A Member of Crowe Horwath International

Managing pension risks effectively

Pension risk management survey 2017

Audit / Tax / Advisory

Smart decisions. Lasting value.

The highlights

There is room for improvement in the way Trustees manage pension risks, particularly non-traditional risk areas such as cyber/data protection risks, documenting risk strategies, establishing good 'Value for Members' and simply finding more time to consider pension risks in a holistic manner.

- With just under 30% of respondents telling us that their pension scheme has not reviewed its risk register in the last six months and 8% not having done so in the last 12 months, there is definite scope for improvement when it comes to pension risk management.
- Trustees of Defined Benefit (DB) schemes focus primarily on managing financial risks, whereas Trustees of Defined Contribution (DC) schemes see the greatest risks as being those potentially resulting in members being treated unfairly or making the wrong decisions.
- The key risks concerning Trustees are:
    - **DB pension arrangements**: funding volatility, the strength of the employer covenant and implementing an inappropriate investment strategy.
    - **DC pension arrangements**: delivering 'Value for Members', designing the default fund and poor communication.

Just below these, featuring in our top 10 risks, are concerns over IT/cyber/data protection risks, which applies across both types of pension arrangements.

- Almost all respondents feel they know their pension scheme's top three risks and can describe how these risks are being mitigated, but is this a personal view rather than a Trustee body view?
- Pension scheme Trustees are comfortable managing financial and regulatory risks, but less comfortable dealing with non-traditional risks. Risks which need to be managed better going forward include:
    - fraud/cyber/data protection
    - changing advisors
    - quality of communications (DC, in particular).
- Typically, smaller schemes have fewer resources available and therefore often outsource pension services. They also tend to spend less time reviewing pension risks and rely heavily on external advisors for support.

Introduction

Risk management is an overused term in our industry and is being used to incorrectly describe solutions which just ***reduce*** risk rather than ***manage*** risk.

Longevity/inflation hedging and liability reduction exercises all claim to be risk management projects. In reality they are solutions which mitigate risks existing within the scheme. For example:

- longevity hedging solves concerns around funding volatility due to changing mortality rates
- effective Trustee governance is a solution to ensure Trustees do not make a wrong decision due to lack of knowledge or insufficient clarity regarding roles and responsibilities.

Risk management is much broader than this. It is an approach to managing pension risks, which focuses on three areas:

- risk culture e.g. what are the Trustees' views on managing risk?
- risk process e.g. how do Trustees' measure risk?
- risk infrastructure e.g. how do Trustees' manage risk?

The diagram below illustrates some of the key issues which need to be considered under each of these broad headings.

As the number of risks and their potential impact on pension schemes increase, now is an ideal time to look at how pension risks are being managed in the UK.

We have 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 145 participants, sets out the results of our survey. We welcome feedback from readers on any of the topics raised within this report.

Who is managing pension risks?

We asked respondents for their views as to who (in addition to Trustee boards) is responsible for managing pension risks for their scheme.

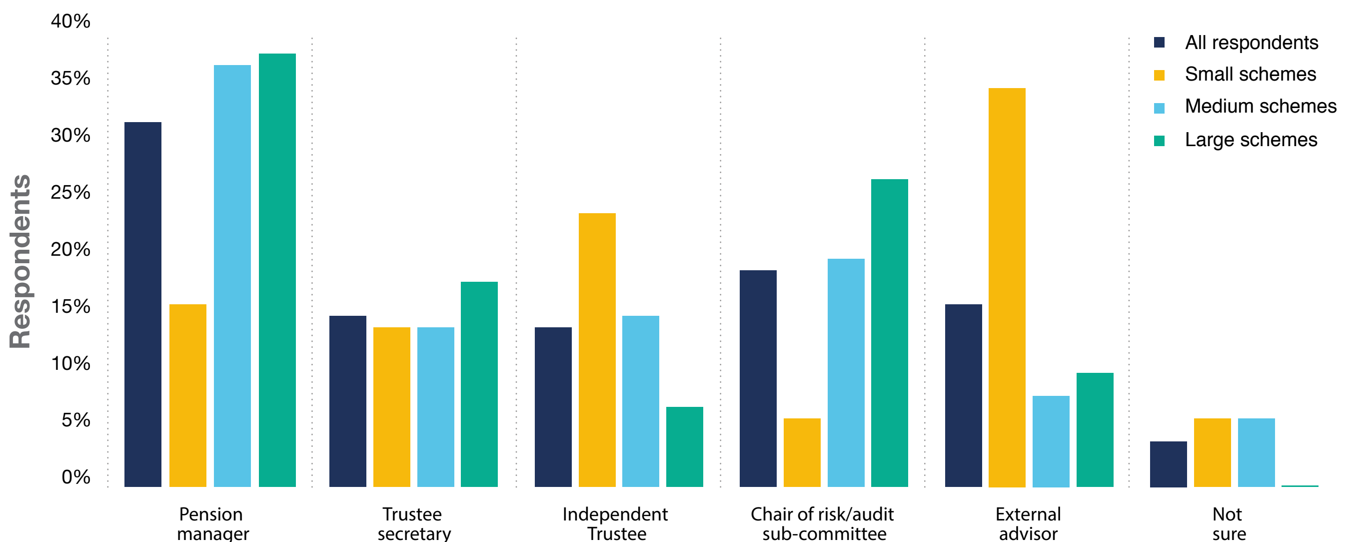
Views regarding who is responsible for risk management varied considerably, both generally and by scheme size.

