Item 6

Pension Fund Investment Sub-Committee

11 November 2013

Review of Pension Fund Risk Management

Report of the Head of Finance

Recommendation

Members are asked to consider and approve the Register of Risks in **Appendix A** and to approve the process by which this has been compiled, making any suitable additions or amendments as appropriate.

1 Introduction

1.1 Warwickshire County Council is responsible for the delivery of benefit promises made to members of the Warwickshire Pension Fund. It achieves this by setting objectives and goals with varying timeframes. Risks lie in failing to meet the intended goals.

1.2 Risks that are established as an issue for the Warwickshire Pension Fund must be identified and evaluated via a risk evaluation model. These risks must be prioritised with existing controls or new controls implemented to mitigate the risks. This should be recorded in a risk register, which needs regular monitoring.

1.3 As the Pension Fund Investment Sub Committee (PFISC) has decision-making powers with regard to the running of the Fund, it is recommended that members should have a reasonable understanding of risk management within a pension scheme context.

1.4 Moreover, the PFISC members should consider their perceptions of risk within the Pension Fund and the plan should be adapted accordingly. This approach, whilst not requiring a significant input from the Committee, should engage the Committee sufficiently so that it sees the value from the process and feel sufficiently included in the outcome decisions.

1.5 A schedule of risks and the control mechanisms in place is shown in **Appendix A**.

2 Risk Management Process

2.1 The risk management process needs to start with the objectives of the Pension Fund. These are set out in the Fund's business plan. The risks involved in achieving those objectives then need to be identified, and quantified in terms of the likelihood of them occurring and the impact if they did occur.

2.2 Once the risks have been quantified, the Fund will need to identify which are the priorities. Priorities will be scheme specific and will reflect the Fund's perception of the risks identified and should be set having regard to the objectives.

2.3 Controls then need to be implemented in order to manage the identified risks. In many cases controls will already be in place but they should be reviewed for their appropriateness and revised as necessary.

2.4 The process is summarised as follows:

1. Identify the objectives of the Fund (Business Plan)
2. Identify the risks
3. Quantify the risks
4. Decide on priorities
5. Set control mechanisms in place
6. Monitor

3 Register of Key Risks and Control Mechanisms

3.1 A risk register is a useful way of recording risks and resultant controls and is a convenient format for ongoing monitoring and review, which is essential in a changing environment.

3.2 Continual monitoring will identify changes in risk exposure, relative to any agreed tolerances, and the emergence of new risks.

3.3 As well as identifying the risks, officers have scored each risk according to its possible impact and likelihood of happening.

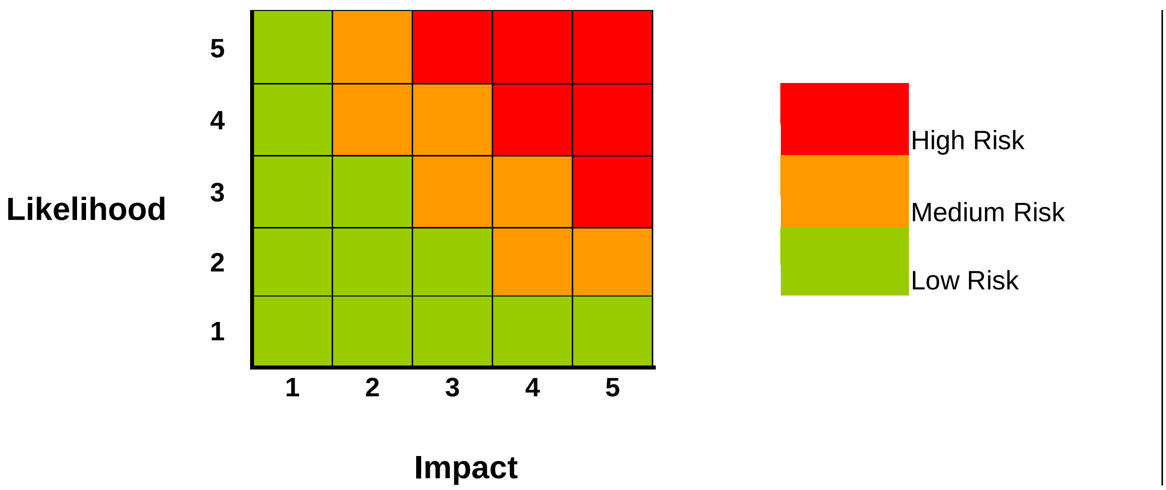
3.4 A table showing the various scores attributable to impact and likelihood is shown in Table 1 overleaf.

