Can you risk it?

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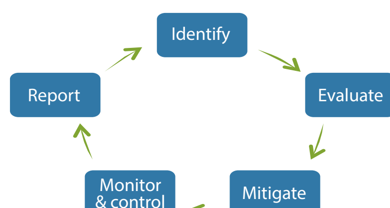
Finian O'Driscoll looks at manging risks for pension schemes.

Following the financial crash in 2008, risk management has become a major function in banks and insurance companies. So it is no surprise that risk management is one of the key requirements in the Pensions Authority's Financial Management Guidelines for trustees of defined benefit pension schemes.

Pension schemes need to take some level of risk in order to generate sufficient returns so that the benefits provided can be funded at an affordable cost. A risk management framework will help the trustees to determine the appropriate level of risk the scheme should take.

The Pensions Authority in their Guidelines expect that trustees should undertake an annual risk assessment which identifies the biggest risks, how likely they are to occur and what impact they would have on the scheme should they occur. Trustees should then examine what the scheme should be doing to limit the risks.

So what does this involve? A risk management framework will involve the following tasks:



Identification of risks

The first task is to identify scheme risks which will typically be grouped into the following categories:

- Scheme management
- Funding and solvency
- Investment
- Legislative
- Sponsor covenant

A risk register should be drawn up where the various risks under the above headings are evaluated.

Evaluation of risks

Risks should be evaluated by the likelihood of their occurrence and potential impact. Non-financial risks will require qualitative measure of risk. Financial risks may allow for some quantitative measurement of risk, this can be done by doing a scenario / sensitivity analysis. Techniques such as "VaR" (value at risk) are sometimes used, with any modelling proportionate to the nature and scale of risk.

Mitigation of risks

It is important to remember that the aim is not to eliminate all risks. Rather the aim is to understand the risks involved and decide what level of mitigation is appropriate.

Mitigation can mean:

- Removing the risk altogether (e.g. fully hedging the interest rate or inflation risk)
- Reducing the likelihood or the impact of the risk to an acceptable level
- Transferring some or all of the risk to other parties
- Accepting or exploiting the risk

Decisions should be noted in the risk register and responsibility should be assigned for the management and monitoring of each risk.

Monitoring and control of risks

The risk register needs to be reviewed for effectiveness of the risk mitigation processes previously agreed. This will include:

- Reviewing the performance of individuals and entities involved in the operation of the scheme
- Examining areas where mitigation did not work as planned
- Examining areas where agreed mitigation was not fully implemented

Consideration should be given to any new risks that have been identified and the relevance of risks previously included should be examined.

It is suggested that there should be a high level review annually with a more formal review every three years (unless there is a significant change in the circumstances of the scheme). Periodically an external review of the risk management framework could be undertaken.

Reporting risk management

The trustees should get reports in relation to the following delegated functions:

- Legislative compliance
- Service levels
- Risk incidents / issues
- Emerging risks

The trustees should consider communicating details of the risk management framework to members. Options in this regard include:

- Disclosure of risk appetite statement
- Inclusion of a risk analysis in triennial valuation reports
- A report to members on the regular reviews of the scheme's risk register in the Trustees' Annual Report

While not yet a regulatory requirement, the trustees may be asked to report on the scheme's risk management framework to the Pensions Authority.

The Chinese symbol for risk is a combination of danger and opportunity. Strategically managing risk by following a risk management framework should help trustees and scheme sponsors balance this danger and opportunity and help in good decision making for all stakeholders.