

managing risk

in the Local Government
Pension Scheme



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Foreword

Effective risk management stands at the heart of sound corporate governance across all organisations and functions and the Local Government Pension Scheme (LGPS) is no exception.

The introduction of new governance requirements in the LGPS in 2015, specifically the Pensions Regulator's new role and the establishment of local pension boards, reflects the increasing importance of risk management. It also reinforces the need for administering authorities to focus their risk management activities on all areas of scheme management and not just investment, noting of course that management of investment risk is rightly a fundamental concern.

In this publication, with contributions from leading actuaries and LGPS practitioners, we explore how risk manifests itself across the broad spectrum of activity that constitutes LGPS financial management and administration, and how, by using established risk management techniques, those risks can be identified, analysed and managed effectively.

The vast majority of LGPS funds have in place well developed and sophisticated risk management strategies. Our intention in preparing this publication has been to encourage administering authorities to review their approach to risk management given recent changes to the operation and governance of the scheme. As part of their governance processes funds should be regularly reporting all risks to committee and the local pension board, embedding a robust risk management approach and processes which link to all key strategic documents as well as recording risks and progress on an active risk register.

There is always a danger when explicitly reviewing risk that a more risk averse approach is adopted, almost by default. Sometimes the biggest risk is not taking any risk – the only strategy that is guaranteed to fail is not taking risk.

The panel would like to thank Alison Murray, Chris Darby and other colleagues at Aon for their contributions to the guidance.

Mike Ellsmore
Chair of the CIPFA Pensions Panel

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CHAPTER 1

Introduction

If you don't have effective risk management, you don't have effective management.

***Chance or Choice: Guidance on Effective Risk Management and Internal Control in
Local Government (SOLACE/ZM, 2000)***

RISK MANAGEMENT IN THE LGPS

The Local Government Pension Scheme (LGPS) is a funded public service pension scheme, with the most recent (2018) statistics from the Ministry of Housing, Communities and Local Government (MHCLG) indicating that administering authorities in England and Wales alone are responsible for the management of in excess of £270bn of assets for the benefit of 5.8 million members. During the year ending 31 March 2018 the scheme collected over £11.6bn employer and employee contributions from over 17,000 participating employers, including local authorities, other public sector bodies, and the private and voluntary sectors. The scheme administered £9.8bn in benefit payments, including pension payments to 1.7 million pensioners.

A significant source of funding for the LGPS is receipts from the tax payer and it is little wonder that there is significant public interest in ensuring robust risk management practice across the scheme as a whole, for the benefit of a variety of stakeholders. Ultimately effective risk management will lead to substantial financial and non-financial benefits and should be an integral part of both committee and local pension board meetings.

WHAT IS RISK?

Risk can be defined as the combination of the probability of an event and its consequences.

In all types of undertaking, there is the potential for events and consequences that constitute opportunities for benefit (upside) or threats to success (downside).

ISO/IEC Guide 73

WHAT IS RISK MANAGEMENT?

[Risk management is] a central part of any organisation's strategic management. It is the process whereby organisations methodically address the risks attaching to their activities within the goal of achieving sustained benefit within each activity and across the portfolio of all activities.

A Risk Management Standard (Alarm, 2002)

The management of integrated or holistic business risks in a manner consistent with the virtues of economy, efficiency and effectiveness. In essence it is about making the most of opportunities (making the right decisions) and about achieving objectives once those decisions are made. The latter is achieved through:

- *controlling risks*
- *transferring risks*
- *living with risks.*

Delivering Good Governance in Local Government: Framework (CIPFA, 2016)

Risk management should affect all of an organisation's activities that have a direct bearing on the delivery of its objectives and a clear approach to risk and risk management should be set out in corporate policy. These principles apply equally to administering authorities of the LGPS.

In the chapters that follow we examine the basics of risk, risk policy formulation and risk management, and how this applies to the administering authority as a scheme manager of the LGPS.

The need for effective risk management is reflected throughout LGPS regulation and guidance, including:

- Regulation 7 of the *Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016* (Regulation 12(2) of the *Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010*).
- The Pensions Regulator's Code of Practice 14 (which includes a section on internal controls and managing risks).
- The CIPFA Publication *Delivering Good Governance in Local Government: Framework* (2016 Edition) based upon the CIPFA/SOLACE Code of Corporate Governance
- Statutory guidance under Regulation 58 of the LGPS Regulations 2013 (Regulation 56 of The Local Government Pension Scheme (Scotland) Regulations 2018).
- Regulation 64 of The Local Government Pension Scheme Regulations (Northern Ireland) 2014).
- *Preparing and Maintaining a Funding Strategy Statement in the LGPS*, 2016 Edition.
- CIPFA's guidance on *Investment Pooling and Governance Principles*, published in 2016.

Overall responsibility for risk management falls to the body with delegated responsibility for managing the fund, often the pension committee or equivalent, and the legal requirements relating to internal controls apply equally where schemes outsource services connected with the running of the scheme. However, the local pension board and officers advising the committee and assisting in the running of the fund should also have a role in relation to risk management.

The Pensions Regulator's Code of Practice 14 states that scheme managers must establish and operate internal controls. The risk management process should use a risk-based approach and ensure that sufficient time and attention is spent in:

- identifying, evaluating and managing risks
- developing and monitoring appropriate controls.

Scheme managers should seek advice as necessary.

Good pension fund governance suggests:

- developing a risk policy specifically for the pension fund
- setting the risk management strategy in line with the risk policy
- overseeing the risk management process including development of a risk register and ongoing, regular monitoring of the risks identified.

RISK POLICY

A risk management policy is a formal record of an organisation's appetite for risk, its risk management structures, and its approach to risk management. The policy will articulate:

- the organisation's risk philosophy, attitudes to, and appetite for, risk
- how risk management is to be implemented
- risk management responsibilities
- the procedures that should be adopted in the risk management process.

An example of a risk policy is set out at Appendix A.

The approach to risk in the context of the pension fund and in the wider administering authority may not always be the same due to differences between the administering authority's role as a public body and its LGPS stewardship role. The administering authority should therefore have its own risk policy.

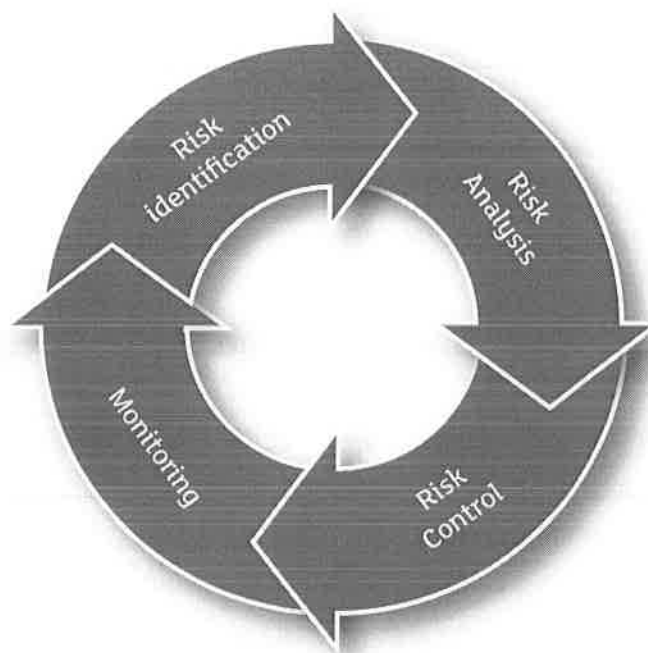
The risks associated with the pension fund should be clearly communicated to those affected by any adverse effects arising from the failure to manage risk effectively. For example, all fund employers are exposed to the potential effects of investment risk since failure to manage investment risk may lead to higher employer contribution rates. Administering authorities should ensure that risk policy is understood by all stakeholders.

While the high-level risk policy will set out the administering authority's approach to risk, underpinning the risk policy should be a more detailed, operational document that sets out how the authority intends to manage and treat risk in relation to the fund, as described further below.

RISK MANAGEMENT STRATEGY AND PROCESSES

The risk management strategy sets out how an organisation intends to manage and treat risk. The strategy should also outline the governance processes, systems and tools that the organisation will use to manage risk (for example use of a risk committee, allocation of roles and responsibilities with regard to risk management, the use of risk registers).

The risk management process can be considered as a continuous loop which systematically looks at risks surrounding the organisation's past, present and future activities. The main processes involved in risk management are indicated in Figure 1.1 and detailed in the following chapters.

Figure 1.1: Risk management cycle

Source: CIPFA

Risk identification

Risk identification should be proactive, horizon scanning for potential risks, and reactive, learning lessons from reviewing how past risks have manifested themselves.

Risks can be identified through:

- formal risk assessment exercises
- internal audit reports
- ongoing performance measurement exercises, including against the fund's objectives or its business plan
- staff liaison sessions, including at regular management meetings
- feedback from local pension board and/or pension committee meetings or directly from the members
- liaison with other administering authorities and regional and national groups, including the Scheme Advisory Board, CIPFA, etc
- legal determinations including those of the Pensions Ombudsman, the Pensions Regulator and court cases
- business planning or strategic workshops involving the administering authority
- business or service continuity plans developed by the administering authority.

Once identified, risks should be documented, usually on a risk register, which will become the primary control document for the subsequent analysis, control and monitoring of those risks.

New risks can emerge and so risk identification should include allocation of sufficient time and resource identifying these, and should therefore be integral to the day to day management of the fund.

Risk analysis

Having identified potential risks, the next stage of the process is to analyse and profile the risk. The Pensions Regulator's Code of Practice sets out that scheme managers should:

- develop a process to evaluate the risks, in order to identify those that are critical to the scheme (fund), and which in turn enables the administering authority to
- consider the impact and likelihood of a risk materialising to determine a priority for managing risks and
- implement and/or review controls to mitigate risks that are appropriate to the outcome of the risk evaluation.

Standard analysis techniques focus on risk scoring, based on a number of factors:

- an assessment of their frequency and probability of occurring
- an assessment of their severity and impact
- an assessment of existing controls
- cost effectiveness of additional controls.

Key to this process is consistency and simplicity. The scoring system needs to be clearly communicated and understood; a low overall score does not necessarily mean that the risk can be discounted, especially where likelihood may be 'low' but impact 'high' if it does occur.

Many administering authorities will have a risk policy which applies to the organisation as a whole, including analysis techniques. Administering authorities should consider whether it might be advantageous to adopt the same techniques, such as scoring criteria – particularly if extracts for the pension fund risk register could be reproduced within the organisation's overall risk register (for example, escalation of the critical risks). If that is the case, the criteria may need to be expanded to include pension fund specific information.

Risk control

Risk control describes actions taken to reduce the likelihood of a risk event occurring, the frequency with which it might occur and reducing the severity of the consequences should it occur (it may also describe actions taken to position an organisation to benefit positively from a risk event). Risk control actions could comprise taking steps to avoid, transfer and/or mitigate risk.

Possible courses of action against risk:

- **Risk elimination:** Ceasing an activity or course of action that will give rise to the risk.
- **Risk reduction:** Taking steps to mitigate either the occurrence or the impact of the risk, ie select a course of action that has a lower probability of risk or put in place procedures to manage risk when it arises.
- **Risk transfer:** Transfer the risk to another party either by insurance or through a contractual arrangement.

A key determinant in selecting the action to be taken will be its potential impact on the fund's objectives in the light of the administering authority's risk appetite. Equally important is striking a balance between the cost of risk control actions against the possible result of the risk occurring.

Effective risk management requires an understanding of the cost/benefit analysis to identify whether the cost of minimising risk is justified by the potential cost of unmanaged risk. Legal requirements to actively manage risk also have to be taken into account.

Administering authorities should recognise that it is not possible to eliminate all risks. Accepting and actively managing risk will therefore be a key part of the risk management strategy.

The Pensions Regulator's Code of Practice states that scheme managers should consider issues such as the following when designing internal controls to manage risks identified:

- how the control is performed and the skills of the person performing the control
- the level of reliance that can be placed on information technology solutions
- whether the control will stop something happening or merely detect something that has already happened
- the frequency and timeliness of a control process
- the process for reporting errors or control failures
- how the control will ensure that data are managed securely.

Risk management monitoring

Risk management monitoring is the final part of the risk management cycle. In monitoring risk management activity, the administering authority should consider whether:

- the risk control approach taken achieved the desired outcome
- the procedures adopted and information gathered for undertaking the risk assessment were appropriate
- greater knowledge of the risk and potential outcomes would have improved the decision-making process
- there are any lessons to learn for the future assessment and management of risks.

Progress in managing risks should be monitored and recorded (on the risk register). Reporting to the appropriate governance body (eg pensions committee and local pension board) should be on a regular basis and including it as a standing item would reflect best practice. Reporting should include the whole spectrum of risks, not just those being controlled.