We estimate that at least 70% of respondents represented pension arrangements which have a dedicated pension manager responsible for their scheme. It is surprising, therefore, that for these schemes, just under half of respondents felt that the pension manager should be responsible for managing risks.

There was no significant variation between DB and DC schemes. However, there is considerable variation in views depending on the size of the pension arrangement.

Trustees of larger schemes (who are more likely to have full-time pension professionals managing the scheme), are more likely to rely on pension managers and risk committee chairs to take responsibility for managing risks.

Trustees of smaller schemes, tend to rely on Independent/Professional Trustees and/or external advisors for direction and support regarding risk management. We question whether Independent Trustees and external advisors are aware that they are expected to fulfil this role?



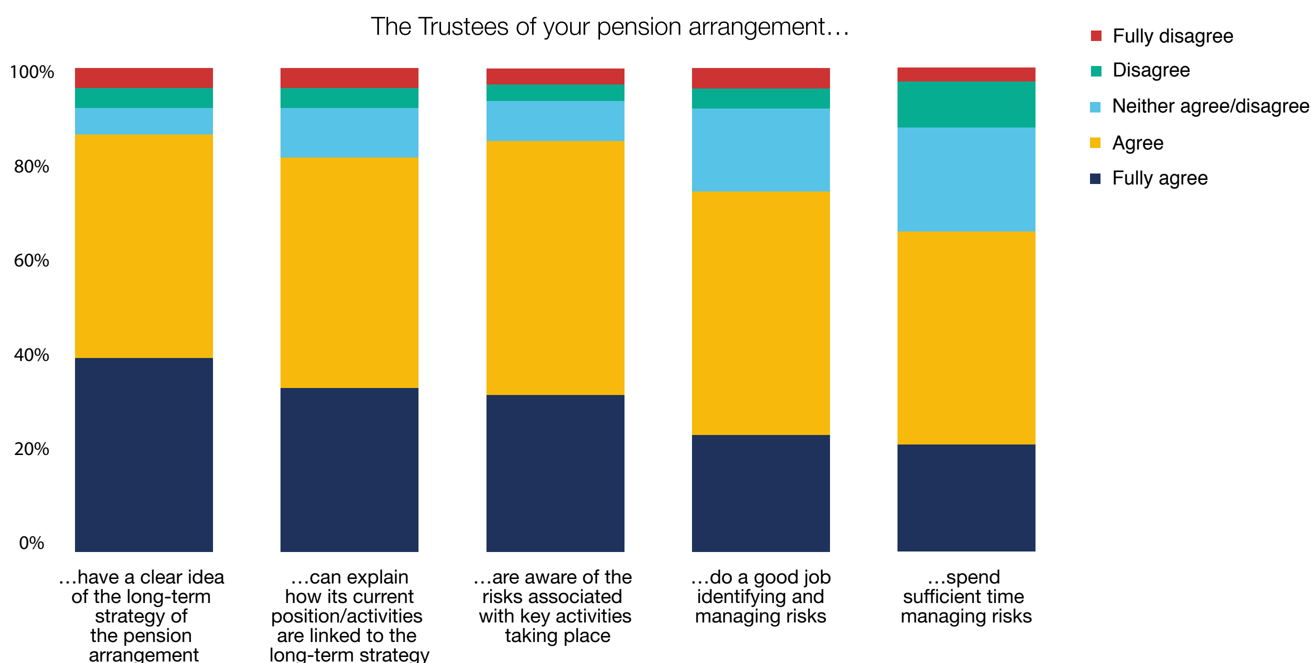
Managing pension risks: are we doing enough?

