DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

WEDNESDAY, 19 OCTOBER 2022

Report of the Director - Finance and ICT

Derbyshire Pension Fund Risk Register

1. Purpose

To consider the Derbyshire Pension Fund (the Fund) Risk Register.

2. Information and Analysis

The Risk Register identifies:

- Risk item
- Description of risk and potential impact
- Impact, probability and overall risk score
- Risk mitigation controls and procedures
- Proposed further controls and procedures
- Risk owner
- Target risk score
- Trend risk scores

The Risk Register is kept under constant review by the risk owners, with quarterly review by the Director of Finance & ICT. A detailed annual review of the Risk Register by Derbyshire Pension Board (the Board) was also introduced in early 2021. The Board reviewed the Risk Register at its February 2022 meeting and the identification of any new or increased risks facing the Pension Fund is discussed at meetings of the Pension Board. A copy of both the Summary and Main Risk Registers are attached to this report as Appendix 2 and Appendix 3 respectively. Changes from the Committee's last consideration of the Risk Register are highlighted in blue font.

2.1 Risk Score

The risk score reflects a combination of the risk occurring (probability) and the likely severity (impact). Probability scores range from 1 (rare) to 5 (almost certain) and impact scores range from 1 (negligible) to 5 (very high). A low risk classification is based on an overall risk score of 4 or less; a medium risk score ranges between 5 and 11; and a high risk score is anything with a score of 12 and above.

The Risk Register includes a target score which shows the expected risk score once the proposed additional risk mitigation controls and procedures have been implemented. The difference between the actual and target score for each risk item is also shown to allow users to identify those risk items where the proposed new mitigation and controls will have the biggest effect. Trend risk scores going back to the first quarter of 2020-21 provide additional context.

2.2 Flexible Working Arrangements

The Fund's activities continued to be maintained, and the services to employers and members continued to be delivered, while the majority of the Pension Fund team worked from home during the Covid pandemic. Following discussions with the team, it was agreed that staff would spend at least half of their working hours in the office to support the ongoing development of a cohesive team and to support both the structured and unstructured knowledge sharing/learning that takes place when colleagues work together in the office. The Fund has been allocated around 60% of its pre-Covid space as part of the Modern Ways of Working initiative which means that those members of the team who wish to spend more time in the office can be accommodated.

2.3 High Risk Items

The Risk Register has the following five high risk items:

(1) Systems failure/Lack of disaster recovery plan/Cybercrime attack (Risk No.13)

(2) Fund assets insufficient to meet liabilities (Risk No.20)

(3) LGPS Central Limited related underperformance of investment returns (Risk No.31)

(4) Insufficient cyber-liability insurance relating to the pensions administration system (Risk No. 42)

(5) Impact of McCloud judgement on administration (Risk No.46)

2.4 Systems failure/Lack of disaster recovery plan/Cybercrime attack & Insufficient cyber-liability insurance relating to the pensions administration system.
The National Cyber Security Centre warned of a heightened cyber threat following Russia's attack on Ukraine and has advised organisations to bolster their online defences. Pension schemes hold large amounts of personal data and assets which can make them a target for cybercrime attacks. The trusted public profile of pension funds also makes them vulnerable to reputational damage.

Robust procedures are in place for accessing the systems used by the Fund and the Pension Fund's Business Continuity Plan includes the Business Continuity Policy and Business Continuity Incident Management Plan of Aquila Heywood (the provider of the Fund's pension administration system, Altair).

Detailed Data Management Procedures have been developed for the Fund which set out why members' data needs to be protected, how it should be protected (including a section on protecting against cybercrime) and what to do when things go wrong. These procedures have been rolled out to the Pension Fund team in a number of briefing sessions providing the opportunity for discussion and feedback.

A project has been started to map and document the Fund's data to ensure that it is understood where it is held, on what systems, how it is combined and how, and where, it moves; the related activities will be risk assessed as part of this process and a review of the information security arrangements of relevant suppliers to the Fund will be undertaken.