A risk register could include the following headings:

- name of risk or risk area
- strategic objective affected by the risk
- risk category (eg investment risk)
- the likelihood of the risk occurring
- potential impact of risk should it occur

- risk rating score (ie likelihood x impact)
- owner of risk
- current controls
- additional control measures
- date of assessment (and when next assessed)
- risk status (using for example a 'traffic light' system)
- direction of travel (improving/worsening/no change).

Given the recognition that a lot of pension fund risks cannot be removed or reduced to a low level, and an element of risk can actually be advantageous (for example, in the investment strategy), it would also be advantageous to include the target risk rating score.

An example risk register can be found on the Pensions Regulator's website and one is shown in Appendix B.

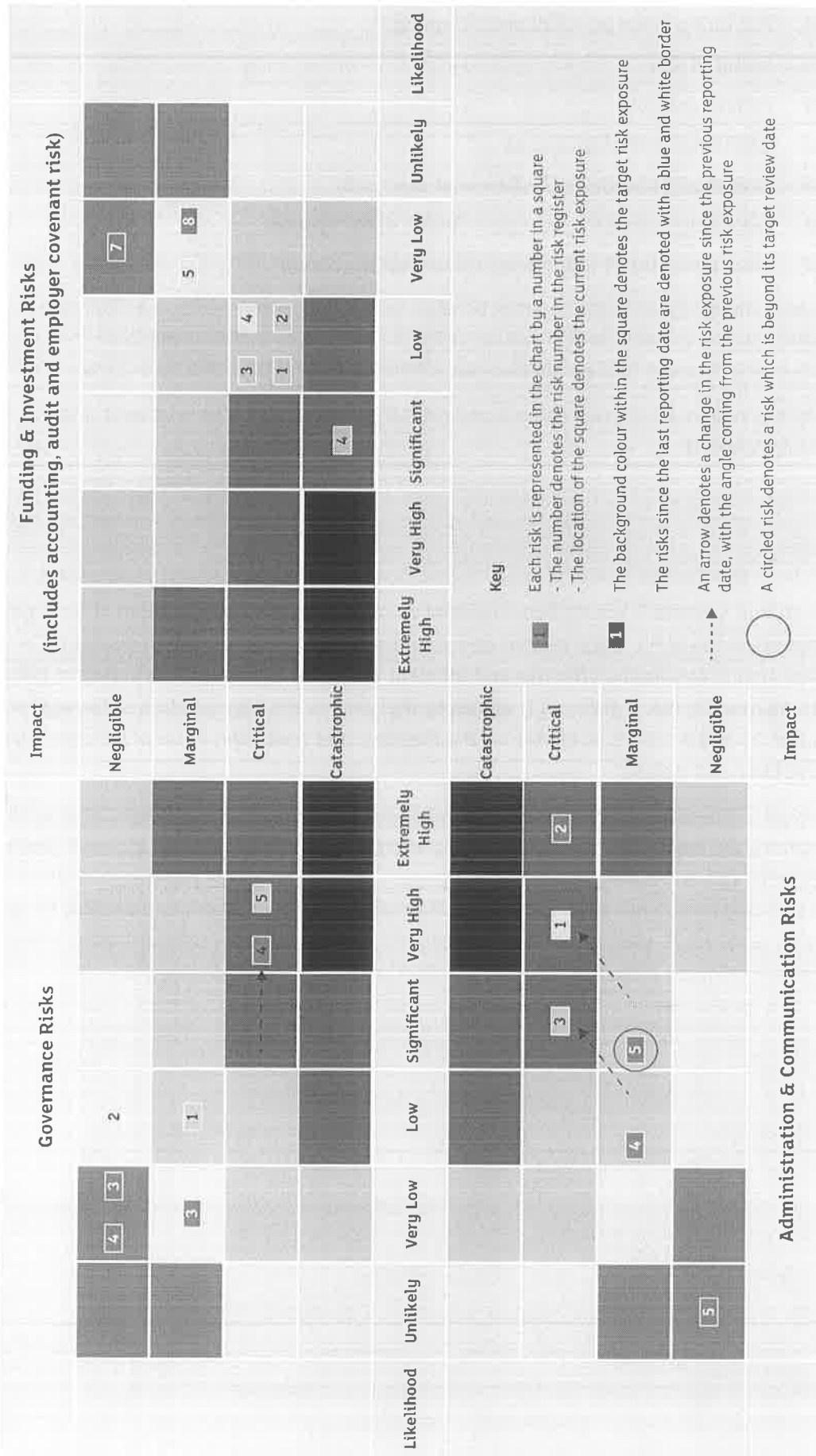
As the primary tool for monitoring and reporting on risk, review of the risk register should be a standing item at pension committees, with the focus on the highest risk areas or those where the risk assessment, controls or status has changed since the last review.

National Scheme Advisory Board guidance on the creation and operation of local pension boards in the LGPS suggests that one area the board could consider in discharge of its core function to ensure the effective and efficient governance and administration of the scheme is to "review the risk register as it relates to the scheme manager function of the authority" (see page 66 of the LGPS's *Guidance on the Creation and Operation of Local Pension Boards in England and Wales*).

As an alternative to, or in conjunction with, consideration of the risk register at each committee meeting, a risk dashboard, consisting of a combination of pictorial (such as charts, graphs, etc) and narrative commentary summarising the fund's position in relation to key risks may be helpful. The snapshot position presented by a dashboard enables those charged with governance management to identify the status of various risks at a glance and prioritise those that need attention. An example dashboard is shown in Figure 1.2.

Figure 1.2: An example risk dashboard

All Fund Risk Heat Map and Summary of Governance Risks



Source: Aon

Finally, the risk management process should itself be monitored to ensure that those charged with governance have ownership of the risk process and are accountable for the delivery of the risk management strategy. It also helps to ensure that risk is properly embedded in the management of the fund.

The Pensions Regulator's Code of Practice states that scheme managers should:

- continually review exposure to new and emerging risks, including significant changes in or affecting the scheme
- review their risk register regularly and evaluate risk assessment arrangements, procedures and systems, including where there are significant changes in or affecting the scheme.

LGPS RISK TYPES

This guide groups risk under the following headings:

- **asset and investment risk**
- **liability risk**
- **employer risk**
- **resource and skill risk**
- **administrative and communicative risk**
- **reputational risk**
- **regulatory and compliance risk.**

In the chapters that follow, this guide looks at each of these risk areas in turn and takes each through the risk management cycle set out earlier.

Asset and investment risk

The LGPS is a funded scheme; LGPS pension funds exist to manage the risk of future contribution streams being unable to meet future benefit payments by building up a pool of assets from which future liabilities will be met.

Funds are exposed to a number of asset and investment risks that pose a threat to the fund meeting its objectives. The scale of several of these risks is very great, so much so that they tend to dominate other risks and can divert attention from other risks that might be equally or even more important. There is potential misunderstanding of risk, eg considering the familiar to be low risk and the unfamiliar to be high risk.

The administering authority's approach to asset and investment risk, including the ways in which risks are to be assessed and managed, must be set out in the authority's investment strategy statement. It is a regulatory requirement to then invest, in accordance with its investment strategy.

IDENTIFYING ASSET AND INVESTMENT RISK

The ultimate aim of an LGPS pension fund is to ensure there are sufficient assets to meet benefits as they fall due. It is therefore important to analyse asset and investment risk relative to liabilities, and understand the potential for asset/liability mismatch risk to ensure risk is measured against the fund's core objectives.

Other key aims of the fund (as noted in Preparing and Maintaining a Funding Strategy Statement in the LGPS (CIPFA, 2016)) are to:

- seek returns on investment within reasonable risk parameters – risk and reward related to different investment strategies as well as specific holdings therefore also needs to be incorporated into the risk management process
- enable primary contribution rates to be kept as nearly constant as possible and (subject to the administering authority not taking undue risks) at reasonable cost to the taxpayers, scheduled, resolution and admitted bodies, while achieving and maintaining fund solvency and long-term cost efficiency – which should be assessed in light of the risk profile of the fund and employers – and the risk appetite of the administering authority and employers alike.

Risk identification should start by considering risks to these objectives alongside documentation of the overall investment objectives of the fund.

We set out below typical asset and investment risks that could ultimately lead to funds being unable to meet their aims. The list is not exhaustive and should be periodically reviewed and emerging risks added using techniques as outlined in the introductory section of this guidance. As an example, emerging risks include those related to investment pooling.

Asset/liability mismatch risk

The risk that pension fund assets fail to grow in line with the developing cost of pension fund liabilities. Liabilities increase each year, due to new accrual and because existing liabilities are one year closer to payment. This feature means liabilities have bond-like characteristics. However, most LGPS funds have limited investments in bond-like assets because of anticipated lower returns than some other asset classes and a desire to diversify their portfolio. Funds have historically largely invested in return-seeking assets where returns typically carry greater uncertainty and have proved to be more volatile.

Triennial actuarial valuations assess how well the funds are developing to meet the cost of liabilities. The value placed on fund assets is generally based on prevailing market values at the time of the valuation. The value placed on liabilities depends on the discount rate used by the actuary. This is usually set above 'risk free' returns, taking prudent account of the excess return expected to be earned from assets in the future, with the balance made up from contributions from the employers and members.

There is a significant risk arising from the failure of asset returns to meet the prudent rate used to discount liabilities. Fund benefits will come into payment over the course of multiple decades so the risk of persistent underperformance relative to the discount rate is key.

This differential performance between assets and liabilities has resulted in a significant volatility in funding levels across funds, highlighting the materiality of the asset/liability mismatch risk for most funds.

Liability risk is considered in more detail in the next chapter. However, it is useful to understand how the key financial liability risks interact with asset movements.

Discount rate risk: Discount rates are typically set based on a prudent view of future investment returns that may be achieved by a fund over the medium to long term. The outlook for future returns is driven by current market conditions and expectations within the financial markets. Changes in expected future investment returns and volatility and covariance of returns on asset classes affect the discount rate used to value liabilities; this is in turn reflected in variations in the value placed on liabilities. Related to this, the administering authority's risk appetite may change between valuations leading to further changes in the discount rate. This is largely measurement risk, since the liability cash flows do not change.

Inflation risk: The risk that unexpected inflation or pay growth increases the pension and benefit payments, and that pension fund assets do not grow fast enough to meet the increased cost. This will change the size of liability cash flows (and asset cashflows to the extent that funds are invested in inflation linked assets – ie inflation matched).

Asset risks

Concentration risk: Arises if there is a significant allocation to a single asset category, sub-category or security whose underperformance relative to expectations would result in difficulties in achieving funding objectives.

Investment pooling risks: As set out in the CIPFA guidance on investment pooling governance principles, Investment Pooling Governance Principals for LGPS Administering

Authorities (CIPFA, 2016), investment pooling introduces a number of different risks for LGPS authorities as well as potentially changing the magnitude of existing risks and how administering authorities might respond to them. These risks include asset and investment risk; employer risk; resource and skill risk; administration risk; reputational risk; and regulatory and compliance risk. Administering authorities should refer to that guidance for more detail, and in particular the major risks, such as transition risk, that will need to be carefully managed during the implementation phase, as well as the risk of failure of the operator itself, or its internal risks and controls.

Illiquidity risk: Arises where a fund cannot meet its immediate liabilities because it has insufficient liquid assets. Most LGPS funds have sufficient investment income and contributions to meet benefits as they arise, but funds have been maturing as a result of outsourcing of services and other reductions in local authority workforces and other employers closing to future new entrants or future accrual within the LGPS.

Forced selling depresses the prices of illiquid assets. Illiquid assets are expected to be subject to higher levels of price volatility than other assets, because it is likely that their prices will suffer sharp falls in periods of market stress. Investors in illiquid assets should expect to be rewarded by the expectation of higher returns, an illiquidity risk premium, to compensate for the illiquidity and potentially higher volatility. This can be advantageous to investors who are unlikely to become forced sellers of illiquid assets.

Currency risk: Arises from the variation in the prices of assets relative to liabilities caused by the movement in currency rates. The liabilities of LGPS funds are naturally denominated in sterling. By contrast, a substantial proportion of funds' assets are denominated in currencies other than sterling. Essentially, unless other steps are taken, an LGPS fund will have exposure to movements in exchange rates. This variation is only harmful to funds if sterling is appreciating relative to other currencies.

Manager underperformance risk: The failure by fund managers/pooling operators to achieve the rate of investment return assumed in setting their mandates. Passive managers generally deliver returns in line with benchmark expectations. Active managers are challenged to outperform benchmarks but can only do so by taking positions which differ from benchmark allocations.

Transition risk: The risk of incurring unexpected costs relating to the movement of assets among managers. Visible costs arise from dealing charges and market spreads when assets are sold and purchased in a transition. However, there are less obvious costs and risks, eg if assets are sold into cash and there is a delay prior to reinvestment, market movement in the interim period carries a risk of loss of market exposure.

Custody risk: The risk of losing economic rights to pension fund assets, when held in custody or when being traded. The risk might arise from missed dividends or corporate actions (eg rights issues) or problems arising from delays in trade settlements.

