

December 2009

The Pensions
Regulator 

Consultation on revised guidance on internal controls

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Introduction

This is a consultation document on revised guidance on *Internal controls* produced by the Pensions Regulator ('the regulator'), the body that regulates work-based pension arrangements. The revised guidance has been especially constructed to assist trustees of smaller schemes. We recognise that there may be some inherent limitations for smaller schemes due to resource and financial constraints, particularly for very small schemes.

This revised guidance¹ replaces the original version published in February 2007 and is designed to complement the code of practice on internal controls. It should be read in conjunction with the code.

Background: legal framework

Section 249A of the Pensions Act 2004 gives effect to the requirement under Article 14(1) of the European Directive 2003/41/EC that schemes should have adequate internal control mechanisms in place. There is therefore a legal requirement in the Pensions Act that trustees of an occupational pension scheme must establish and operate adequate internal control mechanisms.

The legislation states that:

'The trustees or managers of an occupational pension scheme must establish and operate *internal controls* which are adequate for the purpose of securing that the scheme is administered and managed:

- (a) in accordance with the scheme rules, and
- (b) in accordance with the requirements of the law."

As defined in the legislation, '*internal controls*' means:

- (a) arrangements and procedures to be followed in the administration and management of the scheme;
- (b) systems and arrangements for monitoring that administration and management; and
- (c) arrangements and procedures to be followed for the safe custody and security of the assets of the scheme.

In November 2006 and February 2007 the regulator published, respectively, its code of practice and guidance both to set out our expectations and to assist trustees of occupational pension schemes in complying with the legal requirement to have 'adequate internal controls' in place.

We made a commitment to review these documents after a reasonable period.

¹ The regulator would like to thank *Axa Life*, *Kim Gubler Consulting*, *The Telegraph Staff Pension Plan* and *Watson Wyatt* for helpful assistance in developing and providing some of the material in the draft guidance.

The role of internal controls

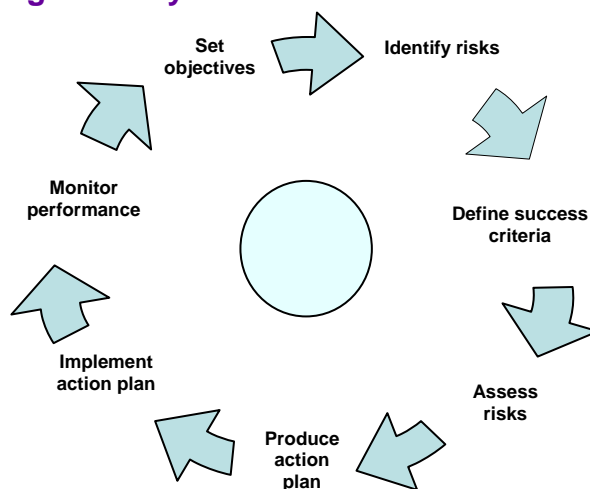
Adequate internal controls are a key feature of a well run scheme and underpin quality governance. The presence of an adequate internal controls framework provides reasonable assurance that members' benefits and scheme assets are protected.

Development of revised guidance

When we published our code of practice, we encouraged trustees to adopt a risk-based approach when assessing the adequacy of their internal controls environment. Our code of practice places a lot of emphasis on the role of risk management (paragraphs 21–27), recommending that trustees use this approach as a platform for assessing and developing an adequate internal controls framework.

Whilst many trustees were familiar with the concepts addressed in the code, it was recognised that for some, particularly those of smaller schemes, further support was needed, specifically in relation to the aims and objectives of a risk management exercise. As a result guidance was produced to walk trustees through each of the key stages of a risk management cycle identified in the code. The diagram and stages have been replicated below:

The scheme risk management cycle



Whilst the content of our original guidance was appropriate at the time of publication, it is now recognised that trustees, particularly those of smaller schemes, require further support.

Our annual governance surveys indicate that progress is being made in certain areas of scheme stewardship, for example managing conflicts of interest. Those surveyed who 'strongly agreed' that the board has appropriate processes in place to manage conflicts of interest has increased from 45% to 60%. Despite this, weaknesses have been identified in relation to specific management activities undertaken by small and DC schemes.