Aligning risk management practices to help support long-term goals.

In order to achieve the pension scheme's long-term strategy, Trustees will set themselves and key stakeholders some crucial objectives to deliver.

These objectives will require certain activities to be undertaken. Ultimately, it is these activities which could have risks (and rewards) attached to them which have to be managed.

Aligning risk management practices with strategic goals



When asked about the strategic alignment of their risk programme, and whether Trustees are doing enough to manage risks, the vast majority of respondents felt that their Trustees:

- had a clear idea of the scheme's long-term strategy
- understood how specific actions currently being taken linked into their strategy
- understand the risks associated with current activities.

However, there was less confidence in areas such as whether Trustees were doing enough to identify and manage risks, and whether enough time is being spent managing risks.

This message was very consistent when we looked at different scheme types. There was, however, a significant difference in views around how much time should be spent managing risks. Smaller schemes and corporate respondents were much more dissatisfied with the amount of time being spent managing risks compared with the views of larger pensions arrangements and respondents whose roles were Trustees/pension professionals.

How frequently are pension risks being reviewed?

One of the challenges facing Trustees when it comes to managing pension risk is whether to:

- consider risk management as a separate, independent exercise at each Trustee meeting, or
- ensure risk management underpins all decision making and is covered as part of the day-to-day running of the pension scheme.

Although we agree with the second point, Trustees also need to be seen to be managing risks, including documenting discussions and decisions. We would advocate reviewing the Trustees' risk philosophy and effectiveness of the risk management programme itself at least once a year. Therefore, in reality, both approaches should apply.

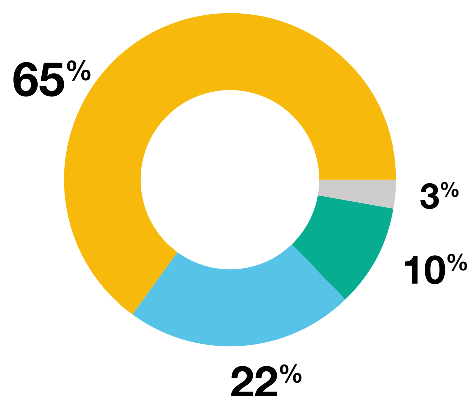
It is encouraging to see how many pension schemes have reviewed their pension risks in the last six months. However, our survey reveals that in the last six months:

- 32% of pension schemes have not looked at their risk strategy
- 33% of pension schemes have not looked at their risk controls
- 28% of pension schemes have not looked at their risk register.

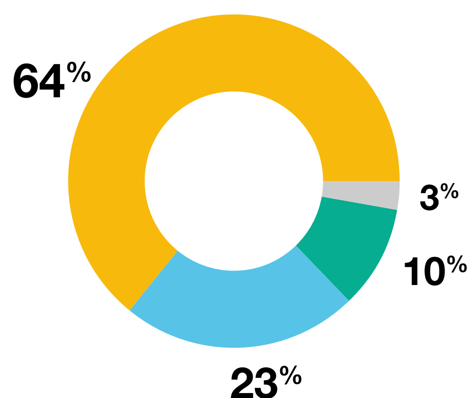
The more concerning issue is that 8-10% of pension schemes have not reviewed any of these areas of risk management in the last 12 months.

Frequency of pension risks being reviewed

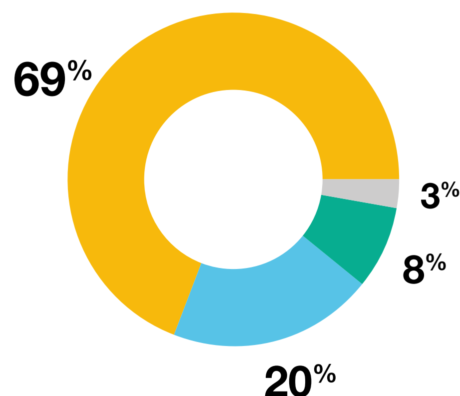
Risk strategy



Risk controls



Risk register



Last 6 months | 6-12 months | Over 1 year | Don't know

The table below shows that the approach taken to formally manage pension risks varies considerably. In particular:

- large schemes seem to be managing their risks more proactively than smaller schemes
- pension schemes where respondents have come from a corporate background are less likely to have reviewed their risks in the last 6-12 months.

