Pensions Committee

2.00pm, Wednesday, 17 March 2021

Risk Management Summary

1. Recommendations

The Pensions Audit Sub Committee (Committee) is requested to:

1.1 note the Quarterly Risk Overview as at 8 February 2021;

1.2 approve the group's Risk Appetite Statement; and

1.3 note the update on Brexit related impact and risk.

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Risk Management Summary – In Depth Review

2. Executive Summary

2.1 In line with the Lothian Pension Fund's (LPF) ongoing risk management procedures, this paper provides an overview of LPF's risk analysis for consideration by the Committee.

2.2 This quarter the group's 'Risk Appetite Statement' has been included in order to provide important context on how the Risk Management Group assesses the group's risks. This will now be routinely considered and reviewed by the Audit Sub Committee annually, alongside the full Risk Register and Risk Assurance Overview, at its in-depth review of risk management.

2.3 In response to the Committee's request, an update on Brexit related impact and risks has been prepared and included this quarter. As previously highlighted, the direct impact on the fund is limited but there continues to be meaningful uncertainty at this time and potential for material indirect impact.

3. Background

3.1 LPF's risk management procedures require it to:

3.1.1 maintain a detailed operational risk register which sets out all the risks identified and assessed by the officers on an ongoing basis against the group's risk appetite, the degree of risk associated in each case and the action taken to mitigate those risks (the Operational Risk Register); and

3.1.2 produce a summary report of the risk register for the Committee and the Pensions Committee which highlights the material risks facing the group and identifies any new risks/concerns and the progress being made over time by the officers in mitigating the relevant risks (the Quarterly Risk Overview).

3.2 The Conveners and Independent Professional Observer receive a copy of the full risk register every quarter.

3.3 The Audit Sub Committee routinely reviews the full risk register on an annual basis as part of its in-depth review, which also includes a review of the group's overall risk assurance and risk appetite.

3.4 The LPFI Limited (LPFI) and LPFE Limited boards consider their own risks separately and, in the case of LPFI, in line with the regulatory requirements of the Financial Conduct Authority. However, material risks relating to these operational subsidiaries do feed into the overarching group risk management process.

4. Main Report

4.1 The Quarterly Risk Overview as at 08 February 2021 (Appendix 1) is included for the Committees consideration.

4.2 The risk management process for the LPF group is integrated throughout the group's governance and controls. In particular, the Committee should be aware of the following:

4.2.1 *Risk appetite:* considered and set by the Senior Leadership Team (SLT) in conjunction with the Risk Management Group. A copy of the group's risk appetite statement is included for context (Appendix 2).

4.2.2 *Risk management group (RMG):* routine meetings held quarterly and otherwise on an as required basis to consider and assess all elements of the LPF group's risk framework, including the risk appetite, register, overall assurance position and any more granular risks escalated from other sub-groups. The group comprises representation across all functions and includes the SLT.

4.2.3 *Compliance checklist:* listing critical points of compliance for monitoring and as a reference point for breach reporting. Reviewed and signed off on a quarterly basis by SLT, with key actions being tracked by the risk function and relevant business units.

4.2.4 *Assurance Overview and Mapping:* providing analysis and oversight of the group's overarching risk assurance framework across the 'four lines of defence', and mapping those points of assurance to relevant risks. This is managed by the risk function, with oversight from RMG and SLT, and presented to the Committee annually.

4.2.5 *LPF group systems and controls assessment:* managed by SLT and the LPFI and LPFE boards and reported to Committee and JISP annually.

4.2.6 *Third party supplier management:* a supplier management framework is managed on an ongoing basis by the risk function in conjunction with the wider business and overseen by SLT. This framework continues to be developed and enhanced in conjunction with other developments within the group.

4.2.7 *Internal Capital Adequacy Assessment Process (ICAAP*): which is managed on an ongoing basis by the SLT and RMG. The ICAAP itself is reviewed and approved at least annually by the LPFI board, with various aspects considered separately and, in more detail, routinely throughout the year. This process will be the subject of regulatory change from June 2021 and the group are currently involved in a programme to comply by that date.

4.2.8 *ICT oversight and governance procedures:* which are managed by the ICT Oversight Group on an ongoing basis and overseen by the SLT.

4.2.9 *People and HR Procedures:* which are managed by the People Group on an ongoing basis and overseen by the SLT and the LPFE board.

4.2.10 *Investment Controls and Parameters (LPF Group Controls and Compliance report):* which are now mostly automated on the CRIMS order management system, managed by the compliance, front and back office functions and overseen by SLT, the LPFI board and JISP (with annual reporting to Committee).

4.2.11 *Overall review of governance and the LPF group structure:* managed by SLT and overseen annually by the Committee and Pensions Committee.

4.2.12 *COVID-19:* as above, managed by SLT on an ongoing basis, in conjunction with the Risk Management Group and other dedicated sub-groups as required.

4.3 The group's statement of risk appetite is included in Appendix 2.

4.4 An overview of the impact on Brexit on the group is included in Appendix 3.

5. Financial impact

5.1 There are no direct financial implications as a result of this report.

6. Stakeholder/Regulatory Impact

6.1 The Pension Board, comprising employer and member representatives, is integral to the governance of the fund and they are invited to comment on the relevant matters at Committee meetings.

6.2 Except as otherwise stated in the report itself, there are no adverse health and safety, governance, compliance or regulatory implications as a result of this report.

7. Background reading/external references

7.1 None.

8. Appendices

Appendix 1 – Quarterly Risk Overview, as at 08 February 2021

Appendix 2 – Group Risk Appetite Statement

Appendix 3 – Brexit Update

Quarterly Risk Overview

08 February 2021

Executive Summary

This document provides a summary of the assessment of the LPF group's risks by the Risk Management Group (RMG) on 8 February 2021. The RMG oversees the LPF group risk register, which is reviewed on an ongoing basis by the risk function and at least quarterly by RMG itself.

Risks are managed across the group by existing controls – activities and measures put in place to prevent and detect risks. These controls are subject to ongoing monitoring and assurance. Where further one-off actions are needed to mitigate risks, these actions are managed at an operational level with reporting to, and oversight by, the RMG. This report provides a narrative update on relevant key risks, rather than lists of actions and controls.

Prevailing risk climate

The LPG group continues to carry a higher than normal level of operational risk as it transitions its model to an increasingly arms-length structure, but in doing so it is significantly mitigating other fundamental structural and operational risks. This period of organisational transformation is now (excluding consideration of Project Forth) giving way to a more settled stage of 'bedding-in' and reflective assurance work, with the ongoing project to implement a separate managed service provider for core ICT being the only significant non-BAU initiative.