Further, whilst (overall) the proportion of schemes that are 'very confident' that they have appropriate internal controls in place to monitor and mitigate key governance functions has increased marginally, the results are still low.

Our research combined with anecdotal and case-related evidence has triggered the need to conduct a formal review and consultation. This was launched last autumn with an online questionnaire which asked voluntary participants a number of questions specific to the layout, format and content of the code and guidance.

In January 2009 we held a workshop to further explore the benefits of existing material and obtain views and experiences from a broad range of stakeholders. The following questions were debated:

1. Are trustees (of all schemes) dedicating sufficient time to assessing the adequacy of their internal controls framework, risk assessment etc?
2. Does the **code** provide trustees with sufficient principles-based material to address the legal requirement to have internal controls?
3. Should the **code** address in more detail our expectations in managing and addressing key risks? Eg should we stipulate activities we **would** expect trustees to undertake as a matter of course, in the code?
4. Is the **guidance** too theoretical? Could it be improved by addressing aspects of the code, for example matters identified in response to question 3 above, in a more practical manner, eg using case studies?
5. How could regulatory material be improved, particularly with small schemes in mind?

Both the questionnaire and the workshop played a crucial role in the overall direction of the review. Overall the online questionnaire identified good levels of satisfaction for both the code and guidance. Views on the applicability of guidance for smaller schemes were muted (46% 'don't know'). Delegates at our workshop noted that the principles identified in the code still remained fit for purpose; however, there was an appetite for more practical, less theoretical guidance. In particular our guidance should provide a little more clarity about the regulator's expectations.

As a result of this it was agreed that the code should remain unchanged and our efforts should be concentrated on the development of practical and targeted guidance. Whilst the revised guidance is not intended to be exhaustive, it covers seven risks:

- People** 1) A lack of knowledge and understanding
- Processes** 2) Conflicts of interest
- 3) Ineffective relations with advisers
- 4) Poor record-keeping
- 5) Deterioration in the employer(s) covenant
- 6) Investment risk
- 7) Ineffective retirement processes

These have been identified as specific areas where improvements are needed and should be included in a trustees' assessment of risk and subsequent controls framework.

Application of good practice and timetable

As noted in the code and revised guidance, initially trustees should focus on significant risks to their scheme. Trustees should set up adequate internal controls which address significant operational, financial, funding, regulatory and compliance risk.

The areas covered in this revised guidance include issues already addressed in other regulatory material. However, this revised guidance considers the inherent risks trustees should seek to mitigate as a matter of good practice together with a (non-exhaustive) list of controls.

We are aware that many schemes have robust risk management and control procedures in place. For those that do not, we would expect trustees to adopt the good practice identified in the guidance promptly. The failure to establish and operate adequate internal controls is a breach of law; we may pursue cases where a failure results in a materially significant risk to beneficiaries.

Format of revised guidance

Our revised guidance has been developed primarily as a *web-based* product. It has been designed to enable users to navigate to relevant risk areas (identified above) and therefore focus on areas specific to their scheme.

The preliminary sections include a number of important messages and outline the process we would expect trustees to follow, including a number of activities trustees should undertake as a matter of good practice.

The guidance does not seek to duplicate material contained elsewhere: however, it includes key messages and signposts users to other useful resources. This includes material produced both by the Pensions Regulator and by other external bodies.

Whilst we would expect trustees to address risks in order of priority, this guidance includes risks which are considered significant in most schemes. Over a period of time we would expect trustees to become familiar with all the sections included in this guidance.

Consultation questions

The regulator would like to hear from trustees, particularly of smaller schemes, and other interested stakeholders on the areas covered in this consultation document. We would welcome comments on the guidance in general, but would particularly welcome comments on the following specific areas:

Content

1. The revised guidance has been developed primarily for smaller schemes – will trustees of these schemes find this document useful? If not, why not?
2. In this guidance we set out the activities and controls we would expect trustees to undertake. Does the revised guidance clearly set out our expectations in terms of establishing and operating adequate internal controls and complying with good practice? Are they reasonable?
3. Do you feel able to extract information relevant to your scheme, and will this guidance help you develop robust control procedures?