These numbers by themselves do not necessarily paint the full picture. A number of pension schemes may be managing their pension risks perfectly well, but perhaps in a more informal manner. There may also be a communication issue. For example, pension risks are being reviewed regularly by someone (such as a pensions manager or Chair of Trustees) but this information is not being shared with all stakeholders.

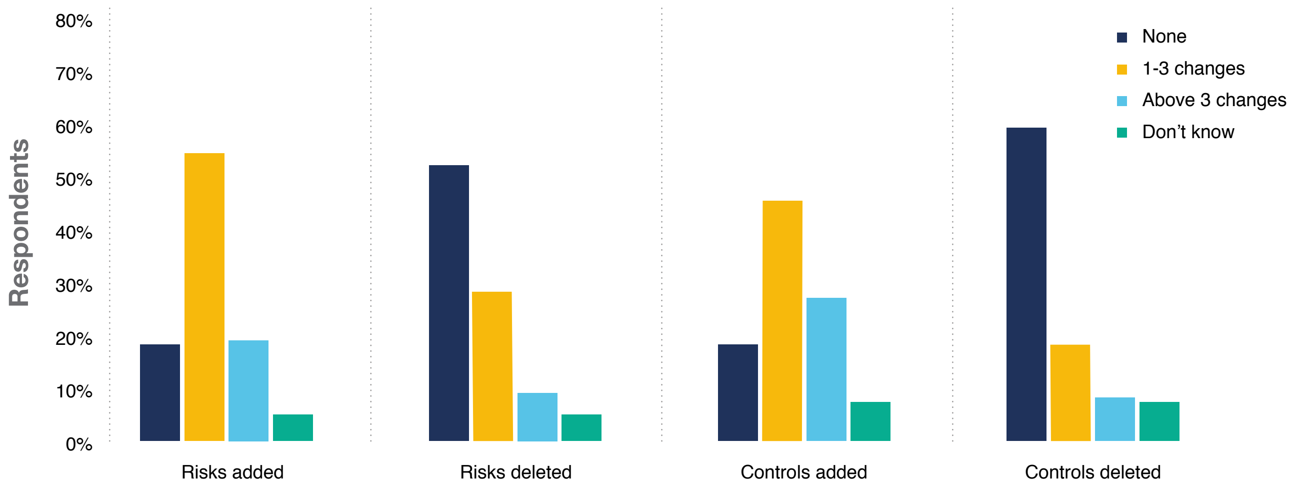
Having said this, these numbers do suggest that pension risks need to be formally assessed more frequently than currently is the case.

	Respondents who have not reviewed their risk strategy in the…		Respondents who have not reviewed their risk controls in the…		Respondents who have not reviewed their risk register in the…	
	…last 6 months	…last 12 months	…last 6 months	…last 12 months	…last 6 months	…last 12 months
All respondents	32%	10%	33%	10%	28%	8%
Large schemes	23%	6%	23%	6%	21%	6%
Medium schemes	42%	12%	35%	8%	31%	6%
Small schemes	31%	13%	40%	16%	31%	11%
Pension professionals	32%	10%	29%	10%	22%	7%
Trustees	29%	8%	29%	6%	29%	4%
Corporate	35%	10%	42%	10%	32%	13%

How proactively are Trustees managing pension risks?

Having identified that Trustees are not formally reviewing potential risks as frequently as they should be, we now focus on identifying the types of actions arising from a formal review of risks by the Trustees.

To conduct this analysis, we have assumed that any formal risk management review would be documented on a pension scheme's risk register (through a combination of adding or deleting risks/controls).



Our findings show that the majority of schemes who have reviewed their risks do tend to make some changes to their risk register, mainly by adding a small number of risks/controls.

As you would expect there is a strong relationship between changes in risks/controls being added and risks/controls being deleted. There also seems to be a tendency by Trustees to add rather than delete risks, a trend which is obviously not sustainable in the long-term.

