

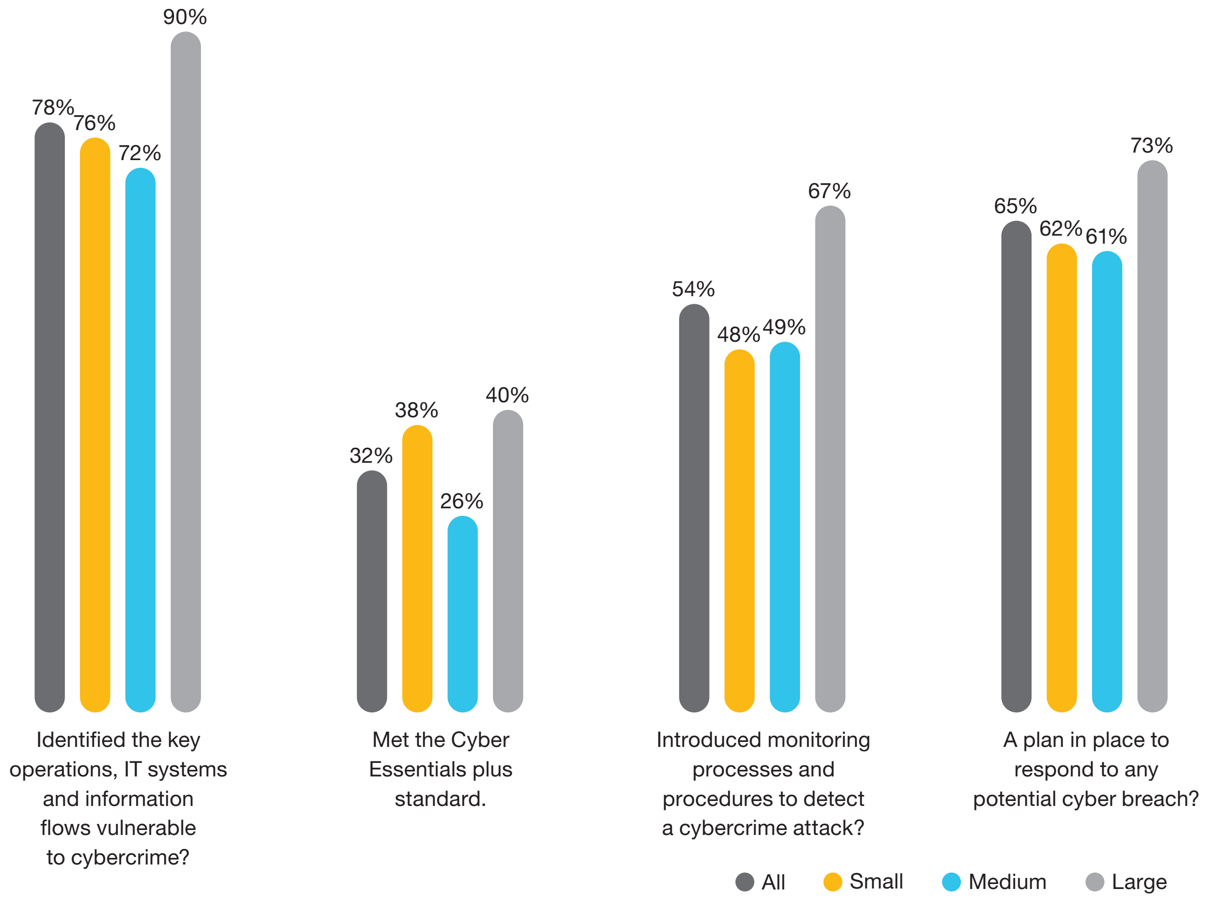
The latest findings show that most pension arrangements have reviewed their cybercrime policies or working practices (including IT systems), approximately two-thirds have a plan in place ready to respond to a cybercrime breach. However, only around half have processes in place to determine when a breach takes place.

Cyber Essentials Plus is the proposed benchmark accreditation which the Pension Regulator recommends is adopted for managing potential cybercrime issues. A higher proportion of respondents (68%) do not currently hold the proposed benchmark accreditations (CEP) recommended by the Pensions Regulator.

