For Professional Clients Only

Risk Management

A robust framework

The demands on pensions scheme trustees and sponsoring employers continue to grow due to the ever-increasing level of regulatory requirements, the range and complexity of options available to both defined benefit and defined contribution members and the time required to agree solutions.

In this landscape, the risks associated with running schemes are complex and the outcomes are significantly impacted by how well those involved manage these risks. In addition to the more traditional risks like longevity, covenant and investment volatility we are also facing risks associated with the increase in complexity of member options, the inevitable risk of missed opportunities in a market where pricing is transient, as well as the new and emerging risks of cyber attacks and climate change.

It has never been more important to have in place robust risk management plans to actively manage the broad range of risks that pension schemes face.

Broader experience of risk management

Learning from corporates

Within corporate organisations, risk management and internal controls systems are often well established and understood. With this in mind we have looked at what pension schemes can learn from corporate risk management. In particular the *"Guidance on Risk Management, Internal Control and Related Financial and Business Reporting"* from the Financial Reporting Council provides a high-level overview of some of the factors boards should consider in relation to the design, implementation, monitoring and review of the risk management and internal control systems. The following questions posed for companies read very well across to pension schemes with little alteration:

- How has the board agreed the scheme's risk appetite?
- How does the board ensure that it has sufficient time to consider risk, and how is it integrated with discussion on other matters for which the board is responsible?
- To what extent do the risk management and internal control systems underpin and relate to the scheme's business plan?
- What are the responsibilities of the board for crisis management? How effectively have the scheme's crisis management planning and systems been tested?
- How effectively does the board capture new and emerging risks and opportunities?
- How does the board ensure it understands the scheme's exposure to each principal risk before and after the application of mitigation and controls, what those mitigations and controls are and whether they are operating as expected?
- How are processes or controls adjusted to reflect new or changing risks, or operational deficiencies? To what extent does the board engage in horizon scanning for emerging risks?

In this document we have set out a risk management framework that we believe all schemes should consider as part of their risk management programme

Empower Results®

Outside of the UK

When we look outside of the UK we find that the adoption of the *European Pensions Directive* over 2019 by many European Countries has resulted in an increased focus on risk management for pension schemes in these countries.

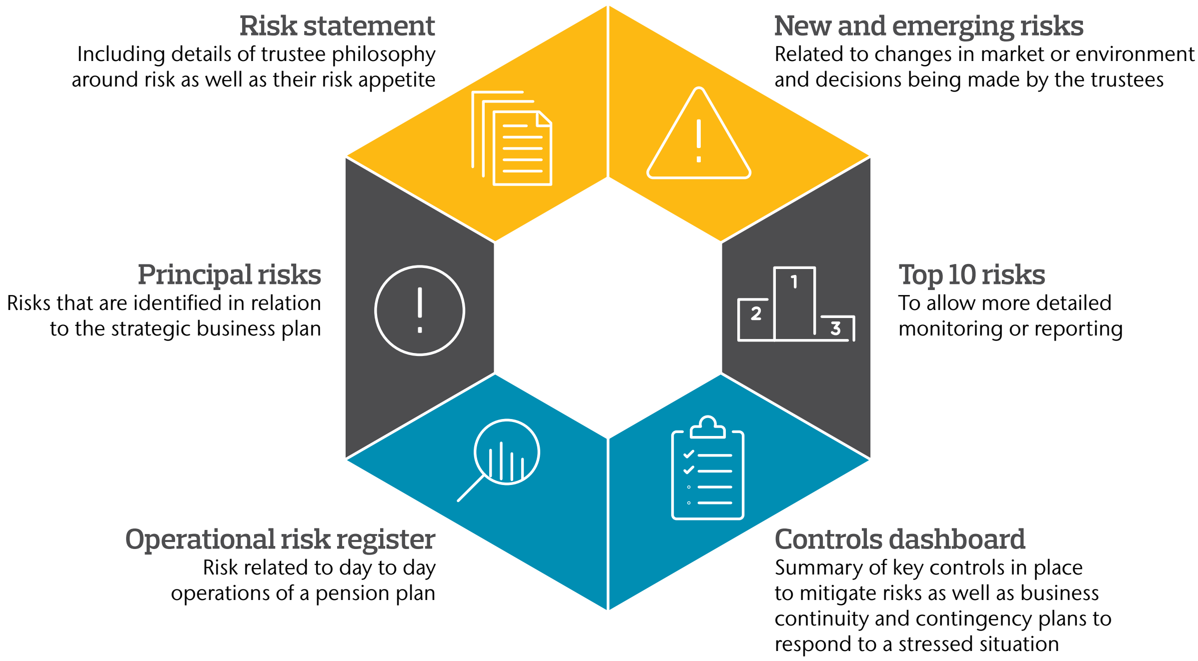
In particular under the revised Pensions Directive there is a requirement to have a risk management and internal audit function as well as written policies on risk management. Schemes are also required to produce an own-risk assessment every three years covering:

- How risk management is integrated into decisions
- The effectiveness of the risk management system
- How the scheme prevents conflicts of interest
- The overall funding needs of the scheme
- The risks to payment of retirement benefits
- A qualitative assessment of mechanisms protecting retirement benefits
- A qualitative assessment of operational risks
- Where investment decisions reflect environmental, social and governance factors, an assessment of new or emerging risks

This has led to a number of actions, including a trend in some countries to appoint specialist risk advisers to support a pension scheme, and robust risk management planning more generally.

Aon's risk management framework

The following illustration sets out what we see as the key components of a successful risk management plan which covers all of the areas set out under the European Pensions Directive as well as taking some of the learning from the corporate governance space.



Aon's risk management framework ensures that all aspects of risk are considered

Risk statement

The framework overarches everything that is done on risk and includes a statement around the trustee philosophy on risk as well as their risk appetite. It also sets out the nature and extent of the principal risks that the Board faces and those risks they are willing to take in achieving their strategic objectives.

This then provides the basis against which all risks are assessed. To ensure the risk appetite is implementable and measurable it is helpful if this is described in terms of risk objectives with clear tolerances. This then informs critical processes and decisions.

The framework also provides clarity on how risks should be scored both in terms of their severity and likelihood. Through this document, clarity is obtained on which risks currently sit outside of the trustee risk appetite and those that are within.

This is typically a principles-based document that is put in place for the longer term but reviewed annually.

Principal risks

Principal risks are those risks that threaten the delivery of the strategic objectives of the scheme — performance, future prospects or reputation. They are the 'top down' risks facing the board.

It is typical to record principal risks as well as areas of mitigation and contingency planning as part of or alongside the strategic business plan. Principal risks should be considered not only at each trustee meeting, but there should also be dynamic monitoring of the key controls to ensure any significant control failure is identified immediately (see top 10 risks below).

Operational risk register

These are the risks associated with the day to day running of the scheme. These could be considered the 'bottom up' risks faced by the board.

This is the document that most pension schemes currently have in place.

Ideally it is long enough that the key risks are captured but not so long that it is impossible to review on a regular basis. Many schemes have oscillated between a risk register that is too short to one that spans many pages.

In our experience the best risk registers capture the right level of detail by identifying themes of risk and bringing together a number of individual risks into key headings.

This document tends to be reviewed by sub-committees or outside of board meetings by those owning the respective business areas, with reporting if any material issues arise at each board meeting.

New and emerging risks

This is the document that allows the, trustees to stay ahead and pre-empt the new and emerging risks and threats to their scheme. This could be related to changes in the external market or environment in which the tustees are operating. It is also the place where the trustees consider the new risks that relate directly to the decisions they are making now.

Focusing on these two areas specifically allows the trustees to keep their risk management plans to remain dynamic and ensure that they capture the risks facing the scheme today and potentially those that could materialise in the future.

