Summary
• Key person risk could potentially be reduced if the UK followed countries such as the Netherlands, where the number of pension schemes has reduced through consolidation.
• The risk is particularly prevalent among employers with DB schemes as a large number are closed to accrual.
• Having a succession plan in place should be a priority for the pension scheme managers or sponsoring employer, who can determine potential risks and identify suitable individuals for training.

Eggs in one basket

Key person risk – over-reliance on individuals within a company pension scheme who know how it is managed – continues to be a particular problem for the UK. Graham Buck examines whether there is a solution

Denmark, the Netherlands and Australia regularly receive kudos for the sustainability of their retirement schemes. The three countries share common features, such as a relatively small number of large pension funds that enable them to strengthen their governance and achieve economies of scale.

For the Netherlands, these benefits have been achieved largely through scheme consolidation. Last August, the Dutch central bank reported that the number had fallen by 75 per cent over the past 20 years, with the 1,060 corporate pension schemes that existed in 1997 falling to just 268.

The reduction in the UK is more modest, with an estimated 5,886 DB schemes in 2016 against 7,800 a decade earlier. Some of this consolidation has been achieved through initiatives such as the Local Government Pension Scheme (LGPS), which created eight investment pooled vehicles from what were previously 89 smaller ones. However, a major contributory factor has been the number going into the Pension Protection Fund (PPF), following the insolvency of a sponsoring employer.

That situation isn't unique to the UK – the US has also seen little movement towards consolidation over the past decade. As a result, not only do many schemes miss out on the economies of scale achieved through consolidation but they may be hampered by 'key person' risk, or over-reliance on one or two key individuals within the company who are fully conversant with the scheme's history and how it is managed.

A costly process

Rather like a football team's dependence on a star player, the scheme's day-to-day running and performance can suffer if a key trustee is unavailable; more so when he/she leaves the company. Smaller pension schemes have a tougher challenge in recruiting suitably qualified new trustees and typically delegate fund management decisions to investment consultants, whose incentives are based on quarterly results against set market benchmarks.

"Replacing key people can be costly and time-consuming. The only way to mitigate this risk is to put a succession plan in place," says Aegon head of pensions Kate Smith. "Pension scheme managers, or the sponsoring employer, should determine potential risks and identify other people to develop and cross train, so more people can take up the reins if need be.

"Along with this all processes should be documented so new staff can get to grips quickly with how the scheme is managed in order to mitigate potential issues and ensure that skills and expertise are not lost.

"Succession planning is just as important for running a pension scheme as it is for running a business. Keeping all the knowledge and expertise in the hands of one or two people is short-sighted and potentially leaves the scheme vulnerable. If something unforeseen happens to a key person, it can be nigh on impossible to replace them immediately, which ultimately could lead to mismanagement and members' benefits not being settled on time."

Pinsent Masons head of pensions Carolyn Saunders states that key person risk potentially affects schemes of all sizes, as the level of risk depends on the extent to which a key person is supported by advisers and/or consultants and on the degree of involvement in and knowledge of the scheme across the trustee board. This will vary from scheme to scheme, irrespective of size. However, building a close working relationship between an employer and the trustee board will help mitigate the impact on the employer of losing a key pensions resource.

"Key person risk is a particular issue for employers with DB schemes," adds Saunders. "If the DB scheme is closed to accrual – as so many are – the employer is unlikely to replace a pensions manager who retires. The risk can be mitigated to a certain extent by using advisers and ensuring that they are all joined up with one another, so that each has a good overview of what is happening with the scheme."

The skills required in a successor also reflect whether the incoming trustee joins a DB or DC scheme. According to accountancy firm Crowe Clark Whitehill's most recent pension risk management survey, trustees of DB schemes focus primarily on managing financial risks, while those of DC schemes regard the greatest risks as being those potentially resulting in members being treated unfairly or making the wrong decisions.

So for DB scheme trustees, the risk agenda is headed by the issues of funding volatility, the strength of the employer covenant and implementing an inappropriate investment strategy, while for those in DC schemes, the priorities are delivering 'value for members', designing the default fund and ensuring good quality communications.

However, for both groups the ability to handle IT, cybersecurity and data protection risks are fast moving up their list of priorities. Add to this the plethora of guidance issued since mid-2016 on the impact of Brexit to employers and scheme trustees, who must assure members that its effects on the scheme are being monitored.

Not surprisingly, the survey confirmed that smaller schemes with fewer resources available tend to outsource pension services. In addition, many spend less time reviewing pension risks and rely more heavily on external advisers for support. Smaller schemes also rely more on independent and/or professional trustees to provide them with direction and support in risk management, although it appears these individuals aren't always aware that they are expected to fulfil this role.

A fine line

The recent insolvency of Carillion and a spate of casualties in the retail sector are also examples of trustees having to attempt to walk a fine line when representing their scheme members.

Demand too much from the scheme sponsor and they potentially undermine the company's business investment and even its financial health, but demand too little and the interests of the company's sponsors and stakeholders get priority over those of scheme members. For instance, Carillion's scheme trustees spent 10 years in a fruitless attempt to get the construction services group to increase its level of contribution.

Indeed, The Pensions Regulator's most recent guidance to trustees, issued last December, on the wide-ranging duties and responsibilities that it expects of pension scheme trustees is a daunting 40-page document that could deter prospective new trustees as much as it informs.

Written by Graham Buck, a freelance journalist