We would argue that it is critical that pension arrangements do not just focus on cybercrime prevention solutions, but have a plan in place to deal with different scenarios post-breach.

Figure 8: Potential vulnerability to cybercrime of pension arrangements*

Regarding cybercrime, the Trustees have...



*Respondents answering positively

Conclusion

Our survey clearly demonstrates that there are large numbers of pension schemes in the UK managing their risks in a proactive and professional manner. However, there is always scope for improvement and from the findings in our survey there are a number of areas, which Trustees may wish to explore in the coming months.

1

Focus on what matters: prioritising key risks and focus on their solutions, leaving the details such as risk register, control and risk scoring, to the pension specialists to manage.

2

Embrace Integrated Risk Management as a tool to mitigate risks. This should include a discussion on developing the Trustees' views regarding their risk appetite. Spending quality time discussing these topics (considering financial and non-financial risks) will ensure the Trustees have a clear, focused strategy regarding risk management going forward.

3

Ensure specific DC risks are being managed appropriately within a hybrid scheme, by having at least one DC specialist within their Trustee body going forward.

4

Control mechanisms are not working as effectively as Trustees think they are. This is not helped by two-thirds of pension arrangements not having truly independent internal audit support. Trustees should ideally conduct a detailed ‘deep dive’ on their key risks and controls at least once every two to three years.

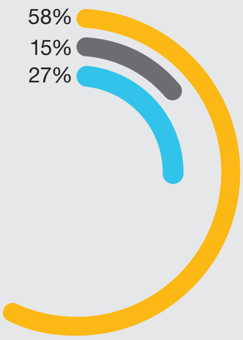
5

Assessing their pension scheme’s potential vulnerability towards cybercrime should be a priority for Trustees especially if they have not done so already. Any review of cybercrime vulnerability should not just focus on solutions relating to prevention but also include preparation of a plan in advance to implement when the cyber-attack occurs.

Appendix: Summary of participants

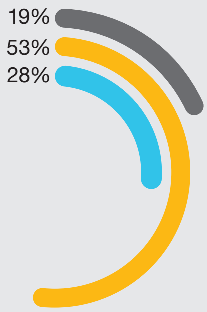
In total, we had 108 responses to our survey, covering a broad range of occupational Trust based pension schemes in the UK.

Type of pension arrangement



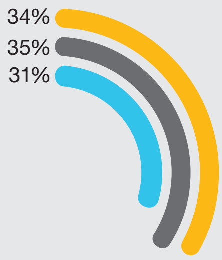
- Trust based DB
- Trust based DC
- Hybrid (DB and DC)

Size of pension arrangement



- Small (Fewer than £100 million)
- Medium (£100 million to £1 billion)
- Large (More than £1 billion)

Analysis of respondents by number of members



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

58% of our respondents were actively involved in a Trust based DB pension arrangement, 15% responded on behalf of Trust based DC arrangements and 27% were involved in some form of hybrid arrangement (i.e. a pension scheme which provides both DB and DC benefits).

The size of pension schemes who responded is measured in terms of the level of pension scheme assets. For the purposes of both this report and our analysis, respondents have been grouped into three categories.

- **Small:** schemes with less than £100 million pension assets (19% of respondents).
- **Medium:** schemes with pension assets between £100 million to £1 billion (53% of respondents).
- **Large:** schemes with pension assets in excess of £1 billion (28% of respondents).

34% of our respondents were actively involved in a pension fund with less than 1,000 members, 35% responded on behalf of a pension fund with 1,000–9,999 members and 31% of respondents responded on behalf of a pension fund with more than 10,000 members.

71% of our respondents confirmed that they had a dedicated pension professional (or team) responsible for managing their pension arrangement. As you would expect, the larger the pension scheme, the greater the likelihood of having pension specialists involved.

Our survey collected the views of individuals with specific responsibility for occupational Trust based DB and DC arrangements in the UK. This report, based on the responses of 108 respondents, sets out the results of our survey and we would welcome feedback from readers on any topics raised within this report.

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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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