The group began supporting its collaborative partners with portfolio management services from December 2020. That brought heightened client servicing and regulatory risks, but improved business resilience, sustainability and enhanced cost sharing. The service is expected to build throughout 2021, subject to JISP and partner fund take-up, but then level off thereafter.

The group continues to operate on a fully remote basis and its business continuity plan is still operating effectively. Good progress has also been made in anticipating medium term adjustments (such as its office refit) to further mitigate the position as soon as that becomes possible. Shorter-term mitigation strategies remain under review, as in some cases these were required to be put in place quickly and on an agile basis. Business continuity in all its facets therefore continues to be a key focus, including around heighted risk of cyber security, fraud, group resilience, culture and staff conduct.

Brexit has introduced regulatory uncertainty in the wider financial services sector, but the FCA has responded as quickly as could be expected and the group continues to track its own key regulatory and supplier risks. As a UK pension fund with predominantly UK counterparties the direct impact on the group is minimal. There of-course remains the potential for significant indirect impact over time. Further detail is provided separately in the Q3 risk report.

Risk register at 8 Feb 2021

Total risks	Materially beyond appetite	Beyond appetite	Within appetite
36	4	13	19

See Appendix 2 for full overview of risks.

Changes since last review 2 Nov 2020

New	Closed	Improved	Deteriorated	Unchanged
0	0	1	3	32

Scoring changes since the last risk review:

- **Risk 9 – Pension Committee (or other) members take decisions against sound advice.** Deteriorated from 24 (6 x 4) to 30 (6 x 5). A review of the delegation of decisions to the Pension Committee is ongoing to ensure that all decisions relating to LPF (including its investments) are made by the Pension Committee. Until this is complete, this risk remains elevated.
- **Risk 10 – Pension Board not operating effectively.** Deteriorated from 24 (4 x 6) to 28 (4 x 7). There are three vacancies on the Board, therefore the probability has been increased until these are filled.
- **Risk 15 – Late payment of pension.** Deteriorated from 27 (9 x 3) to 36 (9 x 4), moving into highest risk category. Probability increased from 3 to 4 - an Additional Voluntary Contribution (AVC) provider has had delays processing members benefits on retiral, which means LPF has not been able to make payments to these members.
- **Risk 28 - Claim or liability arising from shared services.** Improved from 25 (5 x 5) to 20 (5 x 4). Probability lowered around service delivery from 5 to 4, due to successful inception of investment management services during December, and the accompanying implementation and due diligence programme, notwithstanding that this does take the group as a whole into a heightened regulatory regime from a wider risk perspective.

The scoring for three existing material risks – **7 Failure of IT Systems; 11 Business Continuity Issues; 12 Data Protection Breach -** remain unchanged. Elevated scores are partly due to COVID-19 and continuing remote arrangements. It is anticipated these risks will improve meaningfully once the move to the new ICT provider is complete, and related enhancements are delivered.

Other relevant updates

Risk 32 - Over reliance on single core service provider scoring remained unchanged and within appetite at 8 February. On 10 February, our core pensions software provider announced their planned acquisition by a private equity fund. Our initial analysis is that this does not, currently, materially alter risk scoring in this area. This will however remain under close review in light of the meaningful potential for 'change' initiatives by the new owner.

Material litigation – none.

Detailed Update

Update on all risks beyond appetite:

Risk & reference number	Update	Score & movement
7 - Failure of IT systems	COVID-19 remote working remains in place. Resilience is good and stable, but impact and probability remain increased to reflect these circumstances, as well as the pending transition to a new supplier and a heightened climate of risk around cyber security. A specific ICT migration project group meets weekly to closely manage the transition. Change requests with the incumbent remain slow, but KPI information continues to be provided and assessed by LPF in relation to this as well as other areas. Once the new ICT provider process is complete and embedded, this score will improve.	**48 Unchanged**
11 - Business continuity issues	Remains high due to the prevailing COVID-19 situation. All staff continue to work remotely. Progress has been made with the office refit, with practical completion on 1 Feb. Health & Safety policy and procedures and checks ahead of return to office are in progress.	**42 Unchanged**
15 - Late payment of pension	Risk deteriorated to 'materially beyond appetite'. As above, AVC provision has impacted LPF's ability to pay pensions to certain retiring members invested in the relevant product, with turnaround time going from around 5 days to 4 weeks. A number of LGPS administering authorities in Scotland. A verbal update will be provided at the Pensions Committee meeting.	**36 Deteriorated**
12 - Members' confidential data is lost or made public. Breach of Data Protection Act	There continues to be a potential increased risk of cyber attacks as a result of COVID-19 and LPF, as with the wider business community, has experienced targeted phishing attempts. This risk remains on red because of the combination of cyber threat and a number of other business continuity matters (office access, challenges around full remote working, cross systems reliance) arising as a result of the pandemic.	**36 Unchanged**
36 - Cybersecurity protections and/or back-up not sufficient to prevent/minimise cyber-attacks.	As mentioned above, there is currently an increased risk of cyber attacks due to COVID-19 with increasing amounts of phishing and other attempted forms of cyber-fraud on both LPF and its suppliers. We remain comfortable that staff are aware of the risks in these areas. LPF has engaged a Cybersecurity consultant to assess our arrangements, as part of the new ICT provider project.	**32 Unchanged**