Stock lending risk: The risk is that the fund, as lending investor, has no control over who ultimately borrows the stock it has lent. For example, it cannot prevent short sellers from acquiring the stock it has lent. If a fund wishes to vote its shareholding and some of that shareholding has been lent, it will need to get the stock returned so it can exercise its vote. This may be even more complex in an asset pooling environment.

Counterparty default risk: The risk of default of a counterparty in meeting its obligations to the fund. Counterparties are normally involved when there are derivative transactions or currency forwards in place.

Responsible investment and environmental, social and governance (ESG) risks

LGPS investments are increasingly exposed to risks associated with social, environment and governance issues.

Environmental risk: Identifiable across many industries, from extraction of natural resources, to supply chain logistics, to manufacturing. Climate change risk is a specific subset of environmental risk upon which there is a high degree of focus from legislative bodies, recognising that a changing climate could have significant implications for the world.

Firms which do not effectively manage their exposure to environmental risks, including climate change related risk, can be susceptible to (as one example) litigation in response to breaches of the law, thus affecting profitability and the potential for future growth, or future regulation (for example, around carbon emissions) having a significant and material impact on the viability of the business model. If pension funds are invested in such firms the value of their investments are exposed to these risks.

Social risk: Firms affect the environment in which they operate in a number of ways, which includes the impact on social concerns. For example, protection of consumers, labour rights, diversity and inclusion policies, human rights and health and safety are key sub-criteria within this category.

The degree to which firms take account of these areas – for example, ‘living wage’ employers versus ‘minimum wage’ employers; the widespread use of ‘zero-hour’ contracts; inadequate provision of health and safety equipment – forms a key area of risk assessment from this perspective. Firms which exhibit poor social practices are susceptible to litigation, as well as potentially poorer levels of corporate financial performance owing to (for example) a demoralised workforce, or higher rates of staff absence where poor health and safety practices result in injury or illness. These factors can impact on financial returns in the short, medium, and/or long term, therefore constraining investment performance.

(Corporate) governance risk: Individual companies, and occasionally groups of companies, can periodically suffer from corporate governance failures. Examples in the past have been the use of child labour in overseas manufacture, poor safety records, which have resulted in death or containable accidents, and the widespread mis-selling scandals that affected banks and other financial companies. More recently we have had the phone-hacking scandal, London Interbank Offered Rate (LIBOR) manipulation, ‘rogue traders’ in financial institutions and other examples of regulatory compliance failure, all of which again can be traced back to failings in corporate governance.

Poor corporate governance can affect financial returns in the short, medium or longer term and therefore expose investors to specific risk. Arguably, badly managed corporate strategies may be covered within broad equity risk, eg it is inevitable that business plans will need to change as market conditions alter, as new competition enters the market place or to reflect changes in the status of customers and suppliers. Evidence of weak corporate governance

may also emerge after the event, when any financial damage has already been reflected in asset prices.

ANALYSING RISKS

Funding risk

Reporting valuation outcomes on a single set of assumptions disguises the variability of potential outcomes. The pension fund's strategic asset allocation benchmark will be set in line with its stated aims and risk appetite. It assesses risk relative to that benchmark by monitoring the pension fund's asset allocation and investment returns relative to the benchmark over quarterly, annual and longer periods. However, risk assessment needs to consider the returns of the assets relative to the liabilities by monitoring the delivery of benchmark returns relative to liabilities. Asset-liability studies can help by revealing a range of potential funding outcomes.

Many administering authorities will monitor the development of fund assets and liabilities and the impact that any deficit or surplus (the difference between the value of liabilities and the value of assets) and changing financial conditions will have on hypothetical levels of employer contributions. It is important that this interaction is fully understood and that assets and liabilities are valued consistently for this purpose – for example, if the markets view of future investment returns changes, it is likely that the discount rate will need to be updated to maintain the previous level of risk appetite.

Concentration risk

Analysis of concentration of asset holdings by category/sub category and individual holdings can enable a fund to identify areas of concentration risk. Scenario analysis can then provide assessment of the risk of underperformance on the funds objectives and feed into the eventual strategic asset allocation which will include limits on the total value of all investments of fund money that it will invest in particular investments or classes of investment, and must be set out in the fund's investment strategy statement.

Investment pooling risks

Following implementation (see guidance on *Investment Pooling Governance Principles for LGPS Administering Authorities* (CIPFA, 2016)), risks can be broadly analysed as per the other risks set out in this section. The risk strategy and process will need to reflect the roles and responsibilities specific to the operation of investment pools. A full review of risk management strategy and process in the light of investment pooling should be the start point for further analysis, including the identification and evaluation of new risks and changes to existing risks. The administering authority will need to understand the investment pool oversight committee's own risk management arrangements and processes as part of this evaluation.

Illiquidity risk

Liquidity management should feature in strategic asset allocation selection. Funds need to have sufficient cashflow to make benefit payments to members as they fall due. An analysis

of asset and liability cashflow can help to evaluate liquidity risk (ie the likelihood of a forced sale) as well as understanding the potential loss in value where illiquid assets need to be traded.

Administering authorities should also be aware of their advantage in being able to hold illiquid assets which differentiates them from many other investors and that they should expect to receive an additional illiquidity risk premium for holding this category of assets.

Currency risk

Currency risk can be analysed when deriving the strategic asset holding for the fund – asset liability modelling techniques can be used to derive the potential impact of currency movements on the fund's objectives, and in particular the likelihood of material negative impacts.

Manager underperformance risk

Manager selection will generally be carried out by investment pools but administering authorities retain overall responsibility and need to understand the risks and manager selection process adopted by the pool.

Underperformance of passive managers can be measured relative to the given index.

In relation to active managers, past performance may be due to prevailing financial conditions particularly suiting the manager's style of management. Prevailing conditions change over time, which can lead to cycles of outperformance and underperformance. There are widespread examples of pension funds firing underperforming managers (before their performance improves) and hiring outperforming managers (before their performance deteriorates).

Administering authorities should ensure that their investment pool uses an appropriate benchmark to assess active manager performance. For example, if an equity manager follows a 'value' style, it may be appropriate to assess their performance relative to a 'value' benchmark, even if their mandate is to outperform a broad market index. This will provide information about whether the manager is performing adequately relative to their style, and whether the prevailing conditions are providing a headwind or tailwind to their style of management.

Some classes of assets can only be managed on an active basis and the expected return may be sufficient that administering authorities would tolerate a level of underperformance from active management because that is the only way to access the asset class return.

Administering authorities should be aware of the exposure they have to specific managers underperforming relative to the given benchmark and the consequential risk to the funds' objectives.

Transition risk

Appropriate risk management processes will enable identification of significant transitions of assets. Each trade can be evaluated ahead of transition to understand the risk exposure to the fund to enable a risk-based decision to be made on whether mitigating action is required.

Custody risk

Administering authorities should periodically assess their custodian for service quality and operational standards (eg their processes for assessing their sub-custodians in overseas regions). It will also be valuable to conduct periodic audits of currency trades.

Stock lending risk

It is important that administering authorities understand the processes involved in stock lending, in particular that when lending a stock they lose control of it. The main risk relates to collateral management. Committees need to understand the different risks that relate to the assets used for collateral and in particular the risk of cash collateral.

Further guidance on stock lending and managing stock lending risk can be found in the CIPFA Pensions Panel Guide to Stock Lending by Local Authority Pension Funds (CIPFA, 2011).

Counterparty default risk

The principal approach to managing counterparty risk is to understand the nature and materiality of the risk. Processes should be in place to measure counterparty exposure and potential exposure in the future.

Responsible investment and environmental, social and governance (ESG) risks

Responsible investment is an approach that aims to incorporate environmental, social, and governance (ESG) factors into investment decisions, to better manage investment risk and generate sustainable, long-term returns. This is an area on which there has been increasing focus in recent years, both from regulatory bodies in the form of legislation and guidance, and from institutional investors, amid growing recognition that ESG factors can play a material role in investment risk and return. Administering authorities should take their fiduciary responsibilities around considering sources of risk and return seriously and acknowledge that effective management of financially material ESG risks can support the fund's objectives, as long as consideration is given to the need to optimise financial returns.

Many administering authorities consider that it is beyond their level of resource to take unilateral action around controlling ESG risk, and instead leverage the resources of their investment managers – many of whom have dedicated policies detailing their activities, stance, and level of focus on this area – to identify, analyse, monitor and control the risks the fund is exposed to via its indirect investee company holdings.

Understanding the level of risk posed by climate change is an area where the pension fund committee can also take input from its actuarial and investment advisers.

CONTROLLING RISK

Risk is an inevitable and unavoidable feature of LGPS investments and not all risks can be controlled. For example systemic risk arises from the possibility of an interlinked and simultaneous failure of several asset classes and/or investment managers, possibly compounded by financial 'contagion', resulting in:

- an increase in the cost of meeting pension fund liabilities where the outlook for investment returns is reduced
- a reduction in funding levels
- upward pressure on pension costs.

As systemic risk cannot be eliminated, transferred or mitigated, it can only be avoided by ceasing the activity which gives rise to it. This is clearly not an option for LGPS funds. It must therefore be accepted as an inevitable consequence of investment activity.

However many other aspects of investment and asset risk can be managed and some examples are set out below.

| Risk area | Control actions |
|---------------------------|--|
| Funding risk | <p>Funding risk is controlled by determining a strategic asset holding using appropriate asset/liability modelling techniques to inform the fund's investment strategy. The strategic holding should include acceptable ranges of deviation to allow for market movements and active management.</p> <p>Policies and processes should be in place to report breaches to these limits and bring the fund's holdings back within defined limits. Mitigating funding risks may have unacceptable cost (given the conflicting aims of the fund including cost efficiency and stability of primary contributions, for example). Liability matching investment strategies can include inflation and longevity hedges.</p> <p>The investment strategy should be kept under review, typically a minimum of triennially, but this could be more frequent and triggers for a review could include funding levels moving above or below specified limits, or, market instability (eg financial crisis).</p> |
| Concentration risk | <p>Administering authorities should be aware of concentrations among assets they hold and the impact of potential setbacks on asset prices. These should be reported to the relevant body, as set out in the risk management policy.</p> <p>Administering authorities should also be aware of the regulatory requirement to invest in a wide variety of investments and this should inform the fund's investment strategy.</p> <p>Risk control is effectively managed by the limits imposed within the fund's investment strategy statement and implemented through the fund's risk policies, which should ensure that these limits are not breached.</p> |

| Risk area | Control actions |
|--------------------------------------|--|
| Investment pooling | <p>Administering authorities should thoroughly review their risk management policy and processes to allow for new risks and changes to existing risks as a result of investment pooling. This should reflect the roles and responsibilities of those involved in identifying, analysing, monitoring and controlling risk.</p> <p>A full understanding of the role of an oversight committee and its own risk management arrangements and processes will support good overall risk management and enable gaps to be identified in the control process.</p> <p>Control actions for many of the risks are covered within this chapter – it is the policy detail that will typically differ.</p> |
| Liquidity risk | <p>Administering authorities should have processes in place to manage the overall liquidity of the fund, ensuring that cashflow is available to meet benefits as they fall due. They should be aware of the risks to cashflow of different future scenarios such as a decline in active membership, as well as the risks associated with forced sales of illiquid assets. Strategic and tactical asset allocation decisions can be used to manage this risk.</p> |
| Currency risk | <p>It is possible to consider some exposure to overseas currencies as providing diversification. Currencies rise and fall in value over time and some currencies may be appreciating against sterling while some are depreciating. As mentioned above, the risk is harmful only when sterling is appreciating relative to a basket of other currencies. Active managers of bond assets normally hedge overseas currency exposure unless they specifically elect to take currency risk. Active managers of equities do not normally hedge currency risk.</p> <p>It is possible for administering authorities to hedge some or all of their fund's currency exposure using currency forwards, either by using a specialist currency hedging manager or by adopting a passive hedge ratio implemented by a custodian or other provider. Administering authorities may consider that currency risk is relatively small compared with equity market risk and choose to accept the positive and negative swings in value that occur over time.</p> |
| Manager underperformance risk | <p>The impact of underperformance of any single active manager can be mitigated by combining active and passive management and using several active managers. Of course, it also diversifies the benefits of any active manager's outperformance, but appropriate diversification is widely regarded as good investment discipline.</p> <p>Managing the underperformance of active managers and assessing whether to replace them is a difficult task. Some funds operate on the basis of giving managers a three-year timeframe for performance to turn and others base their judgement on the level of underperformance experienced. Loss of key personnel or a change in ownership can make this judgement easier.</p> <p>Changing active managers can be relatively expensive because of transition costs and the lack of certainty that the replacement manager will be more successful. Some funds with strong performance records rarely sack managers outright but implement phased reductions (and increases) in mandate amounts.</p> |

