Risk management: putting it into practice

Although recent legislative requirements have helped to raise the profile of risk management processes and sound internal controls, these arrangements have long been a feature of good scheme governance. Improving standards of governance remains a key challenge for the Pensions Regulator, and in this article we look more closely at risk mitigation and internal controls and their role in good governance.

The regulator continues to undertake a number of projects with a governance theme. This has included research and the publication of codes of practice and guidance. As indicated in our recently published governance discussion paper, we have identified a set of regulatory priorities – including, for example, trustee knowledge and understanding, the management of conflicts of interest and monitoring the employer covenant – which contribute significantly to scheme governance. Our expectation is that these priorities will be underpinned by some form of risk assessment process, along with the implementation of adequate internal controls to manage identified risks, and clearly trustees will have a key role.

The regulator has already acknowledged and indeed publicised the strong correlation that exists between risk management processes, confidence in the internal controls environment and ultimately the increased level of stewardship.

Strong performance and maintaining good levels of scheme governance are key attributes for any trustee board regardless of the size, complexity or nature of the pension arrangement. Smaller schemes are not generally considered to be as well equipped to deal with risk management procedures; but does the evidence bear this out?

The current picture
Evidence gathered from our 2007 governance survey relating to risk management procedures and controls indicates that whilst many schemes have arrangements in place, a large proportion do not. Overall, 59% of all those schemes surveyed have a process to identify risks. Breaking this figure down, the results are more favourable for defined benefit schemes at 65% compared to 46% for defined contribution schemes, as shown in Figure 1 below.

Figure 1: Proportion of schemes that have a process in place to identify the risks that could affect the scheme and its members by scheme type

Results tend to be more favourable for larger schemes.
When questioned on the importance of risk management procedures and the value this would add to stewardship, only 38% of those surveyed perceived risk management as a contributory factor to raising standards of governance. This is too is a rather concerning statistic - in practice, it would be very difficult to imagine a key scheme decision being made by the trustees that did not take into account some form of risk based assessment. Naturally the degree of risk mitigation in relation to any activity should be commensurate to the level of risk it poses at a scheme level, after taking into account the impact on members’ benefits. Regardless of the formality of risk management procedures, trustees will invariably be considering risks in relation to their scheme in the normal course of business; in essence, these risk management practices are already happening on an informal basis.

What we would expect trustees to start doing is to add a degree of formality to risk management practices such that they can justify a certain course of action. This may include, for example, proactively undertaking a slightly more in-depth review of all risks at a scheme level, rather than reacting to risks once they pose a threat or where the probability of the risk crystallising has increased.

Figure 2 below, taken from the results of the 2007 survey, gives a good indication of the number of schemes that are confident that trustees have identified key risks.

Figure 2: Proportion of schemes that ‘strongly agree’ that the board of trustees has identified potential financial or governance risks to the scheme

<table>
<thead>
<tr>
<th></th>
<th>2006</th>
<th>2007</th>
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<tbody>
<tr>
<td>All schemes</td>
<td>47%</td>
<td>46%</td>
</tr>
<tr>
<td>DC schemes</td>
<td>37%</td>
<td>35%</td>
</tr>
<tr>
<td>DB schemes</td>
<td>52%</td>
<td>50%</td>
</tr>
</tbody>
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Whilst the results are more favourable for DB schemes, across the board they are not entirely positive. In relation to the same question, a further 40% at least tended to agree they had identified governance and financial risks: clearly this flags a level of uncertainty amongst trustee board in relation to assessing risks.
A robust risk review programme involves an ongoing process. An isolated review programme will never be future proof, as changes to the scheme and the employer are inevitable. Trustees will need to dedicate time to periodic reviews and may need to update controls in recognition of the changes. Figure 3 below indicates the frequency with which trustees review internal controls.

Figure 3: Frequency with which the board of trustees (or a sub-committee of the board) reviews the scheme’s internal controls

- At least annually: 64%
- At least every 2 or 3 years: 21%
- Less frequently: 13%

Not surprisingly, those schemes that most often review internal controls are the ones most confident that sound controls to monitor and mitigate risks are in place.

Formulating an approach
The regulator’s code of practice on internal controls gave an example of a risk management cycle. While the model (shown in Figure 4 below) is relatively generic, we expect each of these stages would appear in any robust risk management programme.

Figure 4: Example of the scheme risk management cycle
While the concept of risk management theory may appear daunting, it should not act as a barrier to trustees undertaking reviews. It would be a mistake for trustees not to implement internal controls to mitigate risks, not least because it is a legal requirement to do so. This is explored in a little more detail below.

Implementing risk management procedures
Along with our code of practice on internal controls, we issued additional guidance on the subject, primarily targeted at trustees of smaller schemes where it was acknowledged that some additional support was needed.

Despite issuing this guidance we are extremely conscious that some trustees may still be put off by the concept of risk management, but in practice the process is not overly complicated. Put simply, trustees are recommended periodically to review their scheme and identify risks, whether they be real, immediate threats or potential future risks. Once identified, trustees should document these risks, document the most effective way of mitigating them, and implement risk management arrangements – in other words, put in place adequate internal controls.

A key to any risk review process is that it needs to be focused and proportionate. The trustees will, of course, want to focus their resources efficiently. There is no expectation that trustees should or must engage a firm of consultants, for example, to undertake a comprehensive scheme risk review. We would expect trustees to use their discretion when determining whether they have the appropriate levels of knowledge to undertake such reviews, and in the majority of cases, particularly for the smaller schemes, they will: the primary issue for those trustees may be more in relation to time commitments and constraints. Trustees will need to manage this resource issue while also bearing in mind the importance of identifying and mitigating risks to the scheme.

The regulator expects trustees to mitigate key risks to an appropriate level, particularly where the probability of occurrence is high and the impact significant. The procedures put in place to manage risks need not be complex in nature; the key is to identify the risks first. Nor does the entire process need to be over-engineered. It needs to be sufficiently robust to the extent that any residual risk poses a limited threat to members’ benefits.

Managing DC risks
It would be absolutely wrong to assume that risk management procedures are only relevant in a DB environment. The need – and the legal requirement – to implement internal controls is equally applicable to DC schemes.

However, as highlighted earlier, the results of the 2007 survey indicate that risk management related activities are not as visible in DC schemes. This raises a number of concerns, particularly given the complexity of administration inherent in DC schemes. For example, the very nature of DC investment means that trustees need controls in place to carefully monitor contributions, allocations to investment funds and reconcile to membership data (including the reconciliation of units member by member). The lack of such procedures can have a detrimental effect to member benefits and be extremely costly to unravel.
Evidence supports the fact that sound internal controls underpin confidence in risk mitigation procedures regardless of the nature of the scheme's benefit type.

**In conclusion**

The importance of introducing or maintaining a sound internal controls environment cannot be over emphasised. Whilst the implementation of adequate internal controls is good practice, it is also legal requirement.

Risk assessment and risk management are not new concepts in business, and are equally important in a pensions’ environment. Our surveys, when combined with industry feedback, support some fundamental conclusions in relation to risk management and internal controls: that they are a key feature of a well run scheme, and complement a framework for good scheme governance.

Security of members’ benefits is paramount. The degree of security can only be improved if standards in governance are increased: and effective risk management is a key contributor to this.

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