Risk & reference number	Update	Score & movement
9 - Pension Committee (or other) members take decisions against sound advice	A review of the delegation of decision to the Pension Committee is being undertaken to ensure that all decisions relating to LPF (including its investments) are made by the Pension Committee. Until this is complete, this risk has been increased.	**30 Deteriorated**
27 - Group structure and governance fully compliant and up-to-date.	Implementation of Governance Review ongoing. Close monitoring of the LPFI governance and compliance processes as further collaborative developments are implemented.	**30 Unchanged**
25 - Procurement/framework breach	LPF is continuing to work closely and well with CEC's procurment team to best align its procurement processes to the specific needs of the LPF group business and also to satisfy CEC's parent oversight requirements. The risk is static due to the enhanced impact the procurement regime has on LPF's developing business model (sitting unusually within all of the financial services, pensions and public sector regimes) and the fact that it continues to be in the midst of developing new systems, controls and procedures in this area – with progress having been hampered by the prevailing circumstance of the last 6 months.	**30 Unchanged**
8 - Staff culture & engagement issues	Scoring remains unchanged, but a number of initiatives are in hand and expected to reduce the risk in this area. A working group is in place to review and implement actions from our staff survey (Your Voice). A refreshed annual performance process – including personal development, goals, objectives - has begun to be rolled out across the firm.	**30 Unchanged**
20 - Regulatory breach	Quarterly LPFI Compliance Monitoring Programme by external compliance consultant remains in place. Current review is in progress and covers the period to 31 Dec, including go live of investment services and new regulatory obligations. A review of certain European driven regulations has been carried out to assess the fund's position post-Brexit. The Fund has also had to consider its, and its custodian's, position under a US executive order restricting the activities of certain organisations in dealing in a list of Chinese stocks. Ultimately there has been no immediate impact, but the position remains under wider review.	**30 Unchanged**
33 - Staff Resource within the Fund not sufficient to carry out core tasks	This risk remains amber due to the additional resource attributable to significant strategic initiatives such as the implementation of the Digital Strategy, extension of investment management services and Project Forth. However the Organisational Development Review has been sucessfully implemented and so LPF anticipates that the risk will reduce over the next few quarters. SLT are also due to carry out a follow up to the OD review to assess gaps, target resourcing priorities and set boundaries aswell.	**30 Unchanged**
23 - Acting beyond proper authority/delegations	LPF has paid close attention to the operation of its delegations under the present circumstances, with all the team remote working and with key person dependencies in mind. The group	**30 Unchanged**

Risk & reference number	Update	Score & movement
	has only requiried minimal adaption to current processes so far and has sought to introduce supporting systems (e.g. e-signing) where necessary to mitigate any associated continuity risks. Due to the prevailing circumstances and outstanding actions the risk remains on amber, although there has been no breach in existing delegations.	
10 - Pension Board not operating effectively	Recruitment for the three Pension Board vacancies will commence shortly, and nomination and attendance policy confirmed. Until the three posts are filled the probability of this risk has been increased.	**28 Deteriorated**
3 - Failure of an employer to pay contributions	Employers continue to be under increasing financial pressure due to the global pandemic and resulting economic implications. The fund continues to monitor this on an ongoing basis and has established structures and processes to engage with its employers around affordability and potential exit.	**28 Unchanged**
1 - Investment Performance pressure on employer contributions	LPF and the JISP continue to review investment portfolios in order to understand the COVID-19 impact and continue to best position the fund. In addition, LPF is engaging with the actuary regarding assumptions as part of triennial valuation. This risk remains amber until review is complete and actions are clear.	**25 Unchanged**
35 - Inadequate, or failure of, supplier and other third-party systems (including IT and data security).	Supplier management processes and controls are in place but are being reviewed to enhance its risk-based framework.	**25 Unchanged**
2 - Adverse Movement - pressure on employer contributions	Currently in discussions with actuary. 2020 approach will change from deterministic to risk based.	**25 Unchanged**

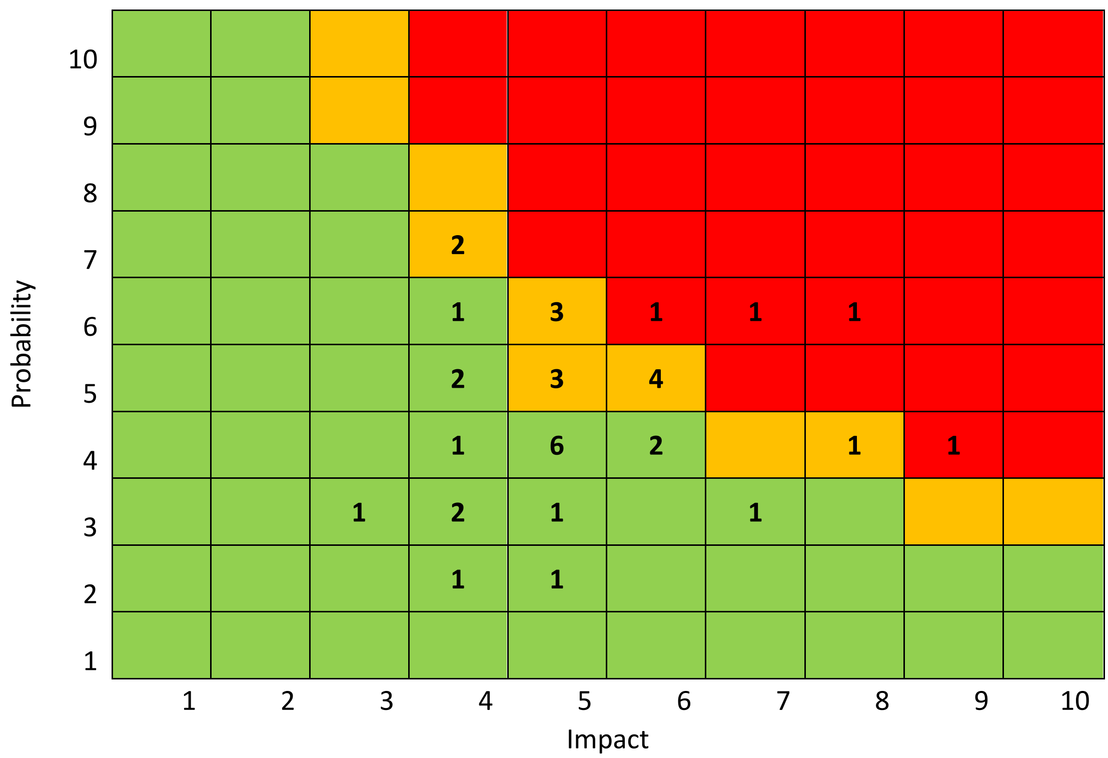
Appendix 1 – Risk Scoring & Distribution Chart

Risk scoring:

	Impact	Probability
1	No discernible effect	Virtually impossible
2	Little discernible effect	Extremely unlikely
3	Some effect noticeable	Remotely possible
4	Some effect on service provision	May occur
5	Noticeable effect on service provision	Fairly likely to occur
6	Some disruption of service	More likely to occur than not
7	Significant service disruption	Likely to happen
8	Material disruption to services	Probably will happen
9	Major service disruption	Almost certainly will happen
10	Catastrophic	Already happening

Risk Status	
	Materially beyond appetite: resolve urgently where possible (probability and impact total 35 and above)
	Beyond appetite: resolve where possible (probability and impact total 25 to 34)
	Within appetite: monitor (probability and impact total 24 and below)

Risk Distribution - at 08 February 2021:



Appendix 2 – Full Risk Key

Full risk register scores, including Red Amber Green (RAG) status at 8 February 2021:

Ref	Risk	RAG
1	Investment Performance pressure on employer contributions	
2	Adverse Movement - pressure on employer contributions	
3	Failure of an employer to pay contributions	
4	Retention of key staff	
5	Fraud by LPF staff or relating to members (including pension liberation fraud)	
6	Staff negligence, maladministration or lack of specialist knowledge	
7	Failure of IT systems	
8	Staff culture & engagement issues	
9	Pension Committee (or other) members take decisions against sound advice	
10	Pension Board not operating effectively	
11	Business continuity issues	
12	Members' confidential data is lost or made public. Breach of Data Protection Act	
13	Loss due to stock lending default	
14	Risk of incorrect pension payments	
15	Late payment of pension	
16	Market abuse by investment team	
17	Portfolio transition issues	
18	Disclosure of confidential information	
19	Material breach of contract	
20	Regulatory breach	
21	FOI process in accordance with law	
22	Incorrect communication with members	
23	Acting beyond proper authority/delegations	
24	Inappropriate use of pension fund monies	
25	Procurement/framework breach	
26	Procurement process compromising ability to secure required resource.	
27	Group structure and governance fully compliant and up to date.	
28	Claim or liability arising from shared services	
29	Unauthorised access to PensionsWEB	
30	Incorrect data from Employers leading to fines	
31	Inadequate contractual protection for services	
32	Over reliance on single core service provider	
33	Staff Resource within the Fund not sufficient to carry out core tasks	
34	Breach of Health and safety regulations	
35	Inadequate, or failure of, supplier and other third-party systems (including IT and data security).	
36	Cybersecurity protections and/or back-up not sufficient to prevent/minimise cyber-attacks.	

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Appendix 3 – Three year risk trends

Ref	Risk	Q1 2018/19	Q2 2018/19	Q3 2018/19	Q4 2018/19	Q1 2019/20	Q2 2019/20	Q3 2019/20	Q4 2019/20	Q1 2020/21	Q2 2020/21	Q3 2020/21	Q4 2020/21
1	Investment Performance pressure on employer contributions	Green	Green	Green	Green	Green	Green	Green	Green	Amber	Amber	Amber	Amber
2	Adverse Movement - pressure on employer contributions	Red	Red	Red	Red	Red	Red	Red	Amber	Amber	Amber	Amber	Amber
3	Failure of an employer to pay contributions	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Green	Green	Green	Amber	Amber
4	Retention of key staff	Red	Red	Amber	Green	Green	Green	Green	Green	Green	Green	Green	Green
5	Fraud by LPF staff or relating to members (including pension liberation fraud)	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
6	Staff negligence, maladministration or lack of specialist knowledge	Amber	Amber	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
7	Failure of IT systems	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red	Red
8	Staff culture & engagement issues											Amber	Amber
9	Pension Committee (or other) members take decisions against sound advice	Amber	Amber	Amber	Amber	Amber	Green	Green	Green	Amber	Amber	Green	Amber
10	Pension Board not operating effectively	Green	Green	Green	Green	Green	Green	Green	Amber	Amber	Amber	Green	Amber
11	Business continuity issues	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Red	Red	Red	Red
12	Members' confidential data is lost or made public. Breach of Data Protection Act	Amber	Amber	Amber	Green	Green	Amber	Amber	Amber	Red	Red	Red	Red
13	Loss due to stock lending default	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
14	Risk of incorrect pension payments	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
15	Late payment of pension	Green	Green	Green	Green	Green	Green	Green	Green	Amber	Amber	Amber	Red
16	Market abuse by investment team	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
17	Portfolio transition issues	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
18	Disclosure of confidential information	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
19	Material breach of contract	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
20	Regulatory breach	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber
21	FOI process in accordance with law	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
22	Incorrect communication with members	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
23	Acting beyond proper authority/delegations	Amber	Green	Green	Green	Green	Green	Green	Amber	Amber	Amber	Amber	Amber
24	Inappropriate use of pension fund monies	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
25	Procurement/framework breach	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber
26	Procurement process compromising ability to secure required resource.									Green	Green	Green	Green
27	Group structure and governance fully compliant and up-to-date.	Green	Green	Green	Green	Green	Amber	Amber	Amber	Amber	Amber	Amber	Amber
28	Claim or liability arising from shared services	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Amber	Green
29	Unauthorise access to PensionsWEB	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
30	Incorrect data from Employers leading to fines	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
31	Inadequate contractual protection for services	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
32	Over reliance on single core service provider	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Amber	Green	Green
33	Staff Resource within the Fund not sufficient to carry out core tasks	Red	Red	Red	Red	Red	Amber	Amber	Amber	Amber	Amber	Amber	Amber
34	Breach of Health and safety regulations	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green
35	Inadequate, or failure of, supplier and other third-party systems (including IT and data security).	Green	Green	Green	Green	Green	Green	Green	Green	Green	Green	Amber	Amber
36	Cybersecurity protections and/or back-up not sufficient to prevent/minimise cyber-attacks.						Green	Green	Green	Amber	Amber	Amber	Amber

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Appendix 4 – Background and Parameters (extract from Risk Register)

The Risk Management Group, and risk register, form part of the LPF group's critical assurance framework, covers all entities within the group and should be read in conjunction with the other forms of assurance set out in LPF's assurance overview document.

The register is formally considered by the Risk Management Group quarterly but is also updated on an ad hoc basis where required. The register also takes into account material risks identified by the wider business, including arising from (i) the other oversight groups (e.g. SLT, People, ICT Oversight and/or any relevant project groups), (ii) any prior board, committee and stakeholder feedback, and (iii) compliance monitoring and processes (e.g. breach reporting, whistleblowing).

*The Risk Management Group itself comprises senior officers of each function within the LPF group, as well as the Senior Leadership Team (**SLT**). All members are accountable for escalating material risks, with a particular focus on their respective areas, for consideration. If relevant and deemed sufficiently material, the risk will be included in the register and monitored by the risk function in conjunction with the relevant business unit.*

The approved risk register is tabled and considered by SLT following sign-off to ensure additional oversight and ongoing engagement with any resulting actions. Those actions are tracked and followed up by the LR&C team with the business on an ongoing basis. The risk register is also circulated to the conveners of the Pensions Committee and Audit Sub- Committee, Chair of the Pension Board and Independent Professional Observer on a quarterly basis, with summary analysis and reporting provided to those bodies each quarter. In addition, an in-depth risk report is provided to the Audit Sub Committee annually, which includes a review of the full register.