| Risk area | Control actions |
|---|---|
| Transition risk | <p>The most appropriate way to manage transition risk is to take professional advice around the inherent risks and appoint a specialist transition manager. The transition manager will have responsibility to project manage the transition and to minimise the risks and costs of the transition by maximising the use of in specie transfers, programme trades and the use of derivatives such as futures to mitigate 'out of market' exposure.</p> |
| Custody risk | <p>Administering authorities should periodically assess their fund's custodian for service quality and operational standards (eg their processes for assessing their sub-custodians in overseas regions). It will also be valuable to conduct periodic audits of currency trades. The fact that the trades are being audited will act as an incentive to custodians to keep transaction fees under greater control.</p> |
| Stock lending risk | <p>It is important that administering authorities understand the processes involved in stock lending, in particular that when lending a stock they lose control of it. Administering authorities need to understand the different risks that relate to the assets used for collateral and in particular the risk of cash collateral. The easiest way to manage this risk is not to accept cash collateral. However, approaches to monitoring, calculating and adjusting collateral can vary in sophistication and operational cost.</p> |
| Counterparty risk | <p>A significant proportion of derivative transactions exchange using clearing houses to reduce counterparty risk. However, this centralises the risk on the clearing houses which will need to be adequately capitalised. Thus while risk can be mitigated, it can reappear in another guise elsewhere in the process.</p> |
| Environmental, social, and governance (ESG) risk | <p>Administering authorities should be aware of the policies of their investment managers in this area, and identify whether this is consistent with their fund's views, beliefs, and objectives around ESG considerations. Pension fund committees should, where considered appropriate, engage with their investment managers (either directly or via the pool) to identify the extent to which these factors are considered within the investment process and establish the degree of comfort that these risks are being appropriately managed on the fund's behalf.</p> |
| Governance risk | <p>Success in ensuring that there are sufficient assets to meet benefits as they fall due depends on good advice and good decision-making from a number of professionals and other participants, including the actuary, investment adviser, lawyer and auditor (see Chapter 5: Resource and Skills Risk in the LGPS). The advice and decisions then need to be acted on and implemented efficiently. Fund officers are also closely involved in the day-to-day management of the funds, while the pension fund committee and any delegated investment sub-committee are ultimately responsible for supervising the overall investment risk management framework.</p> <p>Governance of investment risk will also include effective monitoring, reporting and management of costs associated with the management of the fund's investments.</p> |

MONITORING RISK MANAGEMENT ACTIVITY

The general principles for risk monitoring are set out in this publication's introduction.

Given multiple layers of management and responsibility for investment operations on behalf of a typical LGPS fund (eg fund managers, investment advisors, investment pools), it is important that the appropriate governance body receives sufficient information, which may be from a variety of sources, to enable it to effectively fulfil its oversight role. In particular the administering authority should not rely on the effective risk management of others, but should instead have a process in place to enable it to monitor the effectiveness of that risk management.

CONCLUSION

There are a wide number of risks arising from assets and investment activity. The dominant risk is funding risk, ie the failure of asset returns to keep up with the developing cost of liabilities. Nevertheless, other risks can be material. The most important aspect is to ensure that pension committees understand the nature of these risks, their relative scale and the steps that can be taken to mitigate particular types of risk.

Liability risk in the LGPS

The LGPS is a multi-employer scheme providing benefits to members in line with the LGPS regulations. Each LGPS administering authority operates a fund that controls and invests assets to enable the fund to pay members' benefits as they become due.

The actual cost of meeting members' benefits is not known in advance. Every three years at the triennial actuarial valuation, the fund actuary will place a value on the expected cost of providing benefits already accrued by members along with those expected to build up in the future, known as the liabilities of the fund. The value placed on these liabilities will depend on a number of assumptions made by the fund actuary. Key assumptions are the expected investment return on the fund's assets, expectations of future inflation (which determine pension increases and revaluation of CARE accounts) and how long members live in retirement.

There is therefore a risk that actual future experience is worse than the assumptions, meaning that more money may be needed to pay members' benefits. It is also possible that actual experience may be better than the assumptions made so that the amount of money needed to pay members' benefits is less than expected. In this context liability risk is the risk that the amount of money needed to meet the fund's liabilities turns out to be greater than expected.

Both the fund and the participating employers should consider the effect of liability risk as both will be affected by any increase in liabilities.

- The administering authority is responsible for the fund's overall funding strategy.
- Participating employers will be expected to pay increased future contributions should more money be required to meet the payment of all benefits. They will also have some control over some liability risks that could arise, for example as a result of the use of employer discretions such as payment of augmented benefits.

IDENTIFYING LIABILITY RISKS

The key to identifying liability risks is to consider the assumptions made by the fund actuary at the triennial valuation. These risks can be split into two key types of risk:

- financial
- demographic.

It is then possible to identify the risks that are likely to have greatest impact on the value of the liabilities.

Financial risks

Financial risks include the following:

- **Discount rate risk:** In order to place a value on the fund's liabilities, the fund actuary must make an assumption about the long-term investment return expected to be achieved by the fund's assets. This assumption is used to discount the payment of future pension benefits to a current value and is commonly known as the discount rate. The discount rate adopted will be linked to the actual assets held by the fund and market conditions at the valuation date. The greater the long-term discount rate, the lower the value placed on the liabilities. However, as the discount rate is dependent on market conditions at the valuation date, there is a risk that the discount rate will reduce between valuations resulting in a higher value being placed on the fund's liabilities. This is largely a measurement risk since the liability cashflows do not change. The real risk is that the actual cost of benefits is higher than expected due to investment returns being lower than originally assumed (see Identifying asset and investment risk in Chapter 2, including asset/liability mismatch risk).
- **Inflation risk:** The fund actuary will also need to make an assumption about expectations of future inflation in order to place a value on the liabilities. The assumption adopted will be based on market conditions on the valuation date and will be the basis for expected future pension increases, revaluation of pension accounts and often salary increases (for pre-2014 final salary benefits, or pre-2015 in Scotland and Northern Ireland). There is therefore a risk that the assumption adopted is not in line with actual inflation in the short term – if inflation experienced is higher than assumed, the fund's liabilities will increase. There is also a risk that at subsequent valuations, market expectations of future inflation are higher, leading to a higher value being placed on the fund's liabilities. The latter (assumed future inflation) is largely a measurement risk related to future expected liability cashflows.
- **Salary increase risk:** The assumption made at the valuation in relation to salary increases is likely be linked to future expectations of inflation. There is a risk that salary increases actually awarded are higher than the assumption made which would increase the value of pre-2014 liabilities. There is also a risk that at subsequent valuations, market expectations of future inflation and hence salary increases are higher, leading to a higher value being placed on the fund's liabilities. The latter (assumed future salary inflation) is largely a measurement risk related to future expected liability cashflows

It is also worth noting that salary inflation risk is reducing in significance as the proportion of liabilities in respect of final salary benefits reduces and the proportion of career average revalued earnings benefits increases.

Demographic risks

Demographic risks include the following:

- **Longevity risk:** The demographic assumptions adopted to place a value on the fund's liabilities are usually intended to be a best estimate of the future experience of the fund and should also consider past experience of the fund. However, future life expectancy and, in particular, the allowance for future improvements in life expectancy, is uncertain.

The fund actuary will make an allowance for future improvements in life expectancy in his/her valuation assumptions; however, there is a risk that members will live longer than expected meaning benefits will be paid for longer, and the cost of providing benefits turns out to be greater than assumed.

- **Early retirement risk:** Liabilities for members who retire earlier than assumed in the triennial valuation and receive no reduction in benefits will be higher than expected. While employers will be required to pay additional contributions in cases where members are made redundant there could still be a strain where those contributions are set using different assumptions to the triennial valuation (and particularly where the valuation allows for some or all of a member's benefits to come into payment later than the age used to calculate the strain payment). The risk lies with participating employers rather than the fund, provided employers contribute to cover the additional costs. The more members retire prematurely with no reduction, the greater the cost of liabilities to the employer.
- **Ill-health retirement risk:** The fund actuary will make assumptions about the incidence of retirements on ill-health grounds and the proportion of such retirements which lead to Tier 1, Tier 2 or Tier 3 benefits. To the extent that this assumption is exceeded, or more members are granted higher tier benefits, the fund's liabilities will increase. Some funds may allocate participating employers an 'ill-health allowance' which if exceeded in any one year will require additional contributions to be paid to the fund by the employer. Others pool ill-health experience which means the risk of higher (or lower) liabilities than expected is shared across employers in the fund.
- **Regulatory risk:** Regulatory change is also a liability risk especially for the LGPS where pension benefits are governed by statute. Changes may impact on the fund's liabilities causing them to increase or decrease, eg changes to state pension age which affect the age at which members can draw their benefits with no reduction. There are limited actions the fund can take in relation to regulatory change; however, some control mechanisms are covered below.

LIABILITY RISK ANALYSIS

As part of the actuarial valuation, the fund actuary may calculate the value of the liabilities on a variety of assumptions to demonstrate the impact that a change in assumptions will have on the value of the fund's liabilities. This should also highlight the assumptions to which the value of the liabilities is most sensitive and those which the fund may wish to consider further.

At each actuarial valuation, the fund actuary will analyse the change in deficit or surplus since the last valuation, highlighting the main areas where actual experience differed from expected. This information could be used to inform the assumptions chosen for the future and indicate the liability risks which have had greatest impact on the fund.

Scenario testing and experience analysis is becoming common practice for funds and liability risk could be reviewed on a more regular basis than every three years as part of the triennial valuation.

LIABILITY RISK CONTROL

In common with all risk controls, liability risk controls describe those actions that are taken to reduce the likelihood of a risk arising and if it should arise, to reduce the level of risk to which the fund and participating employers are exposed.

Given the statutory nature of the scheme and the dependence of the liability value on a number of assumptions, it is not possible to eliminate all liability risk. However, there are a number of control mechanisms the fund can implement.

| Risk | Control mechanism |
|---|--|
| Discount rate falls | <p>Regular monitoring of changes in market conditions between triennial valuations, perhaps on a quarterly basis, provides early warning of changes in the outlook for future investment returns.</p> <p>Adopting a prudent discount rate assumption at triennial valuation as a cushion against reductions in future investment return expectations reduces the risk that contributions will be insufficient in the event that actual investment returns are less than expected.</p> <p>Consider holding assets that match the fund's liabilities; meaning that any movement in value of liabilities due to a fall in the underlying discount rate should in theory be matched by a corresponding movement in asset values. Consideration should be given to the impact of any such 'matching' investment strategies on investment returns and pension contributions (all other things being equal, lower investment returns will mean higher employer contributions over the long term).</p> |
| Inflation higher than expected | <p>To the extent that current inflation and hence pension increases are higher than anticipated, the fund actuary will take account of this in setting any deficit contributions.</p> <p>Adopt a prudent inflation assumption at triennial valuation as a cushion against increases in future inflation expectations.</p> <p>Consider holding assets expected to deliver returns above inflation in the long term (eg equities) or inflation linked assets to match inflation linked liabilities (noting the residual mismatch between RPI inflation and CPI linked liabilities). Consideration should be given to the expected long-term impact of different investment strategies on employer contributions.</p> |
| Salary increases are higher than anticipated | <p>Affects pre-2014 benefits only.</p> <p>Employers may have some control over the award of salary increases although government policy and national pay awards can also have an effect.</p> <p>At each triennial valuation, the fund and employers should consider the change in liabilities as a result of salary increases being higher or lower than expected.</p> |

| Risk | Control mechanism |
|--|---|
| Members live longer | <p>Regular monitoring of longevity and other demographic factors through the triennial valuations and interim valuations/ experience analyses provides early warning of any expected increase in contributions and costs.</p> <p>Regular updates from the fund actuary on general longevity experience within UK pension funds and national trends, eg from population statistics.</p> <p>Set mortality assumptions with a prudent allowance for future increases in life expectancy as a cushion against faster than expected improvements.</p> <p>Consider insuring pensioner longevity risk (eg for liabilities where special considerations or circumstances apply), where it is cost effective to do this.</p> |
| Greater number of early retirements | <p>Require employers to make capital contributions in respect of pensions strain arising from early retirements as a result of redundancy or on efficiency grounds.</p> <p>Monitor experience through the triennial valuation process or more regularly (and advise employers of the effect on their contributions).</p> <p>Consider explicit controls in admission agreements for any new admitted bodies joining the fund.</p> <p>Adopt a prudent assumption for early retirements at triennial valuation as a cushion against higher than expected experience.</p> |
| Greater number of ill-health retirements | <p>Regular monitoring of ill-health experience through the triennial valuations and interim valuations/experience analyses to provide early warning of changes in future costs.</p> <p>Consider setting an ill-health allowance and invoice the cost of any ill-health early retirements in excess of the allowance to employers as required.</p> <p>Consider pooling ill-health retirement risk within the fund or external insurance to smooth the effect on employer contributions.</p> <p>Consider explicit controls in admission agreements for any new admitted bodies joining the fund.</p> |
| Regulatory change increases the value of the scheme's liabilities | <p>Keep abreast of any regulatory changes, eg through attendance at LGPS conferences or seats on national bodies such as the LGPS Scheme Advisory Board (or its working groups), PLSA, CIPFA Pensions Panel and participate in relevant government consultations.</p> <p>Any likely developments regarding regulatory change should be factored into the triennial valuations.</p> <p>In interim periods, further updates regarding the impact of regulatory change may be required.</p> |

LIABILITY RISK MONITORING

The triennial valuation process provides the ideal opportunity for the fund to monitor the effects of risk controls and mitigations. However, the administering authority may wish to carry out more regular monitoring, eg through interim valuations, to help it assess whether its control mechanisms are sufficient and respond promptly to any changes in market conditions and/or actual experience.

