Summary
- In December 2015, The Pensions Regulator launched new guidance hoping to prevent trustees from seeing investment in isolation and consider risk holistically.
- Trustees will now have to rebalance the time they address investment, funding and covenant.
- The industry has also questioned whether the integrated risk management guidance will prove meaningful since the best run schemes already employ an integrated strategy. For those schemes without specialist advice, it may prove problematic to comply with the guidance.
- The areas of cybercrime and communication are also areas trustees have to deal with as well as minimising risk and learning from the impact of it hitting a scheme.

Balancing the equation

The Pensions Regulator recently launched new guidance around the need for integrated risk management within pension funds. Gill Wadsworth looks at the issues surrounding this and the investment, funding and employer covenant equilibrium

The FTSE 100 started the year in miserable style. In the first month of 2016 the UK's top 100 companies marked their worst new year since 1988 as the fallout from China's economic slowdown hit markets worldwide.

Defined benefit (DB) pension trustees across the country were, understandably, fretting about the impact on their investment portfolios, but the implications of such market volatility stretches beyond just fund management.

The whole picture

In December 2015 The Pensions Regulator (TPR) launched new guidance which it hopes will stop trustees from seeing investment in isolation and consider risk holistically. The regulator's integrated risk management (IRM) guidance says trustees should treat investment risk as equal to, and interlinked with, the sponsor covenant and funding risks.

TPR guidance states: "[IRM] helps prioritise risks and to assess their materiality. It can take many forms but should involve an examination of the interaction between the risks and a consideration of 'what if' scenarios to test the scheme's and employer's risk capacities."

For some in the industry this guidance is a necessary step towards diverting trustee attention away from investment alone and towards a better appreciation of sponsor covenant risk.

"A good number of schemes have not spent an appropriate amount of time thinking about the sponsor covenant," Lincoln Pensions head Darren Redmayne says. "A consequence of IRM is that trustees are going to need to rebalance the time they spend across all three of

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these risk areas *[investment, funding and covenant]*."

However, there are others who question whether the IRM guidance will prove meaningful since the best run schemes already employ an integrated strategy, while the worst off cannot afford to.

"For the biggest or best run schemes IRM is pretty much embedded already," JLT Employee Benefits chief actuary Hugh Nolan comments. "Those schemes where the employer is not in the best of health and where there is a big deficit, the trustees may have little choice but to take bets on the investment strategy that the company simply cannot back if it goes wrong."

Additionally for those schemes without access to specialist advice in implementing IRM, it may prove problematic to comply with the guidance.

Pan Trustees director Roger Mattingly says "the reality of employing IRM is not straightforward and the logistics of joining up investment strategy, funding strategy employer covenant strength, plus risks to the employer covenant, the impact of any asset backed contributions, any contingent assets and not forgetting the essential grasp of both scheme and employer cash flow, is challenging."

IRM is doable if you know what you are doing but there are under-resourced schemes that cannot afford, or are simply unwilling, to hire the requisite experts, Mattingly adds.

"Many smaller schemes are likely to baulk at the cost of the IRM exercise and are unlikely to have any comparator to benchmark the cost or likely effectiveness of the exercise," Able Governance director Nick Boyes argues.

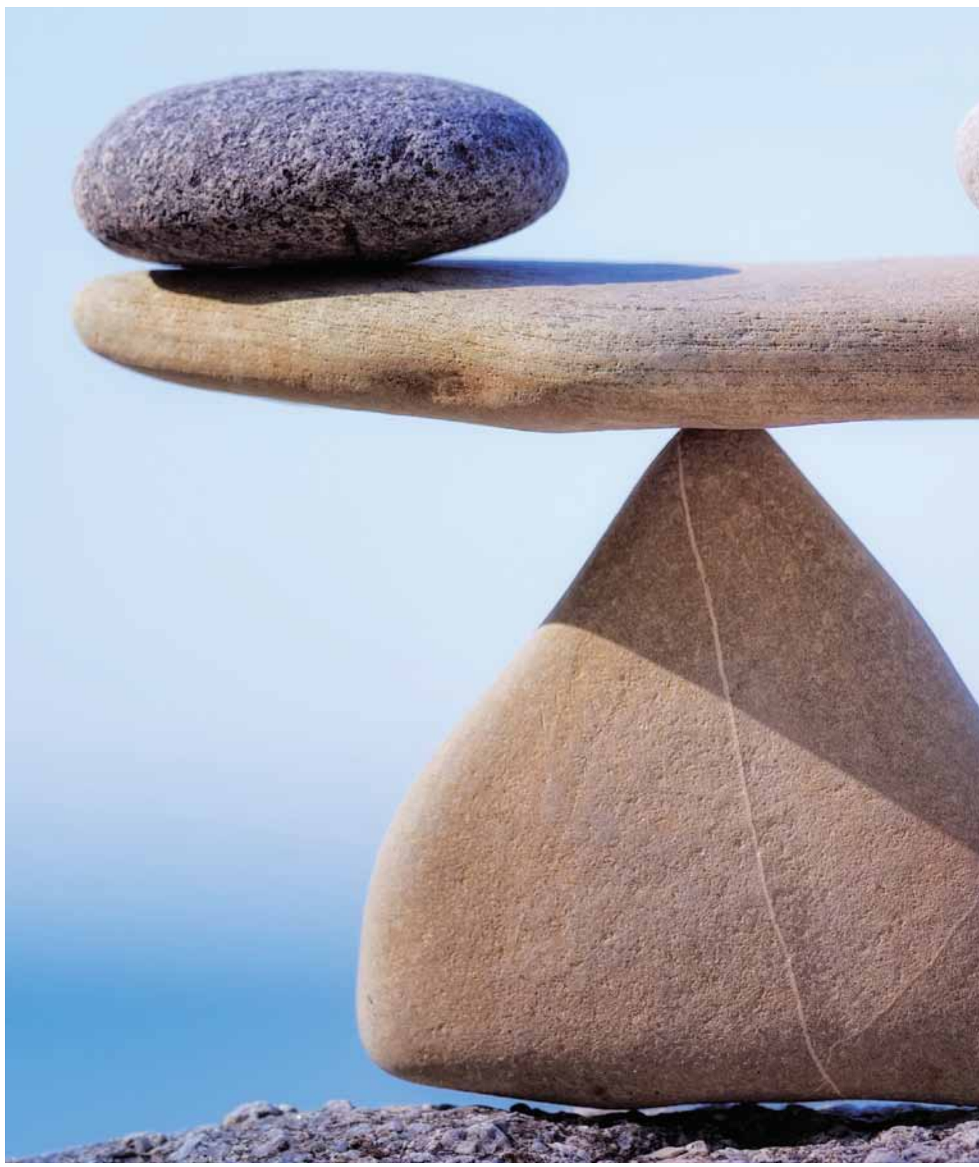
Beyond the considerable challenge of understanding funding, employer covenant and investment risks, trustees must also manage a long list of additional threats to scheme stability, and some commentators believe these may be neglected.