The risk register is a continually evolving document and doesn't purport to be a comprehensive list of every risk or potential exposure to which the LPF group entities are subject or involved in managing. It should therefore continue to be read in the context of the LPF group's overall business strategy, risk appetite and assurance map. The risk register may cross-refer to separate operational project management tools or action trackers which monitor relevant items in more granular detail and for which the business units are accountable.

Importantly, that risk appetite and assurance structure will flex to ensure that it continues to be proportionate to the size and nature of the business of the LPF group and also adhere to the following industry best practice principles:

- *Ensure that the LPF group's risk appetite **aligns with its strategy** and is **set by its senior management team without undue influence** either externally or otherwise across its assurance stack.*
- *Integrates risk as **a key component of the group's management and decision-making** processes, and so through the spine of its governance and operations.*
- *Engenders an **open, 'live' and engaged risk culture** which seeks to pro-actively identify current and future risks for the business, simplifying layers of controls to ensure this is not stifled, and so…*
- ***Not establish or perpetuate systems, controls or processes** which are out of line with, or **disproportionate to, the group's risk appetite**. That can be counterproductive in distracting key focus and resource away from delivering the group's strategy, core function and assurance over a manageable number of critical risks.*
- *Remain **aligned to LPF's existing resources** and organisational development.*

- *Ensure an* ***effective and independent risk and compliance function*** *is maintained, as a general principle and in line with the standards of the UK regulated financial services sector.*

- *Ensure appropriate levels of* ***separation and independence*** *of each of the* ***'four lines of defence'****, as a general principle and in line with the standards of the UK regulated financial services sector.*

- *Ensure appropriate levels of* ***co-operation and information sharing*** *across the* ***'four lines of defence'****.*

LPF Group Statement of Risk Appetite

February 2021

PURPOSE, PROCESS AND ASSURANCE PARAMETERS

This '**Statement of Appetite'** forms part of the LPF group's assurance framework, covers all entities within the group and should be read in conjunction with the other risk and compliance processes and procedures.

The group's risk function and Risk Management Group (RMG) is accountable for maintaining this assessment of the group's risk appetite and, in conjunction with the Senior Leadership Team (**SLT**), ensuring that it continues to align with the group's strategic and other developments. The RMG and SLT also ensure awareness and oversight of the risk appetite and distillation of its principles throughout the group's operations and culture, seeking to address any perceived gaps, misconceptions or inappropriate practice.

The statement is considered and refreshed on at least an annual basis and otherwise as required. It has initially been endorsed by the Pensions Committee and is subsequently tabled to the Audit Sub-Committee annually as part of the group's in-depth risk update.

It is an overarching statement of the group's risk appetite and so should also be read alongside the separate statement of risk appetite for the delivery of regulated investment services by LPFI Limited (**LPFI**), which is considered and approved by the LPFI board on an ongoing basis and at least annually as part of its Internal Capital Adequacy Assessment Process (ICAAP)[1]. That statement is specifically focused on LPFI and includes liquidity and solvency risks not as directly relevant to the wider group.

Risks across the firm are assigned to one of nine categories. Each category is assigned a narrative risk appetite of Low / Medium / High, giving a broad indicator of the level of risk we are willing to take in that area. Low appetite means risk averse, with little or no tolerance for risk; High appetite means we are prepared to take risks to achieve objectives or must accept risks that are out-with our control; a Medium appetite is somewhere in between. Each category has a narrative explanation of this appetite. A quantitative expression is not always deemed helpful given the range across the group but, where pragmatic, quantitative parameters are used as an indicator of the tolerances the group will operate within.

The group's approach to risk is continually evolving and this document will be updated to reflect that. However it doesn't purport to be a comprehensive summary or list of the group's risk appetite or tolerance for all specific operational risks managed by the group. For instance, comparable areas that are inherently less risky than something deemed within appetite, would be within appetite unless expressly confirmed otherwise. Nor does it seek to list in detail all the group's policies, procedures and controls which support its approach to risk. It should therefore continue to be read in the context of the LPF group's overall business strategy and other risk/compliance processes and procedures.

A group-wide LPF risk register is maintained which records high-level risks, an assessment of their impact and probability, and assigns each risk to one of three categories: Within Appetite; Beyond Appetite; Materially Beyond Appetite. This document provides a framework to assist the categorisation of these risks.

[1] To be updated to Internal Capital and Risk Assessment (ICARA) in June 2021.

OVERARCHING PRINCIPLES

The LPF group operates within a complex and multi-faceted environment. It is a public sector pension fund that manages its own member and employer administration and, uniquely in Scotland, operates an in-house investment team to manage the substantial majority of its c£8 billion of assets internally. It also operates a Financial Conduct Authority (**FCA**) regulated investment company (**LPFI**) which provides investment management and advisory services to other likeminded pension funds and institutional investors. The group also includes a separate staff servicing vehicle, LPFE Limited (**LPFE**), which ensures that it has bespoke people and HR processes aligned to its wider strategy and regulatory framework.

The following are important high-level principles framing the group's risk appetite:

- **Client and stakeholder satisfaction:** the Lothian Pension Funds are an important and valued employment benefit for our members and underpin the recruitment and retention strategy of our employers. We understand that our standards of service must reflect that and, although we are not in a market-competitive situation, only have a low-medium tolerance for the risks associated with poor service delivery to those important stakeholder groups.

  We equally recognise that in delivering shared services to other likeminded pension funds we need to ensure we maintain an appropriately high standard of service delivery to those clients. Services to partner pension funds are subject to regulation by the FCA and we have a low tolerance for risk around regulatory breach for those services. However, they are equally delivered under a shared services model which reduces the extent of exposure and client expectation by comparison to an equivalent service in the private sector. The hybrid nature of this service itself represents a risk which the group monitors very closely.
- **Scheme complexity:** the Local Government Pension Fund (LGPS) in Scotland (and the wider UK) is a complex scheme which has built up layers of rules over the last fifty or so years. These rules and regulations are enshrined in statute and set at a national level. We seek to engage actively to ensure they continue to be 'fit for purpose' and to lead on wider structural change, but do recognise that our service provision is hampered by the complexity of a scheme for which we have limited ability to directly influence, whether in terms of simplifications, enhancements or any other change. We are therefore required to tolerate elements of risk associated with this complexity, whilst doing as much as we can to support our members and employers. This is also the case with our reliance on third parties to provide administration software as in-house solutions are unable to cope with the complexity.
- **Financial services standards:** we believe a funded defined benefit pension scheme with responsibility for c£8 billion of assets should operate to the standards of the financial services sector within the United Kingdom, notwithstanding that the LGPS mostly falls outside of the regulatory regimes associated with that sector. The group does however recognise that the operations associated with administering the Lothian Pension Funds themselves do not involve any external professional or retail client exposure, are akin to that of an internal 'OPS'[2] organisation in most regards and so should adopt a suitably proportionate approach to its structures, systems and controls. Equally the group needs to

[2] FCA categorisation for in internal Occupational Pension Scheme model.

balance its operational standards with statutory obligations to appropriately use pension fund monies and ensure 'best value' for its stakeholders.