SUMMARY

Liability risks to the pension fund are many and almost infinite depending upon the level of detail required to be considered.

This chapter provides a summary of key risk within the LGPS funds. The list is not intended to be exhaustive and does not consider employer risks within the funds (dealt with in the next chapter) nor the risks associated with the assets held by the funds (see previous chapter).

Employer risk in the LGPS

The LGPS is a multi-employer scheme, consisting of employers of a variety of types and sizes. Employers may be required by the regulations to operate the scheme for their employees or may have chosen to do so voluntarily; may have one member or thousands of members; may be a large statutory organisation or a small local charity. Each will pose a different level of risk.

The number and variety of employers participating in the LGPS has increased significantly in recent years, leading to increased fund exposure to employer risk and culminating in scheme wide initiatives such as the LGPS Advisory Board's reviews of academies and Tier 3 employers.

Tier 3 employers participating in the LGPS have no local or national taxpayer backing, nor a full guarantee or other pass-through arrangement with a body with such backing – such as some universities, further education colleges, housing associations and charities.

Risks can arise from both the employer's ability to meet the contribution requirements as they fall due and from poor quality or incomplete information being provided by the employer to the administrator. Accuracy of information is even more important now that a career average revalued earnings benefit structure has been adopted by the scheme.

Employer risk can encompass reputational and financial risk.

Reputational risk could occur, for example, if adverse publicity arises for the administering authority as a result of interactions with or failure of an employing authority. This could also lead to reputational risk for an authority as a whole (see also Chapter 7: Reputational Risk in the LGPS).

Financial risk could occur, for example, if the employer is not able to pay over the contributions due for any reason or does not efficiently administer the scheme. As a statutory scheme, member benefits are guaranteed while the financial risk of an employer (and if relevant its guarantor) being unable to meet its contribution requirement falls upon the other employers in the fund and ultimately on the local authority taxpayers, who are the funders of last resort.

However, poor record keeping and administration could affect the members themselves if it led to inaccurate member records and inaccurate payment of pensions.

In this context employer risk can therefore be defined as the current or prospective risk of an employer being unable to meet its contribution requirements, due to whatever reason, and/or to comply with the administration requirements of the LGPS, potentially leading to a detrimental effect on its members and/or the administering authority and/or other employers in the fund.

Good management of employer risk, including identification of those employers most at risk, monitoring and the carrying out of mitigating actions, is therefore vital to reduce risk levels and to avoid or minimise consequential detrimental effects on the various stakeholders.

IDENTIFYING EMPLOYER RISKS

The key to identifying employer risk is to build up an employer knowledge bank, collecting key information for analysis and monitoring, to identify employers which may pose the greatest risk and to quantify or assess the risk to which the fund and other stakeholders may be exposed.

Employer covenant

Where relevant, schemes should put in place systems and processes for making an objective assessment of the strength of an employer's covenant (which should include analysis of their financial position, prospects and ability to pay the necessary employer contributions).

Pensions Regulator's Code of Practice number 14 - Governance and Administration of Public Service Pension Schemes

Assessing and monitoring covenant should be proportionate to the circumstances of the scheme and employer. In order to take an informed view on proportionality, the knowledge bank should include sufficient information to facilitate a high level judgement of the risk of an employer being unable to meet its contribution requirements and therefore a deficit falling upon the other employers in the fund, and (where relevant) the size of that deficit if the risk materialises.

This information could include the below.

Riskiness

The knowledge bank could include details of the following:

- The nature of participation (is the employer a scheduled, designated, community admission body or transferee /paragraph 1(d) admission body?)
- Is the employer open or closed to new members? Are active membership numbers decreasing, increasing or staying level?
- Is there a bond in place? Does the employer have a guarantor from a tax raising body?

Exposure

The knowledge bank could include details of:

- the size of any existing funding deficit if the employer was to exit (including across multiple admissions where appropriate)
- the value of any other sources of security in place if the employer was unable to meet the required contributions following exit.

In addition, maintaining general knowledge of the political and public sector landscape may identify emerging employer risks, eg the introduction of a new college insolvency regime in England which may affect payment of pension deficits on a college insolvency.

The knowledge bank should be updated on a regular basis, noting that employer risk can change rapidly – a recent case in point being the collapse of Carillion in the six months following a profit warning in July 2016.

Administration

The knowledge bank could include details of:

- the level of accuracy of employers' annual contribution return
- the accuracy of employer data as measured as part of a wider data cleanse exercise
- the number of participating members.

EMPLOYER RISK ANALYSIS

The employer knowledge bank can be used as a starting point to analyse and assess the risk that each employer poses. The covenant and pensions administration risks should be analysed separately in two streams, with employers being placed into a risk category for each stream since different control measures and actions will be needed. Analysis and categorisation will enable priorities to be set.

Employer covenant

The information within the knowledge bank should be sufficient to enable the administering authority to take a view on which employers (if any) may warrant more detailed investigation, and the required level of detail for that investigation.

In order to analyse and assess the risks posed by each employer before categorising them, it will first be necessary to determine what is considered to pose a greater or lesser risk. This will assist with consistent analysis of risk, although there will still be times when a single piece of information received should 'set alarm bells ringing' and lead to immediate action. Reasonably broad categories can be used initially and refined over time as the largest risks are dealt with and controls and mitigating actions put in place.

Criteria to consider when analysing and assessing the risk posed by each employer could include, for example, whether the employer is the following:

- A scheduled, designated, community admission body or transferee admitted body. This has historically been considered a proxy for the level of risk, for example some scheduled bodies having tax raising powers while some small community admission bodies are reliant on charitable donations, but care is needed not to adopt too broad a categorization as there can be varying levels of risk within the category of scheduled bodies and community admission bodies.
- Open or closed to new members. A closed body may be considered to be more risky since there may be less time to make good any deficit as ultimately its last member will leave and at that point full funding will be required. Care is again needed to recognise that the build-up of future liabilities will be higher for open employers which will increase the fund's exposure to the failure of the employer.

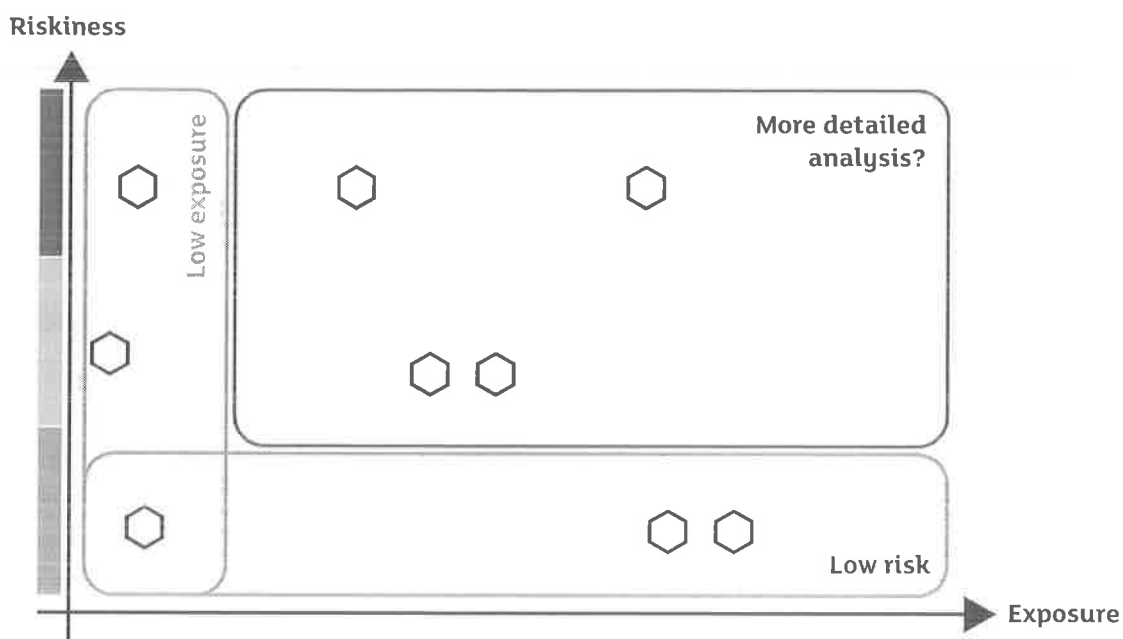
Note that the administering authority is primarily concerned with risk to the fund as a whole. There may be instances where specific scheme employers are exposed to risk (eg as a result

of their outsourcing activity), but where the fund does not believe it is exposed as a result of the scheme employer's guarantee. Some administering authorities may take a view that they should highlight this risk to the employer concerned. Either way, clear communication to employers of the approach taken will ensure there is no misunderstanding.

A key item on which to focus is the potential quantum of financial risk that the employer poses in a worst case scenario of immediate cessation, ie the current deficit on an exit basis (after allowing for any offsetting security).

Analysis of the various risk factors should provide an overall initial view of riskiness of each employer. This could lead to an initial risk categorisation as illustrated in Figure 4.1, where the level of risk is summarised using a RAG (red, amber, green) status.

Figure 4.1: Risk by red, amber, green (RAG) status



Source: Aon

Where more detailed analysis is required it should be noted that the Pensions Regulator's guidance on assessing and monitoring the employer covenant sets out that:

- assessments should be forward-looking and focus on the ability of the employer to contribute cash to the scheme over an appropriate period to achieve and maintain full funding, based on an assessment of the employer's forecast cash flows and the medium and long-term outlook for the business and the market in which it operates
- the administering authority should consider obtaining independent external advice where it lacks the objectivity or expertise required to perform an appropriate assessment.

Further information will be needed for the purpose of a more detailed risk assessment and may include items such as:

- credit agency ratings
- historic and forecast accounting information
- detailed analysis of corporate structures

- company and sector outlook analysis.

Key to the risk analysis system is that it is as clear and consistent as possible so that the information produced is understandable and usable.

Administration

Similar principles could apply for assessing the risks related to administration. For example, criteria to consider when analysing and assessing the risk posed by each employer could include:

- submitting accurate and timely annual contribution returns
- whether the standard or timeliness of returns has reduced.

A large or increasing number of discrepancies between the administering authority's records and the return could indicate an issue with record keeping and notification, and pose a greater risk to the accuracy of member records and ultimate pension payments.

Again, in order to set the risk into context it may be helpful to collect information to enable an assessment of the exposure. This could be the number of active records, or payroll of the employer as a percentage of the fund, for example.

Review

The knowledge bank can also be used to track and identify changing risk levels for each employer and the risk to which the fund is exposed as a whole. Employer covenant can change quickly and the administering authority should monitor the covenant regularly between valuations and have well-developed contingency plans so they can take decisive action if and when required.

In addition, all staff should be made aware of who to report employer information to, how frequently and, in turn, the responsible person should be aware of key information that should trigger an immediate risk mitigation action.

Further criteria could be developed for each piece of information gathered and the results of this exercise should be documented within the risk register.

EMPLOYER RISK CONTROL

In common with all risk controls, employer risk controls describe the actions taken to reduce the likelihood of a risk arising, and if it should arise to reduce the level of risk to which the fund and affected stakeholders (including the employers) are exposed.

Given the statutory nature of the LGPS and the number of contributing risk factors outside of the influence of an administering authority, it is not possible to eliminate all employer risk. For example, it is not possible to eliminate the risk of an admitted body going into receivership, which could be caused by a change in government policy leading to the withdrawal of funding to a charity admission body, leading to insolvency, but it is possible to control the risk exposure by, for example, requiring new admitted bodies to have a guarantor in place and by the use of an appropriate funding target and deficit recovery periods for those organisations without statutory tax raising powers, or just one source of income.

It is also possible to reduce inherited or historic risk exposure by, for example, introducing the requirement for a guarantor or bond, when a long-standing community admission body wishes to make other changes to their admission agreement.

Controlling risks should be proactive and reactive; proactive to reduce and control risk over the longer term and reactive to deal with emerging risks, such as prompt submission, within timescales, of a deficit funding claim to receivers upon an employer being placed in administration. A set of standard procedures to follow in such situations could be prepared.

The key to good risk control is to make best use of the information gained from analysis of the knowledge bank and of the governance tools available.