Following more detailed research, we identified that for those respondents who stated that they had reviewed their risk register in the last 12 months:

- 8% did not make any changes at all to their risk register
- 11% of large pension funds (18% for small schemes) did not add/delete any risks or controls from their risk register
- 11% of large pension funds (around 20% small schemes) did not add/delete any risks or controls from their risk register.

At a time of political, technological, economic and social uncertainty, it is surprising that so many pension schemes have not amended their risk registers.

Top 10 pension risks

We asked respondents to prioritise the top five risks they think DB and DC pension arrangements are currently facing.

Looking firstly at DB risks, it is interesting, and perhaps not too surprising, that financial risks dominate the top of the table. In fact, the top four risks accounted for 88% of all respondents' first choices.

Managing the risks associated with IT/cyber/data protection is a key issue facing the pensions industry, but we must be careful to put its position (and other risks below it) into context.

The importance of the top four risks are rated considerably higher than all others, with over 70% of respondents using their top three choices to identify these. With some exceptions, the other risks were predominantly respondents' fourth and fifth choices.

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

Defined Benefit

Top 10 pension risks facing Defined Benefit schemes

Position	Risks	Importance score
1	Funding volatility	2.88
2	Employer covenant	2.68
3	Inappropriate investment strategy	2.09
4	Investment under-performance	2.00
5	IT/cyber/data protection	0.90
6	Trustee capabilities/governance	0.78
7	Meeting regulatory/compliance requirements	0.61
8	Administration	0.61
9	Sponsor/Trustee relationship	0.52
10	Quality of risk management	0.52

The only significant difference in views between small and large schemes relates to IT/cyber/data protection risks, which was only rated as the tenth highest risk for smaller schemes. This perhaps reflects the fact that many smaller schemes' activities would be outsourced to third parties, with the expectation that their suppliers will be responsible for these risks.

"IT and security is a massive risk when it is not under the Trustee's control… you can only be as good as the weakest link"

By looking at the voting patterns of respondents, it was interesting to see two 'schools of thought' when it came to identifying the biggest UK pension risks. One being those who identified the biggest risks irrespective of potential mitigating solutions (e.g. investment under-performance), and the other being those who ignored any risks which could be mitigated and focused only on those risks which are difficult to manage (e.g. cyber risk).

This reinforces the need to be clear as to how risk is defined in any risk discussions before proceeding.

Defined Contribution

For DC schemes, respondents' concerns focused on how best to deliver 'Value for Members', developing the default fund and the quality of communications to members.

Similarly to DB schemes, there was some variation in scoring depending on scheme size.

The main findings showed:

- communications was rated the biggest risk by smaller schemes
- IT/cyber/data protection risks were perceived to be less of an issue by smaller pension funds.

Top 10 pension risks facing Defined Contribution schemes

Position	Risks	Importance score
1	Delivering 'Value for Members'	2.69
2	Design of default fund	1.98
3	Poor communications	1.82
4	IT/cyber/data protection	1.51
5	Member administration and recordkeeping	1.33
6	Investment performance monitoring	1.33
7	Meeting regulatory/compliance requirements	1.04
8	Fraud/scams	0.82
9	Trustee capabilities/governance	0.75
10	Receiving contributions on time	0.49

Comparing Defined Benefit and Defined Contribution

The risks facing Trustees of DB and DC pension schemes are, and should be, different. This reflects the differing purpose, design and maturity of DB and DC pension arrangements in the UK. Our 'Top 10 risks' tables reflect this difference.

Some of the key differences (from a risk perspective) include:

- Trustees of DB schemes focus primarily on managing financial risks whereas Trustees of DC schemes focus on risks which could result in members being treated unfairly or making the wrong decisions
- poor communications for DB schemes is seen as a very minor risk whereas it is seen as one of the biggest risks for DC schemes
- risks relating to fraud/scams is seen as a much bigger issue for DC schemes than DB schemes.

It is also interesting to compare and contrast the shape of the respective risk profiles between DB and DC arrangements.

- DB pension risks are dominated by a small group of key financial risks. The remaining risks are important but, relatively speaking, do not financially impact the pension scheme. The challenge for Trustees is to mitigate the non-financial impact of these risks.
- Demonstrating 'Value for Members' is a clear winner in terms of the largest risk facing DC pension arrangements. However, after this risk, the 'importance score' only gradually reduces for other risks, meaning there is a wide spectrum of views (typically scheme specific) on importance for the remaining risks.