Table 1: Scoring attached to levels of impact and likelihood

	Score 1 (maybe one or more of the following	2	3	4	High 5
Impact	No financial impact	Minimal financial impact	Financial impact on the scheme	High financial impact on the scheme	Very high financial impact on the scheme
	Affect benefits at individual member level	Affects several individual members	Specific category of members affected (e.g. active, deferred, pensioner)	Affects more than one category of membership	Affects entire membership
	No impact on Trustee reputation	May have some impact but limited to individual or small groups of members	Trustee may be under the spotlight at local media level	Major reputation issue for the trustee (e.g. national press)	Trustees pursued in the Courts
Likelihood	Very unlikely that risk will occur	Unlikely that risk will occur	Risk may occur	Likely that risk may occur	Very likely that risk will occur

3.5 According to the level of impact and likelihood, a category (high, medium or low) can be attributed to each risk according to the following table:

Table 2: Ascertainment of Risk Level according to levels of impact and likelihood



3.6 A register of risks, the control mechanisms in place, the levels of impact and likelihood and assessed risk levels is shown in **Appendix A**.

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Key Risks & Controls **Appendix A**

The Administering Authority has an active risk management programme in place.

The measures that the Administering Authority has in place to control key risks are summarised below under the following headings:

- investment;
- funding;
- strategic;
- hazard;
- operational

Risk	Control Mechanism	Risk Action
Investment Risks		
Fund assets fail to deliver returns over the long term in line with the expected returns underpinning the actuarial valuation and funding strategy. **Impact: 5** **Likelihood: 3** **Risk Level: High**	Assumptions on long term investment returns are made on a relatively prudent basis (as recommended by the actuary) to reduce the risk of under-performance.	Analysis of the funding position is carried out at regular three-yearly actuarial valuations. Interim annual valuations are provided when considered necessary.
Inappropriate long-term investment strategy. **Impact: 5** **Likelihood: 2** **Risk Level: Medium**	The long term investment strategy is based on modelling of the Fund's specific liabilities and funding position under a range of economic scenarios. Advice is received from professional advisors. There is additional advice provided by the Fund's independent advisor.	The strategy is reviewed formally every three years in conjunction with the actuarial valuation – and more frequently when there has been a material change in market conditions. The Actuary will also provide an independent view of the Fund's investment strategy as and when required.
Falls in equity markets lead to a short term deterioration in funding levels and increased	A long term stabilisation approach has been agreed in setting contribution rates	Further opportunities for diversifying the Fund's equity risk will be explored

contribution requirements from employers. **Impact: 5** **Likelihood: 3** **Risk Level: High**	for secure open employers. The ‘growth’ component of the Fund’s strategy has been diversified across property, hedge funds and absolute return funds in order to reduce the exposure to short term stock market volatility.	with the officers and committee members.
High levels of inflation in the future are not matched by asset returns **Impact: 5** **Likelihood: 3** **Risk Level: High**	The Fund is invested heavily in real assets (equities, property) which are expected to offer some protection against higher levels of inflation over the medium to long term.	The risk attached to future inflation levels is assessed within the liability modeling exercises and considered as part of the regular reviews of investment strategy.
Fund faces short term liquidity problems and is unable to meet benefit outgoings. **Impact: 5** **Likelihood: 2** **Risk Level: Medium**	Expected cash movements are forecast and monitored on a regular basis. Arrangements have been made with investment managers to receive income on a regular basis and to be able to access additional income when required.	The Fund also has the option of selling units in pooled funds at very short notice.
Underperformance by active investment managers leads to poor Fund returns. **Impact: 3** **Likelihood: 3** **Risk Level: Medium**	Regular quarterly performance monitoring reports are received. Managers are also monitored by the manager research team of the investment advisors. The Fund makes extensive use of passive management across equities and bonds.	Continued under-performance – or material changes in other relevant business factors - will lead to formal review of the mandate by the Investment Sub-Committee, with a view to possible contract termination. Assets can be switched rapidly to one of the Fund’s passive managers.
Inappropriate choice of new investment manager. **Impact: 3**	A rigorous procurement exercise is carried out and advice taken from the professional advisors and	Members of the Investment Sub-Committee are involved in all decisions relating to the appointment