The contract with Aquila Heywood limits a cyber liability claim to a specified limit, unless a claim is based on an event caused by the contractor performing its services in a negligent manner. Separately, the Pension Fund is included in the Council's self-insurance arrangements with respect to managing cyber security risks, while the Council's cyber liability cover is being reviewed.

Given the heightened cybercrime threat and the review of the Council's cyber liability cover, the probability scores for both of the cyber related risks were increased in April 2022 from 2 (unlikely) to 3 (possible). The impact scores for both risks remained at 4 (high), giving total risk scores for both risks of 12.

In May 2022, the Council was subject to a significant cyber-attack. The attack was quickly identified and steps were taken to contain any potential damage. Forensic analysis was conducted, supported by Microsoft's Detection and Response Team. The Information Commissioner was informed immediately about the attack in view of the potential loss of data. However, at this time there is no evidence that any data was compromised. The Pension Board received a report on the incident at its meeting in September 2022 and Board members have asked to receive the lessons learnt report on the incident when it has been finalised.

2.5 Fund assets insufficient to meet liabilities

There is a risk for any pension fund that assets may be insufficient to meet liabilities; funding levels fluctuate from one valuation to the next, principally reflecting external risks around both market returns and the discount rate used to value the Fund's liabilities. Every three years, the Fund undertakes an actuarial valuation to determine the expected cost of providing the benefits built up by members at the valuation date in today's terms (the liabilities) compared to the funds held by the Pension Fund (the assets), and to determine employer contribution rates. The last valuation was completed in March 2020 based on the assets and liabilities at 31 March 2019. Work is currently being undertaken for the 31 March 2022 actuarial valuation and the preliminary whole fund result is expected shortly.

As part of the valuation exercise, the Pension Fund's Funding Strategy Statement (FSS) is reviewed, to ensure that an appropriate funding strategy is in place. The FSS sets out the funding policies adopted, the actuarial assumptions used and the time horizons considered for each category of employer.

The Fund was 97% funded at 31 March 2019, with a deficit of £163m, up from 87%, with a deficit of £546m at 31 March 2016. The funding level provides a high-level snapshot of the funding position at a particular date and can be very different the following day on a sharp move in investment markets.

Whilst the Fund has a significant proportion of its assets in growth assets, the last two reviews of the Strategic Asset Allocation Benchmark have introduced a lower exposure to growth assets and a higher exposure to income assets with the aim of protecting the improvement in the Fund's funding position.

2.6 LGPS Central Limited

The Fund is expected to transition the management of a large proportion of its investment assets to LGPS Central Limited (LGPSC), the operating company of the LGPS Central Pool (the Pool), over the next few years. The Fund has so far transitioned around 10% of its assets into LGPSC active products and a further 5% into an LGPSC enhanced passive product. By March 2024, the Fund is forecast to have transitioned over 40% of its assets into LGPSC products.

The performance of LGPSC's active funds against their benchmarks has been mixed since the company launched its first investment products in April 2018.

There is a risk that the investment returns delivered by the company will not meet the investment return targets against the specified benchmarks.

The Fund continues to take a meaningful role in the development of LGPSC, and has input into the design and development of the company's product offering to ensure that it will allow the Fund to implement its investment strategy. The company's manager selection process is scrutinised by the Pool's Partner Funds and the Fund will continue to carry out its own due diligence on selected managers as confidence is built in the company's manager selection skills.

The performance of LGPSC investment vehicles is monitored and reviewed jointly by the Partner Funds under the Investment Working Group (a sub-group of the Partner Funds' Practitioners' Advisory Forum) and by the Pool's Joint Committee. LGPS Central Limited is presenting to Committee today on the performance of its Emerging markets Equity Active Multi Manager Fund and its Global Active Investment Grade Corporate Bond Multi Manager Fund.