For example the following:

- The funding strategy statement can take account of the employer risk categorisation emerging from the risk analysis, allowing for example a funding target closer to that which would be used at exit and shorter recovery periods for the higher risk groups and cash deficit contributions for those with reducing payrolls, thereby reducing the risk of being left with a large unpaid deficit should the employer cease.
- The admission policy can require new community admission bodies to be of a certain financial standing and for security such as bonds or guarantors to be in place, thereby reducing the risk of being left with a large unpaid deficit should the employer cease.
- Engagement with employers to find bespoke solutions to issues and agree appropriate actions for the fund and employer's mutual benefit. For example, a lower risk investment strategy may reduce risk for the employer and the fund for employers close to a planned exit.
- Reputational risk associated with adverse publicity, such as a local news article on 'bankrupting a local charity', may be avoided if an alternative solution is found that enables the charity to continue and the fund to receive a greater amount of money over the longer term.
- Legal agreements might be used where sufficient security exists to justify deferring crystallisation of an exit and it is not possible to recover the full debt immediately, reducing the risk of employer default.
- The administration strategy can be used to target record keeping issues and encourage employer compliance by use of employer charges, thereby reducing the risk of inaccurate payments to members and inaccurate knowledge of employer liabilities at valuations producing an insufficient employer contribution rate.
- Employer training programmes can be developed to train new employers' staff taking on pension responsibilities and to cover the issues identified from analysis of the discrepancies between the employers' annual returns and the fund's member records, thereby reducing the risk of inaccurate payments to members and inaccurate knowledge of employer liabilities at valuations producing an insufficient employer contribution rate.

In addition:

- Technology can be used to monitor and analyse issues and to automate much of the checking of employer annual returns and day-to-day data submissions, reducing human error and reporting back promptly to the employer placing the onus back on them to provide good data.
- Communications can be used to ensure that employers are aware of the consequences that can arise from their actions, such as the requirement to pay off a deficit upon cessation as an employer in the fund, reducing the risk of the employer being unable to meet an unexpected financial demand.

EMPLOYER RISK MONITORING

Given the potentially significant sums involved, it is important that employer risk is monitored along with compliant operation of the processes and systems set up to control it, and that records are kept. This should be integral to the administering authority's risk management process and embedded within its fund governance.

Regular monitoring of employer risk can not only ensure that the risk management systems are working effectively and in a timely manner, but also ensure that trends and emerging risks are identified as early as possible and control action taken.

Pension committees should take key decisions around policies and actions connected to employer risk, such as those concerning admission of employers and the setting of funding policies and the funding strategy statement and employer contribution rates.

Administering authorities should monitor if effective risk control is in place, operating well and achieving the desired outcomes. They should then decide if further measures are required or if changes should be made.

Pension committees should receive:

- regular reports on the status and progress of risk identification processes
- the outcomes of risk analysis, levels of risk exposure and comparison with previous reviews
- changes in risk levels following mitigating control actions
- details of particular employers at risk
- details of control actions planned and completed
- analysis of risks experienced, outcomes and where further controls may be necessary.

Resource and skill risk in the LGPS

In the Pensions Finance Knowledge and Skills Framework (CIPFA, 2010), CIPFA recognises that the financial management of pension funds requires specific professional skills that set this activity apart from other local authority financial operations. However the financial management of the pension fund is just one aspect of the role of an LGPS administering authority. Pensions administration, scheme communication and a good IT infrastructure, amongst other requirements, are all essential elements of pension fund management.

Good governance and best practice in the discharge of administering authority functions require having the right people with the right skills with the right level of funding. Without this, the authority may be unable to effectively discharge its duty as an LGPS administering authority, placing the fund at financial and reputational risk.

IDENTIFYING RESOURCE AND SKILL RISK

Resource and skill risks can arise in four ways:

- inadequate staffing levels for the roles required
- inadequate knowledge and skills for the roles required
- inadequate resources to support staff in their roles
- turnover amongst elected members and hence membership of pension committees.

Of all the of the risk areas identified in this publication, the area of resource and skill risk is perhaps the one over which administering authorities can exercise the greatest control.

Through a process of rigorous business planning, supported by knowledge and skills analysis tools like the *Pensions Finance Knowledge and Skills Framework*, an administering authority can identify where skill and resource risks may occur. The horizon scanning associated with business planning will also help to identify other longer-term events that may present risks to resource and skill availability. For example GMP (and scheme) reconciliation has required material internal resource or funding of an external provider and put additional strain on pensions administration staff and scheme communications.

Similarly, the ongoing focus on implementation of new investment pooling arrangements has had a material knock-on effect on fund resources and skills available for administration functions.

Although resource allocation lies within the control of the organisation, external factors such as public sector funding constraints affect available resources. Administering authorities

should therefore also consider how the wider economic circumstances and political environment might affect the availability of resources. Budgetary constraints may, for example, result in the loss of experienced, skilled staff.

Other events such as unplanned staff departures or changes to membership of pension committees or local pension boards may also give rise to the risk of loss of knowledge and skills.

Identified risks should be detailed on the risk register and a risk owner should be assigned.

RISK ANALYSIS

Resource and skill risk should be analysed using the same standard risk analysis methodology outlined earlier, and to counter the inherent uncertainties that this presents, the analysis process should be as consistent and simple as possible.

As with any other risk analysis, this will be subjective and affected by local issues and priorities.

RISK CONTROL

As noted earlier, risk controls are those actions taken to reduce the likelihood of a risk event occurring, its frequency and the severity of the consequences should it occur. Risk control actions could comprise taking steps to eliminate, transfer and/or mitigate risk by the introduction of control processes.

Risk elimination presumes that administering authorities have the capacity to cease the particular activity that gives rise to the risk. However as with many other local authority roles, the role of an LGPS administering authority is designated by statute and therefore an authority cannot simply cease the activity.

Resource and skill risk therefore must be managed using risk reduction and/or risk transfer techniques that seek to reduce the probability that risk will occur (proactive controls) or lessen the impact of the risk should it arise (reactive measures).

Proactive controls could include:

- preparing annual and mid-term business plans which identify short- and long-term resource requirements
- ensuring adequate budgetary provision for staff and resources to meet demands
- conducting annual skills audits to ensure that skills remain relevant to the roles being undertaken
- preparing and executing annual training plans for officers and members
- appropriate recruitment and retention policies for roles where skills are in high demand/ short supply
- establishing procedures and processes to promote stability of membership of pension committees and local pension boards
- utilising shared services or outsourcing to transfer or share resource and skill risk with third parties.

Reactive controls could include:

- succession planning for key roles to mitigate the effect of planned or unplanned departures.

RESOURCE AND SKILL RISK MONITORING

The general principles for risk monitoring are set out in this publication's introduction.

In relation to resource and skill risk, administering authorities should carry out regular assessments of the skills and knowledge of officers, pension committee and local pension board members through self-assessment, gap analysis or other means.

Monitoring of resource risk should be closely aligned with fund business plan reviews as well as performance measurement against KPIs or disclosure deadlines. This will help to inform the review of the risk register.

2.1

CHAPTER 6

Administrative and communicative risk in the LGPS

The increasingly challenging environment in which the LGPS operates requires pension funds to undertake effective business planning. Risk management should be embodied within the business planning process and should be considered in relation to all aspects of operations. The management of risks applies just as much to the administration of the benefits as it does to the investment of funds.

The diversity of employer organisations, the complexity of scheme regulations, the size of pensioner payrolls and the dependency on ICT systems are known challenges for LGPS administration teams, but the underlying risks need to be assessed and managed by the pension fund.

Risk consequences for administration may most obviously be defined in terms of resource (people, technology, etc), but can also have significant impact both reputationally and financially (eg as a result of maladministration or cyber-attacks).

Risk management of LGPS administration should be a dynamic process in order to identify new and emerging risks and to take account of changing priorities and objectives. Arguably, administration risk management needs to be more responsive to the 'here and now' of operational and regulatory challenges compared with say financial or investment risks, which may have a longer-term focus.

Risk registers should be used by administering authorities to record and assess all related investment and administration risks. The register should analyse the risk and drive action to:

- remove/reduce the likelihood of the risk occurring
- increase the visibility of the risk
- increase the ability to handle the risk, should it occur
- reduce the impact of the risk should it occur.

In the same way as individual risks should have risk owners, risk registers should be collectively owned by the pension fund management team and the pensions committee.

The management of administrative risks, including cyber risks, should be embedded into the pension fund's service planning framework to demonstrate that it is an integral part of business planning, decision-making, performance monitoring and budget setting.

As with all risks, administration risks may be both negative threats and missed/unmanaged positive opportunities – scheme communications being a good example of a positive

opportunity to inform and educate scheme members but a negative one when it is not done well. The impact of misinformation, or lack of communication causing scheme members to make the wrong or untimely decisions, can have far reaching financial and reputational consequences.

IDENTIFYING ADMINISTRATION RISKS

The administration risks contained within a fund's risk register may include risks specific to a particular fund or applicable more widely to all LGPS funds. While not an exhaustive list, examples of administration risks may include the following:

- **Failure of ICT:** This risk may impact on the funds ability to make payments, collect income, monitor investments, communicate with stakeholders, etc, and is therefore one of the key operational risks. It may be mitigated by an ICT disaster recovery service hosted by the administering authority or another external provider.
- **Failure to provide accurate and timely advice to employers:** Different employers will have different characteristics and it is important that the risks associated with each employer are considered and understood. The timely and accurate provision of information both to and from employers is important, particularly in the current climate of outsourcing, partnering and service transformation. A close working relationship with all employers in the fund is essential in order to ensure that they understand and take account of pension issues.
- **Over-reliance on/loss of key staff:** Staff are a key resource. Without the appropriate level of staff and experience, there is a risk that a pension fund will be unable to deliver pension services which may have financial, legal or reputational consequences. Investment must be made in staff, including training and development, managed through an appropriate appraisal programme. Succession planning enables the loss of key staff to be mitigated and managed.
- **Data quality:** Another significant administration risk is data quality. Data is the raw material for all administrative processes. It drives the accuracy of member records and pension payments, forms the basis of valuations and determines the success of automation and out-sourcing. While not only reducing risk, good quality clean data can also reduce costs and lead to greater efficiencies.
- **Resources:** The fund being under resourced or having to compete for resources while operating within the policies and procedures of the administering authority which may have very different priorities.
- **Legislative and regulatory changes:** Consultation periods are often short and therefore it can be difficult to fully engage with all stakeholders. To some extent this can be overcome with the use of IT, but often the complexity of regulatory change demands face to face meetings with employers and employees. The implementation of major regulatory reform can be very challenging and a significant drain on resources; dedicated project management can prove useful in these circumstances. During the implementation period reliance is often placed on key members of staff, thereby further increasing risk.
- **Third party provider under-performance:** A typical LGPS fund relies on third party providers for many 'business critical' systems: pensions payroll; benefits administration; accounting systems; and banking systems. While often unthinkable, these systems can

fail. As a minimum, service level agreements which include supplier business continuity arrangements should offer some reassurance, but it is not until these arrangements are tested that business as usual can be guaranteed. Where a third party is used, appropriate oversight by the client (ie the administering authority) will be needed.

- **Data protection:** On a daily basis LGPS funds receive, transmit, process and store huge volumes of personal data. The financial penalties and reputational impact of data mismanagement are significant and have increased under new General Data Protection Regulations (GDPR). ICT security such as data encryption, secure email and document management software is key to the mitigation of this risk. Administering authorities should ensure appropriate arrangements are in place with their advisers and suppliers and that appropriate data privacy notices have been produced and issued.
- **Collaborative working:** Many examples already exist within the LGPS of shared working, from practitioner user groups and networks which share experiences and good practice to regional and national procurement frameworks – which aim to make the selection and appointment of third party service providers more efficient. Increasingly administration services are being shared. Administering authorities need to ensure they retain oversight of any third party providing administration or other pensions services for their fund.
- **Cyber threats:** While many examples of the effect of cyber threats (such as failure of ICT, loss of personal data) should already be covered under existing risks, the evolving nature of cyber risks and associated reputational risk if an event does occur, means administering authorities ought to consider this as a separate risk. They should also ensure that the risks specifically to the fund from cyber threats are at a minimum adequately assessed and considered, rather than simply relying on the policy of the administering authority in its corporate role. Where administration or other key pensions functions are outsourced the administering authority should also ensure that its providers are adequately prepared for possible cyber-attacks and that this risk has been analysed within the fund's overall risk management framework.

ADMINISTRATION RISK ANALYSIS

As with any other risk analysis, this will be subjective and affected by local issues and priorities. Regard should be given to the data scores submitted to the Pensions Regulator as part of the annual scheme return and other measures of data quality and service.

Higher weighting might be considered for risks which would have the highest impact, eg if resource is a key administration pressure, mitigating risks affecting larger employers may have a greater priority because of the impact, should that employer become unable or unwilling to undertake its administration responsibilities.