Likelihood: 2 **Risk Level: Low**	independent advisor.	of new managers.
Fraud or counterparty default by investment managers / brokers / custodian leads to losses for the Fund. **Impact: 4** **Likelihood: 1** **Risk Level: Low**	Securities are held in 'ring-fenced' accounts – either within pooled funds or by the Fund's own global custodian.	Fund managers produce detailed internal controls documents which are independently audited. Client agreements with new service providers are subject to legal review
Non-compliance with CIPFA/Myners Code of Practice **Impact: 1** **Likelihood: 1** **Risk Level: Low**	Level of compliance is published annually in the Fund's Statement of Investment Principles and Pension Fund Annual Report.	Adherence to Code of Practice is reviewed on a regular basis.
Funding Risks		
Deterioration in funding because of a mismatch of assets and liabilities. **Impact: 4** **Likelihood: 3** **Risk Level: Medium**	Triennial actuarial valuations, supplemented with interim valuation funding updates that reflect changes to market conditions. Asset-liability modelling (ALM) is undertaken at least once every three years to assess the long-term financial health of the Fund.	Investment Sub-Committee Board receives regular reports on the Fund's performance and is aware of the impact of significant funding risks e.g. lower interest rates, increasing life expectancies. The Actuary, with input from the investment advisor, discusses and agrees the ALM output with officers and members and sets employer contribution rates at levels that are designed to keep the Fund solvent over the long term.
Fall in risk free returns on gilts, leading to rise in value placed on liabilities **Impact: 4** **Likelihood: 4** **Risk Level: High**	Inter-valuation monitoring and ALM as above. Some investment in bonds helps to mitigate this risk.	Allowance for future volatility on the returns available on gilts is built into the ALM and allowed for in the funding strategy. In particular, the Actuary's long term view is that gilt yields are likely to revert on

		average to a higher level than implied by markets at the 2013 actuarial valuation. This approach recognises that gilt markets have been distorted by recent unusual events and also helps to meet the LGPS regulatory requirement for employer contributions to remain stable over time.
Pensioners living longer **Impact: 4** **Likelihood: 5** **Risk Level: High**	Mortality assumptions set by the Actuary allow for future increases in life expectancy. ‘Baseline’ mortality assumptions (i.e. current death rates) are based on the combined experience from Club Vita data of around 160 large occupational schemes. This gives the Fund a set mortality rates that are tailored to the unique membership profile of the Fund.	Mortality assumptions are reviewed every three years at each actuarial valuation. Annual updates on changes to mortality rates are provided by Club Vita and highlight the impact on liabilities. Pension reform means that retirement ages in the Fund on post 2014 benefits will be linked to State Pension Age (SPA). The Government is committed to adjusting the SPA if mortality rates change in future, which will help to manage this risk within the Fund. Changes to life expectancies are covered under the LGPS cost sharing mechanism e.g. if longevity increases, benefit levels may be reduced.
Falling active payrolls leading to underpayment of deficit recovery amounts. **Impact: 5** **Likelihood: 4** **Risk Level: High**	Active membership is regularly monitored. Recruitment advertising campaigns are regularly undertaken. Auto enrolment may encourage some non-members to take up membership.	The Fund insists that employers make deficit recovery payments as monetary amounts, rather than as a percentage of payroll.

Administering Authority unaware of structural changes in an employer's membership (e.g., large fall in employee members, large number of retirements). Administering Authority is not advised of an employer closing the scheme to new entrants. **Impact: 3** **Likelihood: 4** **Risk Level: Medium**	The Actuary may be instructed to revise the rates and adjustments certificate to increase an employer's contributions between triennial valuations.	The Administering Authority actively monitors membership movements, especially with regard to falling active membership and increases in deferred and pensioner numbers.
Pay and price inflation significantly more than anticipated. **Impact: 3** **Likelihood: 3** **Risk Level: Medium**	As mentioned previously, the Fund invests heavily in real assets that are expected to provide protection against inflation. Employers fund their own salary awards and are reminded of the gearing effect on pension liabilities of any bias in pensionable pay rises towards longer-serving employees. .	Inter-valuation monitoring, as above, gives early prior warning. Salary experience is reflected in each employer's valuation results. Any excessive salary growth will be reflected via upward adjustments to the employer's ongoing contribution rate at each triennial valuation.
Changes to regulations, e.g., more favourable benefits package, potential new entrants to scheme, such as part-time employees. Changes to national pension requirements and/or HMRC rules. **Impact: 3** **Likelihood: 3** **Risk Level: Medium**	The Administering Authority is alert to the potential creation of additional liabilities. The Administering Authority will consult employers where appropriate.	The Administering Authority considers all consultation papers advising of imminent change and comments where appropriate and necessary.