The Fund is also likely to maintain a large exposure to passive investment vehicles in the long term which will reduce the risk of total portfolio underperformance against the benchmark.

2.7 McCloud Judgement

The McCloud case relates to transitional protections given to scheme members in the judges' and firefighters' schemes which were found to be unlawful by the Court of Appeal on the grounds of age discrimination. The Department for Levelling Up, Housing and Communities (DLUHC, formerly MHCLG) published its proposed remedy related to the McCloud judgement in July 2020.

The proposed remedy involves the extension of the current underpin protection given to certain older members of the Scheme when the LGPS benefit structure was reformed in 2014. The underpin will give eligible members the better of the 2014 Scheme CARE or 2008 final salary benefits for the eligible period of service.

The changes will be retrospective, which means that benefits for all qualifying leavers since 1 April 2014 will need to be reviewed to determine whether the extended underpin will produce a higher benefit. This will have a significant impact on the administration of the Scheme. Analysis by Hymans Robertson (the Fund's actuary) suggested that around 1.2m members of the LGPS, roughly equivalent to a quarter of all members, may be affected by the revised underpin. Locally it has been estimated that around 26,000 members of the Fund would likely fall into the scope of the proposed changes to the underpin.

An amendment included in the Public Service Pensions and Judicial Offices Act 2022 (received Royal Assent in March 2022), the enabling legislation for the implementation of the McCloud remedy, has subsequently increased the number of records that will need to be reviewed. It brought the LGPS into line with the other public service pension schemes by extending the scope of the McCloud remedy to include members who were not active on 31 March 2012 but who have LGPS membership before that date and returned within five years and meet all other qualifying criteria. The criteria for a disqualifying break in service was also relaxed.

The uncertainty caused by the McCloud judgement is reflected on the Risk Register under two separate risks for clarity, one under Funding & Investments and one under Administration, although the two risks are closely linked.

The risk score for the impact of the McCloud judgement on funding has been reduced, as detailed below. The administration risk relates to the enormous challenge that will be faced by administering authorities and employers in backdating scheme changes over such a significant period; this risk has been recognised by the LGPS Scheme Advisory Board.

Whilst the Fund already requires employers to submit information about changes in part-time hours and service breaks, the McCloud remedy may generate additional queries about changes since 1 April 2014; employers have, therefore, been asked to retain all relevant employee records. Information has also been requested from employers on the data supplied to the Fund since 2014 with respect to changes in part-time hours and service breaks.

Aquila Heywood has provided the Fund with McCloud related tools for testing on the Altair pension administration system which would be used to identify, and subsequently bulk load, any required additional service history.

A McCloud Project Board has been set up to formalise the governance of this major project. The Fund will continue to keep up to date with news related to the McCloud remedy from the Scheme Advisory Board, the Local Government Association, the Government Actuary's Department and the Fund's actuary and with the development of relevant tools by Aquila Heywood.

2.8 New & Removed Risks/Changes to Risk Scores/Updated Risk Narratives

No risks have been removed from the Risk Register since it was last presented to Committee in May 2022. There has been one change to an existing risk score and the narrative for a number of risks has been updated (highlighted on the Risk Register in blue).

Risk No.33: Failure to maintain liquidity in order to meet projected cash flows. The narrative for the description of this risk has been updated to reflect the risk of counterparties failing to make timely repayments, and to reflect potential cash management related reputational damage. The risk score of 6 (impact score of 3 and probability score of 2) has been reviewed and remains appropriate.

The Pension Fund has a strategic allocation to cash of 2%, with a permitted range of 0-8%. In recent years, the Fund has had an overweight allocation to cash; the weighting at 31 August 2022 was 3.7%. The Fund's cash is managed in line with the Pension Fund's Treasury Management Strategy (TMS) which is approved by the Committee.