RISK CONTROL

Methods of risk control may include:

- **avoidance/elimination:** stopping the activity or finding a different way of doing it
 - **reduction:** putting procedures and controls in place to reduce the likelihood of the loss happening or impact if it does
-

- **retain:** deciding to carry the risk as part of normal operations
- **transfer:** placing indemnity clauses in contracts, obtaining insurance cover or outsourcing the service (noting that this risk will change as a result of the transfer but will not be eliminated – ie ultimately the administering authority remains responsible).

Typical examples of LGPS administration risk controls or risk reduction/mitigation include:

- ensuring committee members are fully trained and supported so they understand the risks and implications
- ensuring staff have correct training/skills and support
- ensuring processes are adequately documented and understood (and followed)
- investing in developing relationships with key stakeholders, including employers (communication, support, training, advice, etc)
- investing in communication with scheme members to educate/inform, support decision-making, manage expectations
- monitoring the effectiveness of all aspects of service, including communication and support
- ensuring adequate/appropriate resource is available for testing and supporting ICT systems (internally and by any third party providers)
- being aware of and ready to take advantage of/exploit new opportunities in technology to tackle existing and new challenges
- maintaining a business continuity plan: testing it regularly; ensuring that it integrates with third party providers; paying particular attention to single points of failure
- ensuring any third party is competent and appropriate for the task (eg annual benefit statements, online facilities) with suitable contract management and performance measurement in place
- ensuring recovery plans address responding to cyber incidents, with these plans being tested and improved on a regular basis.

RISK MONITORING

The general principles for risk monitoring are set out in this publication's introduction.

In relation to administration risk, the fund should monitor and refresh the risk register regularly and review/react to results of monitoring and feedback. Monitoring activity will include:

- own performance monitoring (eg internal data collection, customer satisfaction surveys)
- benchmarking (external)
- monitoring and testing of third party providers (eg annual benefit statements, online facilities)
- complaint analysis
- compliance (eg internal audit).

Reputational risk in the LGPS

The reputation of a local authority (and other non-local authority administering authorities) is a valuable asset. As providers of public services, sometimes to the most vulnerable in society, the ability of an authority to project itself as an organisation in which individuals can have confidence and place their trust is critical to the achievement of its objectives.

The same applies to the role of an administering authority as a scheme manager in the LGPS. Successful scheme administration requires that scheme members, their employers, MHCLG, those with whom the authority has a financial relationship and the whole spectrum of scheme stakeholders have confidence and trust in the administrator.

In this context reputational risk can therefore be defined as the current or prospective risk to the successful achievement of corporate objectives arising from adverse perception of the image of the administering authority, which might give rise to a lack of confidence or trust on the part of LGPS stakeholders or the wider public.

IDENTIFYING REPUTATIONAL RISKS AND OPPORTUNITIES

In recent years there has been growing intensity in the external scrutiny of almost every aspect of the LGPS. Investment decision-making for example is watched closely by organisations that campaign on ethical investment issues; in 2018 the Pensions Regulator indicated an increasing focus on data quality in the LGPS; and investment pooling is a key focus of the government. The level of public and stakeholder interest in the LGPS presents challenges to administering authorities and the risk that the organisation as a whole may be seen in a negative context as a consequence of its actions or omissions in its management of the LGPS.

The key to identifying reputational risks is to understand the context within which the administering authority is operating. This intelligence can be gathered from various sources, either actively or passively, such as:

- participation in formal or informal networks
- training events and conferences
- active scanning of media sources, local and national establishing formal or informal contacts with scheme stakeholders.

This allows the authority to build up a picture of the reputational environment in which it is operating – the expectations of stakeholders and the criteria by which others will judge the organisation.

There is also a positive aspect to the scrutiny that being an administering authority in the LGPS brings: organisations should also assess the opportunity that such scrutiny provides to

improve their reputation. Recognition of good practice by peers, the pensions industry and regulators can enhance organisational reputation.

REPUTATIONAL RISK ANALYSIS

Equipped with an overall assessment of the risk environment, reputational risks and opportunities can be analysed using the same standard risk analysis methodology outlined earlier. However it should be noted that this risk area is probably the one that is most prone to subjectivity when attributing a risk score, as assessing the likelihood and, particularly, impact of reputational risk rests heavily on the perceptions of third parties, which can be varied and inconsistent.

As noted earlier, in order to counter the inherent uncertainties that this presents the analysis process should be as consistent and simple as possible.

RISK CONTROL

Reputational risk cannot be eliminated or transferred so must be managed using risk reduction techniques that seek to reduce the probability that risk will occur (proactive controls) or lessen the impact of the risk should it arise (reactive measures). The latter is particularly important.

As part of a national pension scheme, events may occur at a policy level over which any one fund has little or no influence, and is therefore unable to act to mitigate risk. However reputational effects may well be felt at local level. The work of the Independent Public Service Pensions Commission and subsequent pension scheme reform process are good examples of where individual funds have come under scrutiny due to events at a national level.

Proactive measures could include:

- ensuring that fund management and governance are conducted in an open and transparent manner
- ensuring good lines of communication with fund stakeholders
- engaging with/leading on best practice initiatives.

Reactive measures could include:

- having a prepared media response plan.

RISK MONITORING

The general principles for risk monitoring are set out in this publication's introduction.

As reputational risk is largely driven by external perceptions of an organisation, monitoring whether risk is being managed effectively does not lend itself easily to quantitative measures. However some simple indicators might include:

- tracking communications with stakeholders for negative comments
- monitoring interactions with regulators, standards setters, auditors, etc, for potential areas of weakness

- recording positive versus negative media coverage of the organisation as it pertains to its pensions role.

These can help inform those charged with governance on whether reputational risk is being managed, and also can be used to feed back into the risk analysis process to assess whether changes to risk controls are required.

Regulatory and compliance risk

Pensions and pensions administration are heavily regulated areas. General pensions legislation runs to thousands of pages and administering authorities also have to observe scheme-specific legislation, as well as statutory and best practice guidance.

Each change in the pensions regulatory environment poses challenges to pension scheme administrators, with the removal of contracting-out from April 2016 and changes to pensions taxation via a reduction in the lifetime allowance being just two examples of set piece changes in recent years. The Pensions Regulator has also issued guidance specifically for public service pension schemes and has already fined an authority for not submitting its annual scheme return.

Non-compliance with some elements of pensions legislation may result in specific penalties or sanctions, resulting in financial loss. In other areas, non-compliance may result in costly legal challenge or reputational damage. It is important therefore that administering authorities recognise and take steps to counter the risks posed by regulatory compliance.

IDENTIFYING REGULATORY AND COMPLIANCE RISK

Every piece of legislation or guidance comes with an in-built risk of non-compliance and, as large parts of pension scheme administration are driven by legislative requirements, the risk of non-compliance can arise across a wide range of activities.

The approach to identifying non-compliance risk will therefore focus on those areas where weaknesses in business processes may give rise to risk. This can be reinforced by gathering intelligence on forthcoming legislation and engaging in the statutory consultation process to obtain early sight of planned changes. This will allow new requirements to be built into administrative processes and permit training to take place ahead of new regulations or guidance coming into force. Good sources of information include:

- formal or informal networks
- training events and conferences
- pensions media sources
- formal or informal contacts with scheme stakeholders.

REGULATORY RISK ANALYSIS

With an overall assessment of the current and pending regulatory environment, non-compliance risk can be analysed using the same standard risk analysis methodology outlined

earlier in this publication. In order to counter the inherent uncertainties that this presents, as noted earlier the analysis process should be as consistent and simple as possible.

Further, the Pensions Regulator's Code of Practice 14 states that:

Identifying and assessing a breach of the law is important in reducing risk and providing an early warning of possible malpractice in public service pension schemes. Scheme managers should establish and operate appropriate and effective procedures... [which] include the following features:

- *a process for obtaining clarification of the law around the suspected breach where needed*
- *a process for clarifying the facts around the suspected breach where they are not known*
- *a process for consideration of the material significance of the breach by taking into account its cause, effect, the reaction to it, and its wider implications, including (where appropriate) dialogue with the scheme manager or pension board*
- *a clear process for referral to the appropriate level of seniority at which decisions can be made on whether to report to the regulator*
- *an established procedure for dealing with difficult cases*
- *a timeframe for the procedure to take place that is appropriate to the breach and allows the report to be made as soon as reasonably practicable*
- *a system to record breaches even if they are not reported to the regulator (the record of past breaches may be relevant in deciding whether to report future breaches, for example it may reveal a systemic issue), and*
- *a process for identifying promptly any breaches that are so serious they must always be reported.*

RISK CONTROL

Risk controls are those actions taken to reduce the likelihood of a risk event occurring, its frequency and the severity of the consequences should it occur. As discussed in previous chapters, the potential to eliminate risk through discontinuing a particular activity or transferring risk to a third party is limited in an LGPS context. Therefore risk control actions will focus on using risk reduction techniques that primarily seek to reduce the probability that risk will occur. This might include:

- building compliance checks into business processes, both automated and manual
- ensuring that staff are adequately trained in pensions legislation and guidance requirements
- developing and testing IT systems for compliance with regulations.

RISK MONITORING

The general principles for risk monitoring are set out in this publication's introduction.

As non-compliance risk can arise from failures in business processes, monitoring whether risk is being managed effectively can be measured by reviewing process outputs. This might include:

- undertaking quality assurance reviews to check compliance with regulations
- reviewing the recommendations from internal audit reviews regarding regulatory compliance
- monitoring complaints for regulatory breaches.

These can help inform those charged with governance whether non-compliance risk is being managed and also can be used to feed back into the risk analysis process to assess whether changes to risk controls are required.

Administering authorities should also consider developing a specific mechanism to monitor the fund's adherence to the Pensions Regulator's Code of Practice as part of its monitoring of regulatory risks, controls and compliance.

CHAPTER 9

Conclusions

Effective risk management is an essential element of good governance in the LGPS. By identifying and managing risks through an effective policy and risk management strategy, organisations can:

- demonstrate best practice in corporate governance
- improve their financial management
- minimise the risk and effect of adverse conditions
- identify and maximise opportunities that might arise
- minimise threats.

Successful risk and opportunity management should also:

- ensure that there is a proper balance between risk taking and the opportunities to be gained
- enable funds to anticipate and respond positively to change
- minimise loss and damage to the fund and the administering authority, and to those outside the organisation who are dependent on the benefits and services provided
- make sure that when the authority embarks upon new areas of activity (new investment strategies, joint-working, framework agreements etc), the risks they present are fully understood and taken into account in making decisions.

It is important to recognise that risk management is not an end in itself; nor will it remove risk from a fund or from the fund administration activities of an administering authority. However it is a sound management technique that is an essential part of any successful organisation. The benefits of an effective risk management approach for the organisation include better decision-making, improved performance and delivery of services, more effective use of resources and the protection of reputation.

APPENDIX A

An example risk management policy

INTRODUCTION

The authority is aware that some risks will always exist and will never be eliminated.

Against this background the authority recognises it has a moral and statutory duty to manage risk with a view to safeguarding its employees, protecting its assets and protecting the public.

The authority will meet this duty by adopting best practice risk management (RM) which will support a structured and focused approach to managing risks, and ensuring risk management is an integral part in the governance of the authority at a strategic and operational level.

The overall aim is to embed risk management into the processes and culture of the organisation to help it achieve its corporate objectives and enhance the value of services the authority provides to the community.

THE AUTHORITY'S RM OBJECTIVES

The authority's RM objectives are to:

- integrate risk management into the culture and day-to-day activities of the authority
- raise awareness of the need for risk management by all those connected with the delivery of services (including partners, delivery agents and those involved in any form of collaborative delivery of services)
- enable the authority to anticipate and respond positively to change
- minimise injury, damage, loss and inconvenience to residents, staff, and service users arising from or connected with the delivery of authority services
- establish and maintain a robust framework and procedures for identification, analysis, assessment and management of risk, and the reporting and recording of events, based on best practice (the authority's 'approved RM methodology')
- ensure consistent application of the authority's RM methodology across all authority activities, including projects and partnerships
- minimise the cost of risk.

KEY MECHANISMS FOR DELIVERY

To demonstrate the authority's clear commitment to achieving the objectives of the risk management strategy, the authority has identified the key mechanisms through which they will be delivered. These objectives will be achieved by:

- maintaining clear roles, responsibilities and reporting lines within the authority for risk management
- maintaining adequate representation at departmental and corporate level so that risks may be freely communicated, experience pooled and information, guidance or procedures that may have a significant impact on the authority's risk may be considered
- promoting excellence in risk management
- ensuring that risk management is explicitly considered in all policy decisions, partnerships, projects and key planning processes by incorporating links to all key decision points, eg committee reports (including members), delegated decisions, project management (including project initiation documents)
- maintaining risk registers for risks arising at all levels in the authority, and ensuring that the process assesses risks for likelihood and impact, identifies owners and mitigating controls and ensures that they are reviewed at least annually – ensuring that these are adequately documented and regularly reviewed in the light of changing circumstances
- maintaining registers for all strategic partnerships and projects, including at project initiation stage and obtaining appropriate assurance about the adequacy of those registers
- providing opportunities for shared learning on risk management across the authority and with other authorities, partners and stakeholders where appropriate
- reinforcing the importance of effective risk management as part of the everyday work of employees, and that employees, officers and members are adequately informed and receive training about the risks within their own working environment
- ensuring there is appropriate leadership and monitoring of key corporate projects
- regularly monitoring, reporting and independently reviewing the authority's arrangements
- taking every opportunity to identify and publicise the opportunities that risk management provides for the organisation.