An employer ceasing to exist with insufficient funding or adequacy of a bond. **Impact: 2** **Likelihood: 2** **Risk Level: Low**	The Regulations require the Actuary to undertake a cessation valuation to assess the size of any debt at exit. The debt is levied on the departing employer although the Administering Authority believes that it is often too late to fully address the position at that point.	The Fund mitigates this risk by: • Seeking a funding guarantee from another scheme employer, or external body, wherever possible. • Alerting the prospective employer to its obligations and encouraging it to take independent actuarial advice. • Vetting prospective employers before admission. • Where permitted under the Regulations, requiring a bond to protect the scheme from the extra cost of early retirements on redundancy if the employer failed and from investment market-related risks.
Effect of possible increase in employers' contribution rate on service delivery. **Impact: 2** **Likelihood: 3** **Risk Level: Low**	Seeking of feedback from all employers on scope to absorb short-term contribution rises. Mitigation of the impact of revised rates through deficit spreading, phasing-in of contribution rises and, for open secure employers, the use of a contribution stability mechanism.	Employers are consulted with through senior management contacts, the annual meeting of the fund and regular bulletins from the Pensions office.

Strategic Risks		
Poor employee recruitment/retention **Impact: 2** **Likelihood: 1** **Risk Level: Low**	This is considered to be a low risk during recessionary times.	Membership members are monitored regularly.
Poor communication **Impact: 2** **Likelihood: 1** **Risk Level: Low**	Communication strategy is in place and adhered to.	Feedback taken from scheduled and admitted bodies at the Fund's annual meeting. Variety of means employed for communication to active members, deferred members and pensioners.
Reputation risk **Impact: 2** **Likelihood: 1** **Risk Level: Low**	Group and senior management work hard to foster high office morale, good client relations and a constant quality service.	Work of the Pension Group is monitored continually. Staff/user surveys regularly conducted. Complaints are monitored and acted on immediately and monitored and reported to senior management.
Legislative changes **Impact: 3** **Likelihood: 4** **Risk Level: Medium**	Group staff networks point to early recognition of likely change and possible proactive planning.	Regulatory changes are recognised as a constant with staff well used to dealing with the resultant upheaval.
Hazard Risks		
Deteriorating patterns of early retirements. **Impact: 2** **Likelihood: 2** **Risk Level: Low**	Employers are charged the extra capital cost of non ill-health retirements following each individual employer decision.	Ill health retirement experience is monitored.

Administration records corrupted or destroyed. **Impact: 5** **Likelihood: 1** **Risk Level: Low**	The administration team has now digitally imaged all active scheme member records and has worked through much of the preserved members.	Office is subject to corporate and departmental disaster planning. Data back-ups are stored off site.
Financial fraud **Impact: 5** **Likelihood: 1** **Risk Level: Low**	Comprehensive system of internal controls adopted by management. Fund manager systems of internal control are also monitored via the Society of County Treasurers.	Scrutiny by internal and external audit processes.
Fire/flood/terrorism **Impact: 5** **Likelihood: 1** **Risk Level: Low**	Data well backed up on a regular basis. Main investment data is held by the Fund's global custodian and available online.	Office is subject to the Council's corporate policy re disaster recovery.

Operational Risks		
Lack of succession planning **Impact: 2** **Likelihood: 3** **Risk Level: Low**	Office has experienced turnover through internal promotions and retirements.	Staff levels are regularly monitored. Regular discussions take place as to the implications of future staff resignations and retirement.
Insufficient number of external contract service providers, therefore insufficient choice and consequent poor service **Impact: 4** **Likelihood: 1** **Risk Level: Low**	Regular monitoring of the service provider market place takes place via networking and professional journals.	Recent procurement tender processes have been achieved satisfactorily with no signs of lack of market interest.
Staffing levels failing to support required service delivery **Impact: 2** **Likelihood: 2** **Risk Level: Low**	Regular monitoring takes place via comprehensive quarterly reports.	Recent recruitment has been achieved as necessary, subject to the need for natural wastage.
Failure to correctly establish adequate IT systems and supporting hardware and software. **Impact: 3** **Likelihood: 2** **Risk Level: Low**	Administration team works closely with providers both internal and external.	Requirements and system outputs monitored continually. Data is “cleansed” before each actuarial valuation.
Inadequate user training **Impact: 3** **Likelihood: 1** **Risk Level: Low**	Full programme of user training currently being implemented backed up with training evaluation feedback.	Training is monitored on a constant basis.
Increasing administration expenses (met from the normal contribution rate) **Impact: 2** **Likelihood: 2** **Risk Level: Low**	The Pension Fund Administration budget is subject to the Council’s approval and monitoring process. Regular reports are monitored by Treasury and Pensions officers.	The Council continues to seek value for money with regard to fund admin by reviewing all vacancies, intelligent use of IT resources and monitoring and cost benchmarking.

Administering Authority failing to commission the Fund Actuary to carry out a termination valuation for a departing Admission Body and losing the opportunity to call in a debt. **Impact: 2** **Likelihood: 2** **Risk Level: Low**	The administering authority requires employers to disclose forthcoming changes.	Fund officers monitor via the local and national press for developments in admitted bodies that might have a detrimental effect on the Fund.