Boyes says: "Trustees are probably not giving the requisite time and resource to looking at issues other than investment. The focus tends to be on the asset side of the equation, without much emphasis given to the cost of the liabilities."

The problem is prioritising risk; while reversing the deficit is clearly critical to ensuring benefits get paid, focusing on funding to the exclusion of all else presents its own possible threats.

"If trustees spend a huge amount of time thinking about the investment strategy only to discover that someone has run off with the money, then that may not be time well spent," PwC pension consulting team partner Steve Dicker warns.

Dicker uses custody as an example



of an important area that may be overlooked by trustees grappling with 'bigger' issues.

"You might think you have suitable custody arrangements but when you delve into them you might find the assets are with a sub-custodian of the sub-custodian somewhere around the world. How can you prove that money is yours?"

Dicker also suggests trustees may not be aware of the threat posed from cyber criminals, who see pensions schemes as a possible soft touch compared with their banking and insurance counterparts. Last year a government report showed data breaches cost UK business £1.46 million in the year to June 2015; a potential cost DB schemes can ill afford.

"Banks have been targeted for years and have huge amounts of resource dedicated to cyber-attacks. If you are a cyber thief you would look at pension funds and think these guys have got billions of pounds sitting around, they are being run by lay trustees and - with the best will in the world - they must be an easier target if you want to get your hands on some money by cybercrime than the banks," Dicker adds.

Communications, too, represent a burgeoning risk for DB trustees, particularly after the freedom and choice regime came into force last April. Following the reform, members of defined contribution pension schemes are entitled to take their pension from age 55 with impunity. DB members, however, are not. This has led to a marked increase in the number of DB members asking to transfer out of their plan. Under the new regulations, trustees must inform members of their options and ensure any individual who wishes to transfer out has sought independent financial advice.

"Communications to members is a risk," Nolan emphasises. "The scheme is there to provide benefits to people and if the members make a wrong choice or they don't understand their choices, it presents all sorts of problems for the scheme."

Resources

But just how much additional resource can trustees dedicate to improving communications, protecting against cybercrime, adhering to new guidance and maintaining existing relationships with requisite advises and providers?

Trustees already manage tight budgets, and employing yet more consultants to manage what may be seen as peripheral risk could prove unjustifiable.

"The judgement of Solomon for the

"Trustees are probably not giving the requisite time and resource to looking at issues other than investment"

trustees is how much risk management to do in each area.

It comes back to the risk register and deciding the likelihood of that risk, what the downside is and how much resource to spend," Dicker states.

In many cases the addition of an independent professional trustee can help the board prioritise risks and may limit the need for additional advisers.

Nolan says professional trustees help focus lay trustees' attention on the key risks and avoid getting caught up in the minutia of scheme management.

He says: "I am a great fan of lay trustees but they can fixate on a small issue and get distracted from the bigger issues. Professional trustees or a strong chair are able to take away from that."

A professional trustee may also provide invaluable experience should the worst happen, and better prepare the trustee board to avoid making mistakes.

Finding the right balance

Risk management is a delicate balancing act; on the one hand trustees must be managing threats effectively but on the other they have a limited budget with which they can insulate the scheme from all eventualities.

Appreciating the scheme faces myriad risks and understanding that none of these work in isolation is a good starting point.

However even schemes with the best resources, overseen by most experienced trustee board, cannot be immune to all risks all of the time. The key is in minimising the impact when risk hits and learning from the experience.

Written by Gill Wadsworth, a freelance journalist