- **Long-term horizons:** as a pension fund with current liabilities and obligations that extend beyond 80 years, the group takes a long-term approach to its business and investment strategies. That should not be an excuse for lack of discipline or robust process in the short to medium term, but does seek to ensure due perspective is given to short term market movements, funding and liability positions etc. This longer-term approach allows the group a higher tolerance for risk in certain areas and is therefore critical to its strategy and operating environment.
- **Governance:** the group views good governance as being critical to its own success and that of its stakeholders and underlying investments, and so has a low tolerance for risk arising from governance that is short of best practice in the financial services industry. However, we are aware that there are certain governance constraints and potential conflicts of interest around the existing public sector administering authority model. Those have been, and continue to be, addressed within the group's governance structures, where possible, but remain an accepted risk in operating the current model. This is however monitored very closely by the group on an ongoing basis, with a particular focus on any extensions to its strategic business plan. Please also see the group's 'Governance Overview'.
- **Resources:** the LGPS sector has historically, and in many quarters continues to be, under resourced. That is not currently the case for the LPF group, which has over the last decade sought to introduce the necessary resource to align to its business plan and deliver a high quality and resilient service to its members and employers. The group operates within the regulatory net of the FCA and so has a low tolerance for any risk arising from under resourcing of its regulated business plan. That translates across to its unregulated pensions business, notwithstanding the lower regulatory bar in the public sector pensions environment. The group does however recognise that its approach to resourcing will also necessarily also be influenced by it being a public sector organisation and with resourcing strategies being subject to 'best value' assessments.
- **Public sector scrutiny:** the group's tolerance for risk is generally reduced given the heightened transparency around its activities, being a public sector organisation. Nevertheless, there are areas where the LPF group does require to rely on publicity exemptions in order not to undermine its commercial relationships in the markets and wider business strategies. These exemptions are not used lightly and the group fully embraces the checks and balances that public transparency brings.
- **Reputational:** similarly the group's tolerance for reputational impact is lower as a result of that transparency and given its need to maintain credibility with stakeholders and its collaborative partner funds, particularly at a time when it is seeking to demonstrate a 'best in class' service and operating model. The group therefore retains a low tolerance for adverse reputational impact, whilst recognising that it is not in a perfectly competitive market environment and so is less sensitive to those commercial constraints.
- **Proportionality:** the group considers its risk appetite in the context of the scale of its business and the sectors within which it operates. In particular:

    - **Members:** it supports approximately 81,500 members, managing 87,900 records. It pays in the region of c.£300 million in benefits annually.
    - **Employers:** it supports 80 employers across a large spectrum of size, type and sector. Any systemic issues across the employer base, or a particular error resulting

in material service disruption/adverse impact to an employer arising from a negligent act or omission by LPF, would be beyond appetite.

- **Assets:** it manages or oversees the external management of c.£8 billion of its own assets and can trade in values in excess of £1 billion.
- **External investment services:** it delivers investment management services for two LGPS funds (c.£40million of AUM with potential to increase to c£1.5 billion over time) and investment advisory and arranging services for a total for four LGPS funds. The group does not market these services more widely. Due to the nature of these services and the liability exclusions in place, a service error would be material if it resulted in a significant loss to a client fund **and** arose from gross negligence or a material regulatory breach by LPFI (with corresponding financial and reputational impact on the group).
- **Regulatory or compliance breach:** it operates across the financial services, pensions, public sector and corporate landscapes. Any regulatory breach which results in a material financial or reputational impact to the group or any of its clients or counterparties would be deemed to be significantly outside of appetite. A persistent and recurring trend in lower level regulatory breaches would also point to the potential for systems and controls, cultural and/or resilience issues and so would also be outside of appetite.

Please also see 'Other Known and Tolerated Risks' for how the group reviews known and tolerated risks and monitors any quantitative ranges around tolerance.

LOTHIAN
PENSION FUND

ACROSS RISK CATEGORIES

This table summarises our risk appetite by category. A more detailed narrative is supplied on the following pages.

Risk Category	Current Risk Appetite		
	Low We are risk averse and aren't doing anything adventurous	**Medium** We're cautious but willing, or must, take on some risk	**High** We're willing to, or must, take on risk
Members & Pension Administration		Low tolerance for poor service to members; we accept risks with scheme complexity and service providers	
Employers and liability management		Low tolerance for poor service delivery; we accept risks associated with employer resourcing and reliance	
Assets and investment management			We pursue higher long-term reward, and accept short and medium term volatility.
Strategic collaboration			We have a higher tolerance to achieve the benefits of scale and collaboration
Legal, risk and compliance	We operate in a complex regulatory environment		
ICT and systems	Resilience of our ICT and systems is critical		
People and communications		We must ensure resilience and long-term sustainability	
Supplier management and procurement		We have a small number of critical suppliers	
Information governance	We process a large amount of members' personal data		

Members and pension administration

As set out in the overarching principles, the group has a low tolerance for risk associated with poor service delivery to members. However, its risk appetite accommodates and accepts:

- Complexity of the scheme.
- Employer resourcing constraints and reliance.
- Heywood monopolistic market position (see below).

Current Risk Appetite: Medium

Employers and liability management

Equally, the group has a low tolerance for risk associated with poor service delivery to employers. However, its risk appetite accommodates and accepts:

- Complexity of the scheme.
- Employer resourcing constraints and reliance.

Current Risk Appetite: Medium

Assets and investment management

As the pension fund is an open, defined benefit scheme, its liabilities extend several decades into the future. Consequently, the fund is able to invest in much longer dated assets with a higher overall tolerance for taking investment risk than many investors with shorter investing horizons. The fund's appetite for risk is constrained by prudence (the future is uncertain) and affordability - the varied nature of its employers is reflected in the different levels of risk assumed in its four (unitised) employer strategies. The fund's risk appetite accommodates and accepts:

- Adverse asset market movements that affect fund values over the short to medium term, in pursuit of higher long-term reward.
- Adverse currency movements that affect fund values over the short to medium term, in pursuit of diversification.
- Tracking error risk, in pursuit of better than benchmark risk-adjusted returns over the long term.