Typically this document is reviewed annually, with additions or deletions in between when a strategic decision is made.

Top 10 risks

A top 10 risk focus allows pension schemes to spotlight on those specific risks highlighted as being ones that could have the biggest impact. A more detailed analysis can then be provided on each of the risks that are drawn out. This is likely to include risks from the principal risk document, the operational risk register and the new and emerging risks document.

Given the importance of these risks, you may choose to set out the early warning signs of each risk materialising are as well as the positive assurance that you can obtain to give comfort on the reduced likelihood of a risk occurring.

This is typically kept under review quarterly.

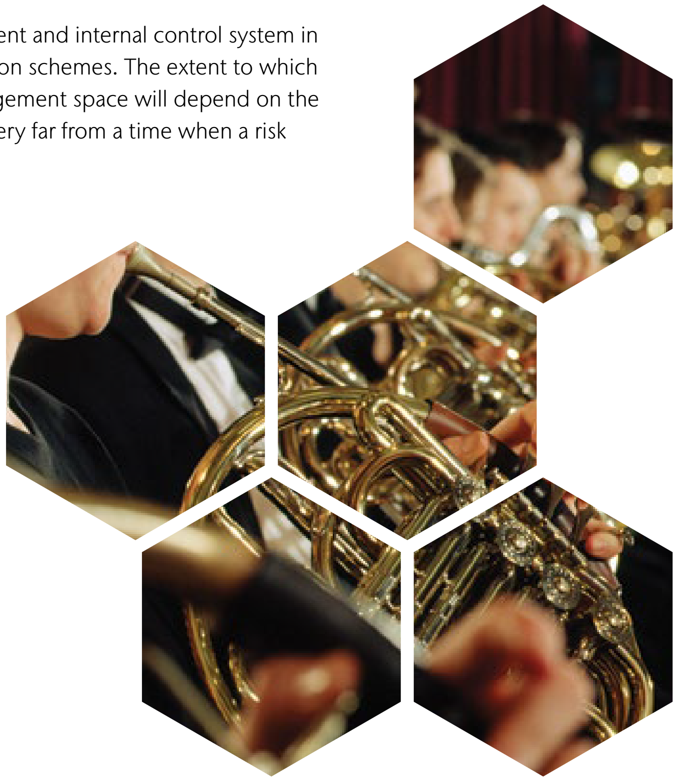
Controls dashboard

This document captures the controls, including business continuity, incident response and contingency plans, that are in place across the risk framework, and frequently incorporated into the operational risk register. Understanding the controls in place provides a different kind of review that focuses very much on the appropriateness of the mitigations in place and whether they continue to remain fit for purpose. Capturing this information in a way that highlights the relative importance of the range of controls, by comparison of gross and net risks, enables trustees to spend time considering those controls which have the greatest impact.

This can draw out different perspectives and is often more engaging for trustees as it is focusing on more tangible outputs.

Typically a review of controls and tests of incident response plans will be carried out annually, or following any substantial change.

It is clear that in this complex world, having an appropriate risk management and internal control system in place is key to the success of any organisational structure, including pension schemes. The extent to which this needs to meet all of the best practices we are seeing in the risk management space will depend on the size, scale, diversity and complexity of the scheme, but we have moved very far from a time when a risk register is something that is picked up and dusted off from time to time.



If you would like more information about Aon's approach to risk management and internal control systems, please contact one of the Governance Team members below, or your usual Aon consultant.

Contact information

Susan Hoare FIA
Partner, Aon
+44 (0)117 900 4441
+44 (0)7971 550 219
susan.hoare@aon.com

Stephen Davidson
Principal, Aon
+44 (0)131 456 6485
+44 (0)7971 969 832
stephen.davidson@aon.com

Sue Austen AIA
Principal, Aon
+44 (0)113 394 3413
+44 (0)7976 194 517
susan.austen@aon.com

Empower Results®