The Trustee toolkit downloadable

Running a scheme

Tutorial two: Risk management and internal controls

By the end of this tutorial you will better understand:

- an effective process for ensuring risks are identified, evaluated and controlled

This tutorial is part of **Scenario one**.

Glossary

A detailed glossary of technical terms can be downloaded from the Resources tab when you log in at **www.trusteetoolkit.com**

The Pensions Regulator

Why is risk control important?

Risks occur every day, in every facet of everyone's life. Let's say you are planning an outdoor barbeque or picnic at the weekend. There is the ever-present risk of rain to ruin an outdoor event, plus additional risks of a lack of sufficient food for the guests or that they cannot find the location. To ensure success you can put in place controls to mitigate these risks such as:

- erecting a marquee to provide protection from the rain
- asking guests to bring a dish to ensure there is enough food
- sending out a map to help them locate the event

In running a pension scheme, you need to identify potential risks. Pension scheme trustees need to be particularly aware of risk, as they have a fiduciary responsibility to the scheme's beneficiaries.

Internal risk controls

Good risk management is a key characteristic of a well-run scheme and a key component of the trustee's role in securing members' benefits. Trustees therefore need to set up a system of internal controls that will help them to prevent and detect errors in existing scheme operations, and help to mitigate new risks.

The legal requirements

Internal controls are defined in the legislation as:

- arrangements and procedures to be followed in the administration and management of the scheme
- systems and arrangements for monitoring that administration and management
- arrangements and procedures to be followed for the safe custody and security of the assets of the scheme

Master trusts

For a master trust to be authorised, the trustees must be able to satisfy the Pensions Regulator that they have sufficient systems and processes in place for running the scheme, including risk management. See the Code of Practice 15: Authorisation and supervision of master trusts for more information.

Consequences of inadequate risk controls

If it rains during your outdoor event, the consequences are not usually too problematic, you can always arrange another one. In a pension scheme however, inadequate risk controls can have more serious consequences.

Some examples of inadequate controls and their consequences

- Benefits calculated and paid incorrectly meaning members could receive too little or too much pension benefits.

- Incorrect contributions collected from members leading to underfunding or overfunding of a scheme and the costs of unravelling the problems.
- Contributions not invested on time.
- Contributions invested incorrectly.
- Employer unable to meet cost of scheme which could lead to the scheme being wound up.
- Trustee discretions exercised incorrectly which could give rise to complaints and claims from members.
- Report and accounts not completed and filed in time which could lead to fines.

Any failure to operate the scheme correctly is likely to cause problems for the members, the trustees, and the sponsoring employer. It could lead to possible financial consequences and/or to reputational damage and ultimately the intervention of The Pensions Regulator.

Managing risk

Trustees should continually review exposure to new and emerging risks, including significant changes in or affecting the scheme. There are four stages to addressing risk:

1. Identify the risks.
2. Evaluate the risks.
3. Control the risks.
4. Monitor the way in which the risks are being controlled.

In addition trustees should regularly (eg annually) undertake risk reviews and assessment exercises to identify whether their existing risk management framework, including their system of internal and external controls is still fit for purpose, ie do they prevent and detect errors in existing scheme operations, and will they help mitigate new risks?

As we look at each of these four stages we will follow Fiona Bryant, and her fellow trustees of the ABC Materials scheme, as she identifies one particular risk and takes it through the process.

1. Identify the risks

Trustees should have a framework in place to help them identify the risks facing their scheme which could have a material impact on its ability to provide good outcomes for members if they are not managed effectively.

It may be helpful to start by identifying all the functions and activities that are carried out when running the scheme and then identify the key risks in carrying out those activities. This should include consideration of forthcoming risks, for example, regulatory change.

Useful sources of information include internal and external audit reports, management information, service contracts, complaints, and administration, actuarial and investment reports.

Case study: ABC Materials

The ABC Materials scheme trustees have completed this exercise. Amongst the many activities and risks they have identified, they are currently looking at one in particular.

The scheme holds a significant amount of information about the members such as names, dates of birth, when they joined the scheme, normal pension dates and contributions paid. All of this data is stored on a computer database.

They have identified a risk that data could be lost if there is a serious systems failure.

2. Evaluate the risks

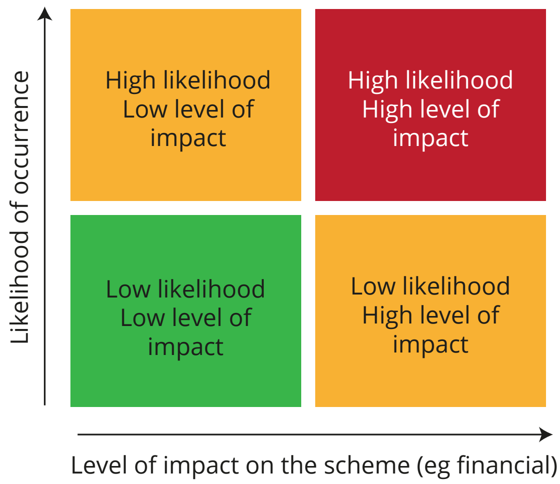
Trustees should develop a process for evaluating and prioritising risks which assesses:

- the impact that risks have on scheme operations
- the probability or likelihood of a risk event occurring

There are different approaches to scoring risk and we will look at two here. Whatever model is used, trustees must be able to identify the areas of highest risk, which therefore need to be given the greatest attention.