The group has a low tolerance for risk arising from external manager conflicts and for consultant-led strategy changes that are costly to implement, which has influenced its model of internal resource resilience, including an in-house investment management team with internal support functions and systems. This model means the group also has a higher appetite for the operational risk that comes with managing that team, but this also mitigates risk through a greater alignment of interest with the pension fund and lower costs which should ultimately protect asset values and funding levels.

Current Risk Appetite: High

Strategic collaboration

The group believes that there are meaningful benefits of alignment and scale which can be achieved through it collaborating with likeminded pension funds and other institutional investors. In pursuing this strategy, the group has therefore sought to increase its appetite for operational and client risk in order to access the benefits and drive fundamental structural improvements for the benefit of its stakeholders.

Current Risk Appetite: High

Legal, risk and compliance

The group has a low tolerance for risk associated with legal and regulatory non-compliance due to the combination of:

(i) it operating within a highly complex regulatory environment, spanning the financial services and public sector;
(ii) additional regulatory client service obligations as part of collaboration;
(iii) public sector scrutiny and statutory obligations; and
(iv) national and industry scrutiny.

However, the group has accepted a greater appetite for risk in this area in pursuing its strategies to operate an internal investment team and deliver regulated services to partner pension funds. The group also needs to be mindful of the different regulatory standards and sanctions that exist across its group from the FCA, The Pensions Regulator and the Scottish Information Commissioner.

Current Risk Appetite: Low

ICT and systems

The group recognises that resilience and security of its core ICT platform and other systems is critical and, particularly in light of the recent pandemic and the heightened standards of the FCA, therefore has a low tolerance for risks associated with poor ICT and systems resilience. The group is currently undergoing substantial business transformation through the delivery of its Digital Strategy in the short to medium term and, in doing so, has meaningfully increased its appetite to take on associated operational risks in the short term to manage and resource future improvements in resilience.

Current Risk Appetite: Low

People and communications

The LGPS sector generally adopts a high tolerance to risk around resourcing the administration of its pension funds, largely as a result of public sector constraints and inherent governance issues. Whilst the group operates within that wider environment, it has made meaningful structural changes to its governance and operating model to allow it to develop its internal asset management and collaborative strategies. Those strategies require the group to recruit/retain investment and supporting professionals and put in place appropriate continuity and succession planning structures to ensure that the platform has long term sustainability and resilience. The group ultimately has a low tolerance for the risk of its strategy being undermined by its inability to recruit and retain relevant colleagues and satisfying FCA SYSC and other requirements. However, it has substantially increased its overall risk appetite in this area by choosing to operate a strategy which requires it to compete in the markets for high quality investment and other professionals.

Current Risk Appetite: Medium

Supplier management and procurement

The group has a small number of critical suppliers where it must take a low tolerance approach to resilience given the fundamental reliance it places on them to deliver its core service. Those include its Custodian, Pensions Administration System, Core ICT and Investment Order Management System providers. The group's third-party supplier management framework details all its suppliers with a rating of criticality and its appetite to risk for those suppliers is negatively correlated so that it progressively increases as the rating of the suppliers reduces.

The group's risk appetite is also higher on the basis that many of its counterparties are very large global players in the financial services and investment sectors, and for whom the level of business provided by the group is less material. That means that the group on its own does not exercise significant commercial leverage with those counterparties.

Current Risk Appetite: Medium

Information governance

The combination of operating within both the public sector and investment markets presents the group with certain challenges around information governance. It necessarily requires the adoption of a higher appetite for risk due to its need to engage with the commercial realities of doing business in the various financial services sectors.

Ultimately pension fund administration involves processing a large amount of personal data and the group's investment activities involve routinely handling commercially and market sensitive information, which means the group has a low tolerance to risk in this area. It is also subject to a number of statutory obligations around information compliance which have potentially significant financial and reputational risks around prospective regulatory sanctions.

Current Risk Appetite: Low

OTHER KNOWN AND TOLERATED RISKS

The risk function maintains a statement of specific areas in which the group is tolerating a known more granular risk. That document also includes an indicative set of quantitative ranges of tolerance in the areas where that is appropriate. These are routinely monitored and updated by the RMG and SLT and drawn from the risk register and prior considerations by the RMG. They will also be considered annually by the Audit Sub-Committee as part of its routine in depth review of the group's risk management – importantly being a B agenda item given the inherent commercial and other sensitivities.

VERSION CONTROL

VERSION	DATE	COMMENTS	AMENDED BY	APPROVER/NAME/POSITION
1	February 2021	Risk Appetite Statement for the Group	SRF	RMG and SLT

SLT ASSURANCE SIGN OFF

I hereby approve this group risk appetite which is aligned to the group's strategy and operational activity:

Struan Fairbairn, Chief Risk Officer
Struan Fairbairn

John Burns, Chief Finance Officer
John Burns

Bruce Miller, Chief Risk Officer
Bruce Miller

Helen Honeyman, Head of People and Communications
Helen Honeyman

Doug Heron, Chief Executive Officer
Doug Heron

APPROVAL DATE: 04 March 2021

APPENDIX 3 - BREXIT UPDATE

The LPF group has been tracking the potential impact and risk of Brexit for a number of years now. We are a UK based pension fund, with UK based employers and a predominantly UK based membership. We also provide investment services to other LGPS pension funds, all being UK based. The direct impact of Brexit on the LPF group, its service delivery and the sustainability of the funds has therefore been assessed to be limited.

However, more widely and indirectly, Brexit will have a significant impact on the environment in which we carry out our business over the coming years, with economic and other ramifications that will influence the pensions and financial services sectors within which we operate. This risk is currently uncertain, with the UK-EU Trade Cooperation Agreement (**TCA**), coming into effect on 1 January 2021, not providing any clarity for the financial services sector around access to the EEA and regulatory equivalence. The TCA is accompanied by a non-binding Joint Declaration committing the UK and EU to cooperation on matters of financial regulation and there is an intention to facilitate this by a Memorandum of Understanding due to be agreed in March 2021. There is therefore meaningful uncertainty in the sector both in terms of the current position (in transition) and also how the UK government intends to use its enhanced regulatory control of the financial services sector.