The Fund's objective when investing cash is to strike a balance between risk and return, minimising the risk of incurring losses from defaults and the risk of receiving unsuitably low investment income. Security of capital and liquidity is placed ahead of investment return. In accordance with the Pension Fund's TMS, it can invest its surplus funds with any of the counterparty types in the table set out below, subject to the cash limits (per counterparty) and the time limits shown.

Sector	Time Limit	Counterparty Limit	Sector Limit
UK Government	Unlimited	Unlimited	Unlimited
Local Authorities & Other Government Bodies	13 months	£30m	Unlimited
Banks (unsecured)	13 months	£30m	£100m
Building Societies (unsecured)	13 months	£30m	£50m
Money Market Funds (MMF)	n/a	£30m	Unlimited
Short Term Pooled Bond Funds	n/a	£50m	£100m

At 31 August 2022, the Pension Fund had loans of £30m to Thurrock Council, made up of six loans of £5m each, out of £80m of loans to Local Authorities at that point. Following the government's appointment of Essex County Council to the role of Commissioner and Best Value Inspector at Thurrock Council in response to concerns about the financial management of the council, a number of press enquires were received about the loans made by Derbyshire County Council and by the Pension Fund to Thurrock Council and the loans were quoted in a number of press articles.

The Fund has been lending to Thurrock Council for several years and all loans and interest have been repaid when they fell due. Loans to Local Authorities are considered to have minimal credit risk with loans backed by the revenues of the relevant Local Authority and all Local Authorities able to access the

Public Works Loan Board lending facility for the purposes of refinancing. All of the loans to Thurrock Council have now been repaid to fund investment commitments and liquidity requirements.

Given the material fall in the level of the Fund’s cash balance over the last year as cash has been invested, it is likely that individual loans to Local Authorities will be on a smaller scale going forward to ensure appropriate diversification. The advice of Arlingclose Limited, the Council’s Treasury Management adviser, will continue to be monitored and taken into consideration with respect to loans to Local Authorities.

Risk No. 38: Impact of McCloud judgement on funding. The McCloud funding risk relates to the risk of there being insufficient assets within the Fund to meet the increased liabilities related to the McCloud remedy. In line with advice issued by the LGPS Scheme Advisory Board (SAB), the Fund’s 2019 actuarial calculations made no allowance for the possible outcome of the cost cap mechanism or McCloud. However, an extra level of prudence was introduced into the setting of employer contribution rates to allow for the potential impact of the McCloud case.

It was announced in July 2022, that there will be no changes to member benefits and/or contribution rates as a result of the 2016/17 LGPS Cost Cap valuations which have now been concluded taking into consideration the Government’s preferred approach for remedying McCloud.

A March 2022 letter from DLUHC to all LGPS administering authorities, set out an expectation of how the McCloud remedy should be allowed for when valuing past service liabilities and setting employer contribution rates at the March 2022 triennial valuation.

Following clarity regarding the outcome of the LGPS Cost Cap valuation and confirmation of the treatment of the McCloud remedy in the March 2022 triennial valuation, it is appropriate to reduce the risk score for the funding impact of McCloud. The impact score remains at 3 (medium) and the probability score has been reduced to 3 (possible) from 4 (probable), giving an overall risk score of 9, down from 12.

3. Implications

Appendix 1 sets out the relevant implications considered in the preparation of the report.

4. Background Papers

Papers held by the Pension Fund.

5. Appendices

5.1 Appendix 1 – Implications

5.2 Appendix 2 – Summary Risk Register

5.3 Appendix 3 – Main Risk Register

6. Recommendation

That Committee notes the risk items identified in the Risk Register.

7. Reasons for Recommendation

One of the roles of Committee is to receive and consider the Fund's Risk Register.

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Appendix 1

Implications

Financial

1.1 None

Legal

2.1 None

Human Resources

3.1 None

Information Technology

4.1 None

Equalities Impact

5.1 None

Corporate objectives and priorities for change

6.1 None

Other (for example, Health and Safety, Environmental, Sustainability, Property and Asset Management, Risk Management and Safeguarding)

7.1 None