The authority recognises the breadth and complexity of the services that it delivers, and also of the mechanisms by which they are delivered. Therefore, in order to assist in the consistent application of sound risk management principles throughout the organisation, a series of toolkits have been produced. These address general risk management, and risk management of partnerships and projects. These can be located on the authority's internet/intranet pages.

Further support, advice and guidance can also be obtained from your local risk management champion, or (when appropriate) the authority's risk and insurance manager.

Example risk register

Public service toolkit downloadable example risk register

| Risk area 1 – Operations | Likelihood (1: least likely, 10: most likely) | Impact (1: least likely, 10: most likely) | Score (likelihood x impact) | Control | Owner | Test | Next review | Comment |
|---------------------------------------|--|---|--------------------------------|--|-------------------------|--------|-------------|---|
| Operational disaster (fire/flood etc) | 1 | 6 | 6 | Business continuity procedures in place for administrator | Scheme manager | Annual | Q1 Y2 | Up-to-date business resiliency programme provided by administrator as at 01/01 Y2, reviewed by scheme manager at meeting in Q1 Y2 |
| | | | | Business continuity plans in place for scheme manager | Scheme manager | Annual | Q2 Y2 | Documented programme in place to ensure continuity will be provided by pension finance manager to scheme manager in time for quarterly meeting in Q2 Y2 |
| | | | | Contracts with all advisers and suppliers are recorded on central database | Pension finance manager | Annual | Q1 Y3 | Contracts held in hard copy in safe, and electronically in secure area of scheme management intranet. Checked by pension finance manager January Y2 |
| Member data incomplete or inaccurate | 5 | 7 | 35 | Annual report from administrator, used as basis for rectification plan | Scheme manager | Annual | Q3 Y2 | Initial rectification plan completed Q3 Y1. New report received from administrator at Q1 Y2 meeting, revised rectification plan agreed with administrator. To review progress at Q3 quarterly meeting |

| Risk area 1 – Operations | Likelihood (1: least likely, 10: most likely) | Impact (1: least likely, 10: most likely) | Score (likelihood x impact) | Control | Owner | Test | Next review | Comment |
|--|--|---|--------------------------------|--|--------------------------------|-----------|-------------|---|
| | | | | | | | | |
| | | | | 'Not known at this address' returns from annual statements checked by tracing agency | Pension administrator | Annual | Q2 Y2 | Details provided by administrator mid January Y2, passed to tracing agency at end of January. 25% traced by quarterly meeting in Q1, update will be provided to scheme manager for Q2 meeting |
| Administration process failure/maladministration | 4 | 8 | 32 | Formal agreement in place with administrator, including SLAs | Pension finance manager | Annual | Q1 Y3 | Last reviewed Q2 Y1, three year agreement |
| | | | | Authority levels clearly agreed and kept up-to-date | Scheme manager | Annual | Q2 Y2 | Last reviewed Q2 Y1 |
| | | | | Review independent audit reports of administrator's processes | Scheme manager | Annual | Q2 Y2 | AAF01/06 held by administrator as at DD/MM/YYYY |
| | | | | Ongoing dialogue with third party administrator | Pension administration manager | Ongoing | Q2 Y2 | Weekly phone calls between pension administrator manager and third party administrator, plus ad hoc calls when necessary |
| | | | | Written reports and quarterly presentations by administrator to scheme manager | Scheme manager | Quarterly | Q2 Y2 | Next report from administrator due two weeks before quarterly meeting |

| Risk area 1 – Operations | Likelihood (1: least likely, 10: most likely) | Impact (1: least likely, 10: most likely) | Score (likelihood x impact) | Control | Owner | Test | Next review | Comment |
|---|--|---|--------------------------------|---|----------------|-----------|-------------|---|
| Risk area 2 – Financial | | | | | | | | |
| Excessive charges by suppliers | 3 | 2 | 6 | Annual review of scheme budget, quarterly review of costs incurred against budget | Scheme manager | Quarterly | Q2 Y2 | Annual budget agreed Q1 Y2. Q4 Y1 charges reviewed and agreed Q1 Y2 |
| | | | | Periodic review of suppliers | Scheme manager | Annual | Q1 Y1 | Planning underway for review of administrator in Q3 Y2, to include cost and performance benchmarking |
| Fraud/Fraudulent behaviour | 1 | 10 | 10 | Conduct a monthly fraud monitoring process of incoming contributions payments against the schedule of contributions | Scheme manager | Monthly | Q2 Y2 | All contributions have been accounted for and have been paid in accordance with the schedule of contributions |
| | | | | Check incoming and outgoing scheme funds against schemes forecast – reconciling all funds | Scheme manager | Monthly | Q2 Y2 | Accounts forecast against actual checked and balance |
| Risk area 3 – Funding | | | | | | | | |
| Employer failure to pay contributions into scheme | 1 | 10 | 10 | Monthly monitoring of contribution payments by pension finance manager and administrators | Scheme manager | Monthly | Q2 Y2 | All Q4 Y2 contributions paid in accordance with Schedule of Contributions |

| Risk area 1 – Operations | Likelihood (1: least likely, 10: most likely) | Impact (1: least likely, 10: most likely) | Score (likelihood x impact) | Control | Owner | Test | Next review | Comment |
|---|--|--|-----------------------------------|---|----------------------------|-------------|-------------|--|
| | | | | | | | | |
| Failure of non- public sector employers | 2 | 10 | 20 | Ongoing dialogue with employer over willingness and ability to pay | Scheme manager | Half yearly | Q3 Y2 | Presentation to scheme manager by pension finance manager scheduled for Q2 Y2 |
| | | | | Annual audit | Pension finance manager | Annual | Q3 Y2 | Accounts for year ended 31 March Y1 signed off by auditors without qualification. Planning for next audit will start during Q3 Y2 |
| | | | | Scheme manager monitoring of employer covenant and business strength | Scheme manager | Half yearly | Q1 Y1 | Financial strength of major employers. Presentation to scheme manager by pension finance manager scheduled for Q2 Y2. Confidentiality agreement signed by all relevant persons |
| | | | | Use of bonds and guarantees | Scheme manager | Ongoing | Q2 Y2 | Pension finance manager confirms that all guarantees are still in force and effective |

| Risk area 1 – Operations | Likelihood (1: least likely, 10: most likely) | Impact (1: least likely, 10: most likely) | Score (likelihood x impact) | Control | Owner | Test | Next review | Comment |
|--|--|---|--------------------------------|---|---------------------|-------------|-------------|---|
| Risk area 4 – Regulatory and compliance | | | | | | | | |
| Failure to interpret rules or legislation correctly | 2 | 7 | 14 | Up-to-date and documented training log, showing completion of scheme-specific and The Pensions Regulator's educational material | Scheme manager | Annual | Q1 Y3 | All relevant persons have completed educational material |
| | | | | Technical advice and updates | Scheme manager | Annual | Q4 Y2 | Updates received from responsible authority, scheme advisory board and professional advisers; acted on. |
| Conflicts of interest | 2 | 5 | 10 | Pension board awareness of legal responsibilities | Pension board chair | As required | Q2 Y2 | All pension board members have completed educational material |
| | | | | All pension board members to declare any conflicts and potential conflicts | Scheme manager | Ongoing | Q2 Y2 | Conflicts document signed by all pension board members, recorded in conflicts register. Reminder, and any changes or additional conflicts, will be minuted at each pension board meeting. |

Note: Public service pension schemes and legislation about the new governance and administration requirements are expected to come into effect in April 2015.

Source: The Pensions Regulator

Sources of further guidance on risk and risk management

HM TREASURY

The HM Treasury website contains a number of useful publications, including:

- *Early Management of the Risks to Successful Delivery*
- *Managing Risks to the Public: Appraisal Guidance*
- *Managing Risks with Delivery Partners*
- *Managing Your Risk Appetite: A Practitioner's Guide*
- *Managing Your Risk Appetite: Good Practice Examples*
- *The Orange Book*
- *Principles for Managing Risks to the Public*
- *Risk Management Assessment Framework*
- *Setting and Communicating Your Risk Appetite.*

ALARM

Alarm, alongside the Institute for Risk Management, produced a document in 2010 entitled *A Structured Approach to Enterprise Risk Management (ERM) and the Requirements of ISO 31000* (AIRMIC, Alarm, IRM, 2010).

The purpose of the guide is to provide an insight into a structured approach to implementing risk management throughout an organisation. The guide:

- describes the principles and processes of risk management
- provides a brief overview of the requirements of ISO 31000
- gives practical guidance on designing a suitable framework
- gives practical advice on implementing enterprise risk management.

The guide is not intended specifically for public sector bodies. However, given the major changes affecting both the public and private sectors, and the growing partnerships between the two, this guidance is highly relevant for those involved in managing risks in an organisation.

The guide explains the principles behind the risk management process, setting it into the context of the organisation's culture and describing the links to the organisation's performance. It also outlines the main components of any risk management policy and the

framework which should be in place for the management of risk within the organisation, including roles and responsibilities. One particular item is a risk management checklist which can be used to check the completeness of the risk management arrangements.

Alarm also produces a risk management toolkit, which can be used as a practical tool to help develop the risk registers at both operational and strategic level.

Calculating a risk score

There are many ways to calculate a risk score, some of which are given below.

The most common method is to multiply the score for likelihood by the impact score as follows:

- likelihood x severity (aka probability x impact).

This would lead to a risk matrix or map as follows.

| Impact/ severity | 4 | 4 | 8 | 12 | 16 |
|---------------------|---|------------------------|---|----|----|
| | 3 | 3 | 6 | 9 | 12 |
| | 2 | 2 | 4 | 6 | 8 |
| | 1 | 1 | 2 | 3 | 4 |
| | | 1 | 2 | 3 | 4 |
| | | Likelihood/probability | | | |

A slightly more complex approach is to score the impact on more than one basis, if this is more preferable to the organisation. This example scores impact on reputation and the financial position. The two impact scores are added together and then multiplied by the likelihood score as follows:

- likelihood x severity (financial + reputation).

This would lead to a risk matrix or map as follows:

| Impact/ severity | 8 | 8 | 16 | 24 | 32 |
|---------------------|---|------------------------|----|----|----|
| | 7 | 7 | 14 | 21 | 28 |
| | 6 | 6 | 12 | 18 | 24 |
| | 5 | 5 | 10 | 15 | 20 |
| | 4 | 4 | 8 | 12 | 16 |
| | 3 | 3 | 6 | 9 | 12 |
| | 2 | 2 | 4 | 6 | 8 |
| | 1 | 1 | 2 | 3 | 4 |
| | | 1 | 2 | 3 | 4 |
| | | Likelihood/probability | | | |

Alternatively (or in addition), consider the strength of controls: current controls and/or ease of improving those controls, to give the following formula:

- (likelihood x severity) + strength of current controls + ease of improving controls.

If controls are good and/or easy to improve, give them a low score; if they are poor and/or will be difficult to improve, give them a high score.

One of the disadvantages with simple multiplication is that it will produce the same numerical score in a number of boxes, although the impact and likelihood are different. The following two matrices or maps are a way round that situation.

| | | | | | |
|-----------------------------|----------|-------------------------------|------------|-----------|----------|
| Impact/ severity | A | AIV | AIII | AII | AI |
| | B | BIV | BIII | BII | BI |
| | C | CIV | CIII | CII | CI |
| | D | DIV | DIII | DII | DI |
| | | IV | III | II | I |
| | | Likelihood/probability | | | |

Thus, if the risk has a score of CII, it means that this is likely to happen, but the impact will not be that great.

The Australia/New Zealand map or matrix uses unique numbers in each cell, weighting towards impact. Some users have turned the concept around and weighted towards probability.

| | | | | | |
|-----------------------------|----------|-------------------------------|----------|----------|----------|
| Impact/ severity | 4 | 10 | 13 | 15 | 16 |
| | 3 | 6 | 9 | 12 | 14 |
| | 2 | 3 | 5 | 8 | 11 |
| | 1 | 1 | 2 | 4 | 7 |
| | | 1 | 2 | 3 | 4 |
| | | Likelihood/probability | | | |

While each of these scoring methods are illustrated with a four by four matrix, they can all be applied to matrices of any size. Also, one can choose whether to have impact or probability on the y and x axes, as suits the organisation.



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