RAG model

This is a fairly simple model where the impact and likelihood of an identified risk is assessed as being either low or high and then plotted on a graph.



The graph has 'likelihood of occurrence' from low to high on the vertical axis and 'level of impact to the scheme' from low to high on the horizontal axis. The graph is split into four quarters. The low impact / low likelihood quarter is green, the high impact / high likelihood quarter is red and the other two are amber. Using this approach, the risk is classified as red, amber or green (RAG). This RAG status will dictate the extent to which mitigating action needs to be taken. It will depend on a number of factors, including judgement.

A risk categorised as red will require immediate attention as it represents a significant threat to the scheme. It is therefore preferable to avoid these risks altogether, where possible.

A risk categorised as green may require a lighter touch, but still requires controls to mitigate it. Do not leave green risks unmonitored.

Scoring model

A more sophisticated model would rate the impact and likelihood of an identified risk using a scale, eg 1 to 10, and multiply these to give the risk categorisation. This helps you to prioritise the risk according to the overall threat it poses to the scheme. For example, a risk given an impact score of 7 and a likelihood score of 4 would have an overall risk category of 28 (7 x 4). Another risk may be given an impact score of 8 but a likelihood score of 1, giving an overall risk category of 8 (8 x 1).

Although both of these risks may have been assessed as being in the amber category on the RAG status, using this model the trustees should be able to see that the second risk may require more controls or monitoring than the first.

Case study: ABC Materials

The ABC Materials scheme trustees are using the RAG status model to evaluate the data loss risk they have identified.

Impact

The impact of loss of member data is significant. The trustees would no longer be sure who all of the members of the scheme are and would be unable to pay out the right benefits to the right members at the right time which is a key responsibility for trustees.

In the defined benefit (DB) section they would also be unable to assess the liabilities of the scheme. Fiona and her fellow trustees rate this impact as high.

Likelihood

The scheme is administered by the employer so the data is held on the employer's systems and the employer should be taking regular backups in case the system fails.

However, the trustees know that there has been very high staff turnover within the IT department and they have little control over whether these back ups are completed regularly. Fiona and her fellow trustees rate the likelihood as medium-high.

Outcome

This places this risk in the red category and requires immediate attention to mitigate the risk.

3. Control the risks

The third stage is to put in place controls to mitigate or treat the identified and evaluated risks. Trustees should ensure that their internal controls are sufficient to both prevent and detect errors.

Trustees also need to understand that, however well constructed and monitored, internal controls reduce, but do not eliminate, risk.

Case study: ABC Materials

The ABC Materials scheme trustees are now discussing potential controls for the red risk they have identified using the RAG status model. They identified the following controls.

- Ask the employer to document their system recovery plans and data back-up procedures and forward these to the trustees.
- Obtain an external review of procedures to ensure that they are adequate and then commission annual checks to ensure that procedures are being followed.
- Request regular reports from the employer which confirm that the back-up procedures are being followed.

4. Monitor the risk controls

Trustees should understand that establishing effective internal controls and mitigation strategies are not one-off exercises, and therefore they need to have procedures in place to:

- regularly monitor the effectiveness of their internal control systems
- ensure that controls are kept up-to-date
- ensure that controls are capable of mitigating new and emerging threats
- periodically review their overall risk management framework

Ideally, trustees should discuss key risks to the scheme at every board meeting.

Case study: ABC Materials

The ABC Materials scheme trustees asked the employer to review their system recovery plans at least annually to ensure that any emerging risks to the systems are identified and mitigated. They also agreed to review the risk once a year to determine whether any additional controls are needed.

Documenting risks and controls

Trustees are expected to use and regularly update a risk register to enable them to demonstrate that they have identified, documented and mitigated key risks. The risk register should contain:

- details of the risks identified
- the likelihood of the risk arising
- the impact of the risk if it does arise
- the actions taken to mitigate the risk
- when mitigation action was taken
- when the risk and mitigation should next be reviewed
- who has responsibility for monitoring the risk, if it is not the whole trustee body

You can download the example risk register from the 'Resources' tab on the Trustee toolkit website. it is for illustrative purposes only and does not constitute a recommendation.

You can learn more by referring to the DB and DC codes and the guide to scheme management skills. Although the guide is linked to the DC code, the guidance set out is relevant for all scheme types. Visit **www.tpr.gov.uk/skills**.

Trustees of master trusts can also learn more on how this relates to authorisation in the master trust code

at http://www.tpr.gov.uk/docs/code-15-authorisation-and-supervision-of-master-trusts.pdf.