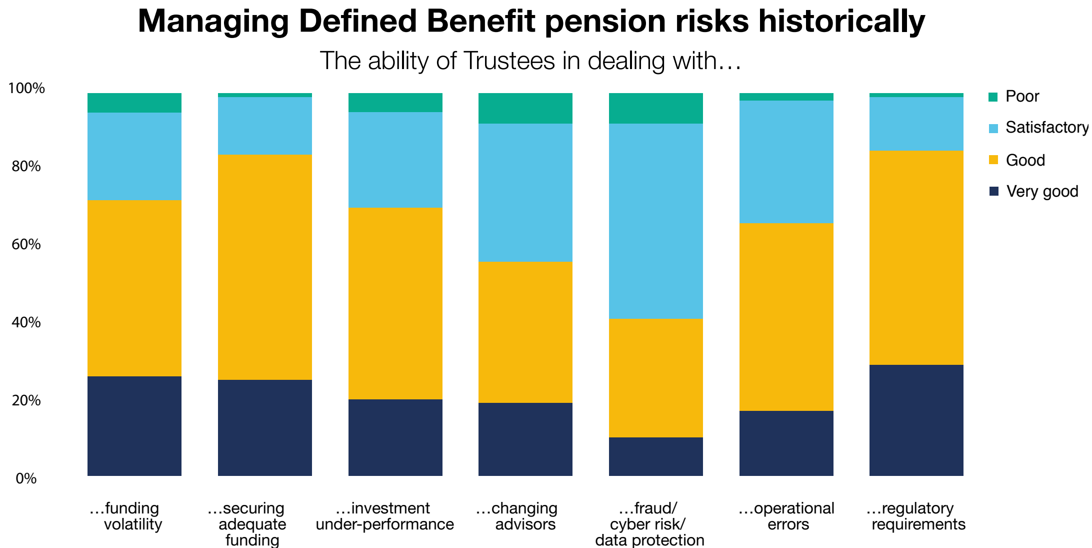
Identifying areas for improvement

Defined Benefit arrangements

The graph below describes how respondents feel Trustees of their DB pension arrangements have historically dealt with specific risks.

Managing Defined Benefit pension risks historically

The ability of Trustees in dealing with…



Traditional areas of risk management, such as managing financial and regulatory risks, are perceived to have been dealt with well. However, Trustees are not as comfortable with the management of less traditional risks such as changing advisors, fraud/cyber risk/data protection (particularly medium-sized schemes), and to a lesser extent how operational/admin errors were dealt with. This message was very consistent across all respondent groups.

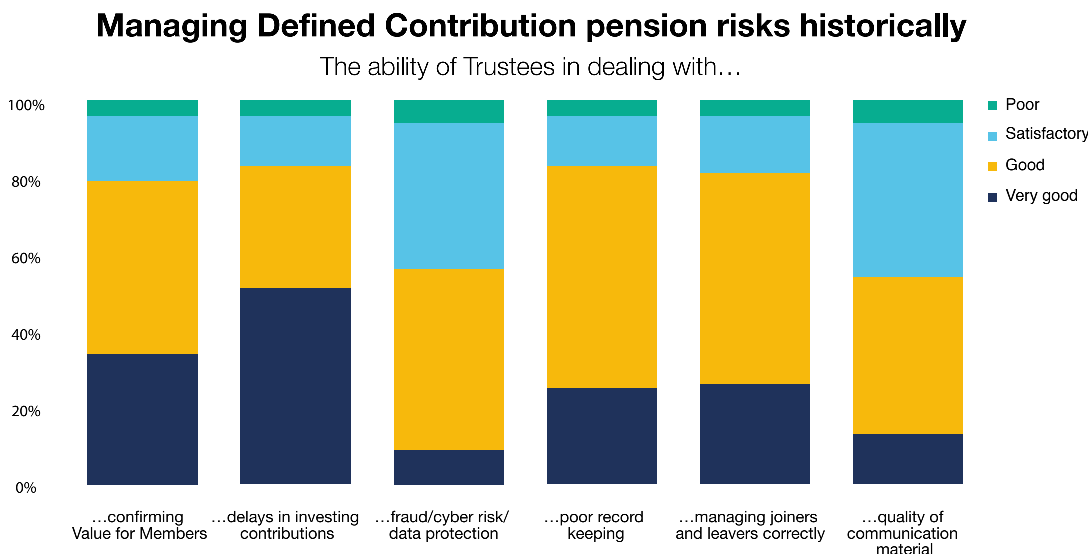
Defined Contribution arrangements

Similarly to DB, Trustees feel they are dealing with most risks reasonably well. However, they too have concerns with fraud/cyber/ data protection risks. An area of particular concern, particularly for smaller schemes, relates to managing risks associated with poor quality member communications.

