Summary

• The Pensions Regulator (TPR) has consistently emphasised the importance of strong risk management in defined benefit (DB) schemes.

• Risk management exercises undertaken by trustees should include scenario testing on how a pension scheme failure could happen.

• Each scheme should have its own risk register to identify specific risks and outline actions to manage them. Each risk should be evaluated or ranked by status, monitored and reviewed regularly.

Putting out fires: Trustees and risk management

In the wake of Carillion's collapse, how do pension scheme trustees identify, monitor and control risks – and how can they protect themselves from the ramifications of their decisions, asks Graham Buck

In a year that began with the construction giant Carillion going into administration and has seen further casualties in the retail sector following the collapse of BHS, the issue of how pension scheme trustees can identify, monitor and control risk remains at the fore.

In its most recent annual funding statement, published in April, The Pensions Regulator (TPR) re-emphasised the importance of strong risk management in defined benefit schemes. Yet with so many different risks needing assessment, it's difficult for trustees to know where to start suggests, consultancy Barnett Waddingham actuary and associate Chris Ramsey.

"Being able to identify the key 'risks' is a crucial part of a trustee's job," he says. "To do this, trustees need to be 'big picture' thinkers – what are they trying to achieve, and what could stop them achieving it?

"Scenario testing how a pension scheme 'failure' could happen is a really useful exercise for trustees to go through. What would it take for this scheme to fail – and is that likely, possible or unlikely? Understanding this will help the trustees to better understand the level of risk they are taking in their scheme."

In the case of Carillion, it's now known that over the seven years prior to its collapse, the group made total contributions of £280 million into its 13 UK pension schemes against dividend payments of more than £500 million. Just weeks before the failure, auditing group EY recommended that the schemes should receive a major injection of cash, but this was rejected by Carillion's board of directors, who maintained that restructuring the company was still feasible.

Ramsey comments that ultimately, the key risk for trustees is where an employer is unable to provide the

necessary support to the scheme, either because the employer covenant weakens or the scheme deficit gets out of control.

"Trustees need to ask themselves whether the employer can afford to bear the amount of risk being taken in this scheme. If the answer is 'no', then they have to reassess whether they should ask for more contributions and whether their investment strategy is sustainable. TPR is due to give further guidance on what it views as an acceptable level of risk in their upcoming revised Funding Code of Practice.

"Trustees also shouldn't forget the risk in the employer's business and need to ask difficult questions. While everything might be running well now, they need to understand what could cause the employer to weaken, and how likely this is to happen. Having a regular dialogue with senior staff of the employer will really help with this."

However, Ramsey concedes that even with the best strategy in place things can go wrong. Again, Carillion is a classic example. As early as 2010 and again in 2013, its pension trustees contacted TPR to request the regulator's assistance in getting the company to pay more into the schemes. Yet as Work and Pensions Committee chair, MP Frank Field, observed, Carillion had "a wholly deficient corporate culture, studded with low-quality management more interested in meeting targets than obeying rules".

Identification and action

Aegon's head of pensions, Kate Smith, recommends that trustees begin by identifying the company's current and future risks. "They can do this using a range of techniques including talking to service providers, learning from past problems, looking at worst-case scenarios and horizon scanning," she says.

"Each scheme should have its own risk register and clear risk statements. The register documents the identified risks, and outlines actions to manage each risk, which should be evaluated or ranked by status, monitored and reviewed regularly. Documenting decision-making is a clear way of managing risk."

Sackers associate director Naomi Brown agrees that trustees must be increasingly comfortable with both assessing and managing risk. "Operational risks, financial risks, investment risks, reputational risks and that relatively recent, but potentially scary, addition of data/cyber risk – to put it bluntly, there's much that could go wrong and the stakes are high."

What's more, the list continues to grow. Aegon recently recommended that, with all UK employers having now published their gender pay gap data, companies "kill two birds with one stone" by tackling gender pay equality while also addressing the gender pension gap. The latter problem will otherwise likely be exacerbated by factors such as women's disrupted working patterns and auto-enrolment, which disproportionately excludes more women from workplace pensions.

A 10-point plan

Brown outlines a 10-point plan for scheme trustees in addressing risk:

1. Take risk management seriously: Trustees should understand the risks they face, their responsibilities for mitigating/managing them and the potential consequences of failing to take appropriate action. Appropriate training can help them start proactively managing risk.

2. Establish a framework for identifying and managing risks: Trustees have various legal obligations to assess and document risks. A risk register enables them to record their internal controls and develop an integrated risk management plan for funding, covenant and investment. A general risk management framework should also be developed to meet their various obligations on data risk.

3. Review it regularly and remain vigilant for new risks: Trustees need to review their risk management framework regularly (at least annually) to ensure it is being complied with and to update it in response to scheme changes, new and emerging risks and reflecting industry best practice.

4. Openly discuss risks and establish clear lines of communications: Trustees aren't generally "at the coal-face" of the scheme and often dependent on others to raise an alarm if something goes wrong or a new risk needs to be addressed. It's therefore essential to establish a culture where risks can be discussed openly and there are clear lines of communications with key providers.

5. Get your priorities right: As trustees don't have finite resources, they need to prioritise those risks most likely to occur and/or which will cause the biggest damage if they arise. A thorough risk assessment should help trustees identify the key risks for their scheme and areas where measures and controls are likely to have the most effect.

6. Get expert help: As risk management is a specialist area, trustees without the expertise should consider looking for support elsewhere. Trustees' professional advisers will be able to help manage a range of risks. The scheme sponsor may also have risk specialists who can offer assistance.

7. Exercise good governance: This includes taking appropriate advice, exercising proper oversight of the scheme's operations, having robust decision-making processes and keeping good records. Getting proper advice is key – if trustees have reasonably relied on professional advice the chances of comeback should be fairly low.

8. Have a clear and robust incident response plan: However good your risk management, things can still go wrong. Any fall-out can be significantly reduced if the issue is well-handled and swift mitigating action is taken. As time is of the essence, it can be helpful to decide in advance how the trustee will respond to a material incident to avoid unnecessary delays.

9. Review the trustee's protection arrangements: Trustees should check what protections they have, identity potential gaps and consider how to fill them. This may include reviewing the trustee's constitution as well as any exoneration and/or indemnity provisions in the scheme rules. They should also think about what recourse they may have against providers under their terms of engagement.

10. Learn from any mistakes: If material risks do emerge, a "warts and all" post-incident assessment can help highlight patterns or systemic issues which need to be addressed and identify areas for improvement in trustees' risk management frameworks and response plans. It should also highlight measures that have worked well! Trustees are unlikely to be viewed favourably if the same problems recur or if they fail to take appropriate mitigating action.

There is also a growing market for pension trustee liability insurance, which has seen several major US carriers enter the market in the past 10 to 15 years, reports advice and insurance broking services group Access Insurance, chief executive Simon Hickman. The cover protects the assets of individual trustees the pension fund, the sponsoring employer and the employees against claims of wrongdoing.

"It's typically been a higher risk than standard trustee indemnity cover, as more is a stake because peoples' livelihoods are involved," says Hickman. "However, coverage has broadened thanks to competition and high levels of indemnity – as much as £50 million or £60 million – are available."

Written by Graham Buck, a freelance journalist