The financial services sector contributes significantly to the UK economy (c.£130 billion and c.1.1 million jobs) and that is particularly apparent in Edinburgh as the UK's second largest financial services hub outside of London. It is difficult therefore to imagine that Brexit will not result in changes in the sector which the fund will need to adapt to, whether in terms of supplier availability, talent pools etc.

Some of the more detailed Brexit related operational considerations are set out below:

RISK	ACTION
Investment Markets	We have previously noted that Brexit creates uncertainty for some of the companies, industries and properties in which our pension fund invests. Brexit is inevitably a short-medium term negative for parts of the UK economy as trade friction makes economies less productive. There is also evidence of companies relocating staff outside the UK. Financial markets, however, are discounting mechanisms, meaning that they anticipate the consequences of future change. This has been evident in asset price movements over the recent years of negotiations with sterling notably weak and the UK stock market becoming one of the cheapest developed equity markets by various measures. Our pension fund is a global investor, not solely a UK investor, and the global benchmarks have a relatively low weighting in UK assets - only 4% of global equities are UK-based. So, that is the context in which Brexit risk should be viewed. Our fund adopts a long-term investment strategy, diversifying across global markets and asset types. We rebalance portfolios over time to achieve required returns. Our allocation to UK assets has increased slightly as UK assets cheapened compared with overseas assets – some attribute this to Brexit uncertainty, but there are other plausible reasons. Actions specifically related to Brexit are likely to be small in scale, if there are any.

External Managers	The fund's external managers have for some time been making transitional arrangements to adapt to Brexit, in the most part involving establishing European branch offices or migrating/restructuring business to existing European hubs. The fund therefore does not anticipate any material issues arising in relation to its existing external managers and has received relevant updates to confirm that suitable arrangements have been made (where relevant).
People and Members	The group has no employees who rely on EU membership for right to work in the UK and therefore experienced no disruption to resourcing levels. Similarly, the provision around settled status for EU member state nationals has meant that the fund's active membership has not been impacted by leavers from within our employer pool.
ICT Managed Service	We have had to consider Brexit as part of the process to appoint Cased Dimensions (**CD**), confirming that: • The contracting entity is based in the Republic of Ireland - Cased Dimensions Ltd (Ireland). This is the parent company. • The services are carried out by employees of Cloud Operate in the UK/NI (wholly owned sub). • Invoices come from Cased Dimensions Ltd (Ireland) with remittance to a UK bank account. • If for whatever reason LPF and CD thought it advantageous to source supply from the UK entity (e.g. an equipment purchase excluding import tariffs or possibly some change in Brexit arrangements further down the line) it has that UK entity to invoice from if needed.
Derivative Trading	LPF previously relied on a European regulatory exemption from the 'clearing' obligation relating to its over the counter (OTC) derivative transactions. Although it looked as though this exemption may lapse as a result of Brexit, the new UK EMIR regulations applicable to LPF and LPFI confirm that pension fund arrangements may benefit from a temporary exemption from the clearing obligation in relation to OTC derivatives that are *objectively measurable as reducing investment risk etc.* The group's use of OTC derivatives is restricted to this purpose currently (i.e. not used as a return seeking investment class) and so will continue to benefit from this temporary exemption. The exemption is **valid for a four-year period from 1 January 2021** and so will need to be kept under review by the group's investment and compliance teams. The new rules require pension scheme arrangements to carry out an assessment to ensure compliance with one of the listed types of pension scheme arrangement that is able to qualify for the exemption. This assessment needs to be properly documented and made available to the FCA on request. We have now completed that

process.

Data Protection

The core data protection principles, harmonised across Europe in May 2018, are now enshrined in the UK Data Protection Act 2018. The UK and EU law is therefore largely aligned at this moment. However, the UK will now become a 'third country' for the purposes of GDPR which means that in relation to future transfers of data across the UK-EU border:

- **UK to EU:** these can continue unimpeded as the UK has decided that the EU has adequate data protection laws. This will however remain under review.
- **From EU to UK:** these may be affected as the EU has not yet made any reciprocal finding that the UK has adequate data protection laws. The EU has however agreed to delay any transfer restrictions for four to six months (known as the bridge) to allow data to flow freely from the EEA as before. The EU Commission has stated that it intends to promptly launch the procedure for the adoption of adequacy decisions under GDPR. In the absence of an EU decision at the end of the bridge, these transfers will need to comply with EU GDPR transfer rules.

We are therefore looking at our supplier arrangements to assess the extent to which any contingency arrangements need to be in place by c. April 2021 in relation to transfer protocols, locations of data centres or legacy data under the old regime, although it is anticipated that adequacy arrangements will be approved by the EU.

As our business and stakeholders are all UK based, we do not anticipate the need to revisit our privacy notices or accessibility arrangements around our Data Protection Officer. We will however continue to review this position as things unfold and also continue to keep an eye on our data transfer protocols for members residing outside of the UK.

Regulations around privacy and electronic communications are largely unchanged aside from reference now to UK GDPR.

Procurement

The Public Procurement (Amendment etc.) (EU Exit) Regulations 2020 (EU Exit Regulations) were signed into law on 19 November 2020 and effectively ensured that the UK procurement regulations would align with the transitional provisions on public procurement as set out in the ratified withdrawal agreement.

Amendments made to the UK procurement regulations will not affect any ongoing procurement procedures commenced before the transition period nor will they impact any ongoing procurement processes. Existing framework agreements will also be unaffected and continue as originally anticipated.

The main change is that procuring entities in the UK are required to publish notices on the new UK e-notification service called 'Find a Tender' instead of OJEU. There are also some changes of references to accommodate.

Under the TCA both the UK and EU have committed to offering increased access to each other's procurement markets and to enhance the transparency of public procurement procedures. There are some additional rules or shared principles in the TCA which apply to all UK and EU procurements.

So, neither the group's ongoing procurements nor the framework arrangements that it relies upon are affected by Brexit. We will continue to keep the new regime under review.

The group has not identified any material supply chain exposure that could arise during any transitional period.

Custody and Taxation

We were notified by Northern Trust that any Irish assets had to be moved from being held in the UK arm of Euroclear to the EU arm, the Euroclear Bank. LPF does not currently have any Irish assets so no action is required. However, the migration requirement runs to assets held to 15 March 2021, so we will continue to monitor the position.

We are also monitoring the impact of a number of tax relaxations (DAC6) and on tax reclaims/double-taxation treaties across Europe.

February 2021