> "Good governance is a vital part of the process in managing risks"

Managing Defined Contribution pension risks historically

The ability of Trustees in dealing with…



Managing risk: individual vs. team effort?

When speaking to clients, a topic which continues to come up, is the extent to which the person managing the risks (particularly scoring/prioritising) has on the final risk rating.

The short answer is that a single individual is just one of a number of factors which influence risk ratings. An individual's personality, timing and organisational culture all contribute as well. Consequently, we believe the best way forward is for a sub-group of Trustees to have some form of oversight role regarding risk management. Other Trustees would then provide strategic input as and when appropriate, alongside high level reviews of the risk management programme.

To explore the subject further, we conducted a bespoke analysis of the key risks perceived by respondents broken down by job title.

Key risks broken down by role/job title of respondent

Defined Benefit

All respondents	Pension professionals	Trustees	Corporate
Funding volatility (2.9)	Funding volatility (3.5)	Employer covenant (2.8)	Investment performance (2.8)
Employer covenant (2.7)	Employer covenant (2.8)	Investment strategy (2.5)	Funding volatility (2.7)
Investment strategy (2.1)	Investment strategy (1.8)	Funding volatility (2.3)	Employer covenant (2.3)

Defined Contribution

All respondents	Pension professionals	Trustees	Corporate
Value for Members (2.7)	Value for Members (2.1)	Value for Members (2.9)	Value for Members (3.6)
Default fund (2.0)	IT/cyber/data protection (1.9)	Default fund (2.9)	Communications (2.0)
Communications (1.8)	Default fund (1.9)	Communications (1.9)	Default fund (1.8)

The table above compares the key DB and DC risks for all respondents (described earlier in the report) with the key risks, dependent on the role of the respondent. The importance score for each risk is provided in brackets.

Our findings suggest that the views of each respondent does seem to depend on the role they fulfil. Although the same risks appear each time (with two exceptions), it is the level of importance each grouping puts on individual risks which is most interesting:

- **DB perspective**: Pension professionals see funding volatility easily as the biggest risk. Trustees have a more diverse view of the key risks, and corporate respondents also have a broader perspective (but investment performance risk is most important to them).

- **DC perspective**: Corporate respondents are very clear what the most important risk is, others agree that it is the most important but Trustee respondents think the risk associated with the default fund is equally as important, and pension professional respondents have quite diverse views (including concerns over IT/cyber/data protection).

Conclusion

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

1. **Should risk management be different for DB and DC schemes?**
   Clearly, the level of financial risk and type of risks differ considerably between DB and DC schemes, but the approach to risk management for both types of arrangements should, in our view, be consistent.

2. **How should pension risks be managed?**
   Fundamentally, we believe in the need for risk management to be embedded in Trustees' decision making capabilities and that risks need to be managed proactively, holistically and in 'real-time'. However, we also believe Trustees have a responsibility to formally review their risk philosophy, confirm key risks and assess the appropriateness of their control mechanisms at least once a year, with short updates in subsequent meetings.

3. **Is it acceptable for smaller schemes to spend less time managing risks than larger schemes?**
   The end outcome of a poorly managed scheme is the same irrespective of scheme size i.e. members lose part of their pension. It is important that all pension schemes ensure that they are managing risks appropriately irrespective of size.

4. **How much does reward impact risk decisions?**
   Obviously, when Trustees consider investment decisions, they are looking at the risk and the comparative return. This is much more difficult when there are no positive returns, and only a downside e.g. cyber risk. Risk is typically measured using a combination of impact and likelihood. Should we not be including reward?

5. **How does Integrated Risk Management fit in to managing risk generally?**
   Integrated Risk Management (IRM) focuses on the key risks impacting a scheme's funding position. We believe the good practices incorporated within IRM should apply to all risks.

6. **Is there enough communication regarding risk management?**
   Our survey suggests not. Trustees need to be aware of what is happening in their schemes and this includes actions being taken to manage risks. We suspect a number of risk management actions/ discussions are taking place but equally, it is quite clear that many Trustees are not being made aware of this.

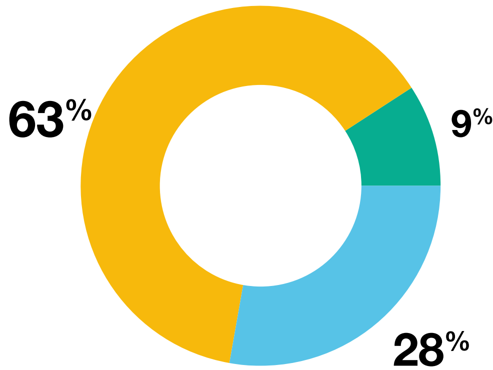
7. **What do we mean by risk?**
   There are a number of different definitions of risk in play at any one time e.g. gross and net risks, financial and reputation, traditional and non-traditional, DB and DC. It is critical when considering risk decisions that Trustees fully understand the types of risk being considered.

8. **Why do risk controls need to be reviewed both regularly and frequently?**
   It is not the identification of risks but the development and introduction of control mechanisms and appropriate monitoring which reassure Trustees that risk mitigation solutions are being carried out correctly.

Appendix: summary of participants

In total, we had 145 responses to our survey, covering a broad range of occupational trust based pension schemes in the UK.

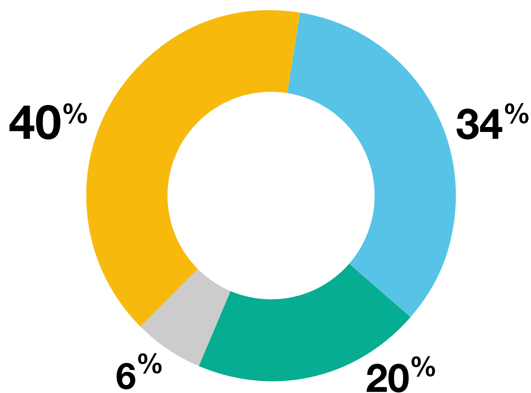
Analysis of respondents by type of pension arrangement



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

63% of respondents were actively involved in a trust based DB pension arrangement, 9% responded on behalf of trust based DC arrangements and 28% were involved in some form of hybrid arrangement (i.e. a pension scheme which provides both DB and DC benefits).

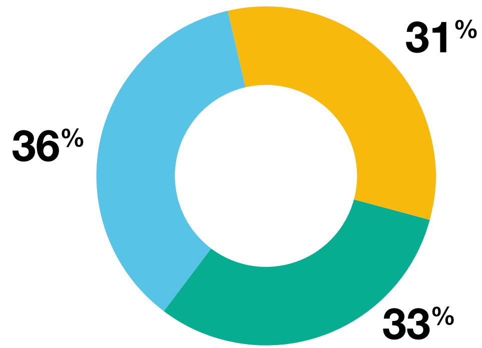
Analysis of respondents by job title



Pension professional
Trustee
Chief Financial Officer/Financial Director/HR Director
External advisor

Job titles of respondents (with regard to managing/overseeing their pension scheme) includes Trustee, external advisor, Chief Financial Officer (CFO), Financial Director (FD), HR Director (HRD) and pension professional.

Analysis of respondents by scheme size



Small (<£100million)
Medium (£100m - £1,000million)
Large (>£1,000million)

We grouped respondents by size after considering the level of their pension scheme's 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
- medium: schemes with pension assets between £100 million and £1 billion
- large: schemes with pension assets in excess of £1 billon.

Smart decisions.
Lasting value.

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About Crowe

Crowe Clark Whitehill is a national audit, tax and advisory firm. We are the UK member of Crowe Horwath International, the eighth largest global professional services network with 200 independent member firms operating from offices around the world.

We believe pension risk management programmes should be customised around the specific needs and objectives of the pension arrangement itself. At Crowe, we have a specialist team to support Trustees (and sponsors) to:

- confirm their risk philosophy (including the identification and prioritisation of key risks)
- develop, review and monitor controls which focus on these key risks
- highlight potential issues early to stakeholders
- identify specific solutions which mitigate risks.

Start the conversation

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