4. The guidance considers seven key risk areas. These are deemed to be both significant and common in most trust-based defined contribution schemes. Do you agree with this statement? Are there other areas you would expect or wish the guidance to cover?

Format

5. We recognise that scheme resources are limited, especially for smaller schemes. The web-based guidance will therefore deliver a series of modules to help trustees address risks in manageable stages – do you agree that the format will help to meet this objective?

Practical guidance

6. In this revised guidance we include a number of case and illustrative examples. They have been included to help demonstrate practically the risks and advantages of both adequate and inadequate internal controls, as well as identifying processes trustees may follow. Do you think they fulfil this role? If not, please share with us other case examples which may add more value – we may wish to include these in our final guidance.

Responding to the consultation

Responses may be made in either of the following ways:

By email to: internalcontrols@thepensionsregulator.gov.uk

(Preferably documents should be in MS Word format)

By post to: **Philip Spary**
Regulatory policy and programmes
The Pensions Regulator
Napier House
Trafalgar Place
Brighton
BN1 4DW

We may need to share the feedback you send us within our own organisation or with other Government bodies. We may also publish this feedback as part of our response to the consultation. If you wish your comments to remain anonymous, please state this explicitly in your response.

If you wish your response to be kept confidential, please make this known and we will take the necessary steps to meet your request. However, please be aware that, should we receive a formal request under Freedom of Information legislation, we may be required to make your response available.

When responding, please advise whether you are responding as an individual or on behalf of an organisation (and if the latter, which organisation).

Closing date

This consultation document was published on **1 December 2009**. The closing date for responses to this consultation is **1 March 2010**.

The Government code of practice on consultation

This consultation is being conducted in line with the seven criteria of the [Government code of practice on consultation](#):

1. Formal consultation should take place at a stage when there is scope to influence the outcome.
2. Consultations should normally last for at least 12 weeks, with consideration given to longer timescales where feasible and sensible.
3. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence, and the expected costs and benefits of the proposals.
4. Consultation exercises should be designed to be accessible to, and clearly targeted at, those people the exercise is designed to reach.
5. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Consultation responses should be analysed carefully, and clear feedback should be provided to participants following the consultation.
7. Officials running consultation exercises should seek guidance in how to run an effective consultation exercise, and share what they have learned from the experience.

Feedback on this consultation exercise

We value your feedback on how well we consult. If you have any comments on the process of this consultation (as opposed to the policy issues raised) please contact our consultation co-ordinator:

By email to: alastair.cowie@thepensionsregulator.gov.uk

By post to: **Alastair Cowie**
Better Regulation Manager
The Pensions Regulator
Napier House
Trafalgar Place
Brighton
BN1 4DW

In particular, please tell us if you feel that the consultation does not satisfy the consultation criteria. If you have any requirements that we need to meet to enable you to respond, please let us know.

Appendix A - Impact assessment statement

The Department for Work and Pensions (DWP) is responsible for conducting Impact assessments for new legislation affecting the legislative framework for pensions regulation. In some circumstances it may be appropriate for the regulator to conduct its own Impact Assessment, and publish this as part of its consultation exercise, where proposals have additional costs for the regulated community above those already imposed by the legislative requirements.

In the majority of cases our proposals will impose no significant additional costs above those already imposed by the legislation. The regulator's codes of practice, for example, are practical guidelines to enable trustees and employers to comply with existing legislative requirements, and do not themselves impose new requirements on regulated parties.

Our 'comply or explain' approach means that where initial analysis suggests that there will be no significant cost impact on the regulated community, and an Impact assessment is unnecessary, we should explain the reasons for this opinion clearly when we consult.

When we initially consulted on the *internal controls code*, we concluded that the overall requirements and scope of new legislation concentrated on matters relevant to good scheme governance. As a result we were of the opinion that robust internal controls were already a constituent part of a well run scheme and would not result in significant new costs to pension schemes and the pensions industry. Indeed, where trustees identified weaknesses in their internal controls framework, as a result of applying principles contained in the code and subsequent guidance, this would result in a potential cost saving to the scheme.

It is therefore our view that the revised guidance will not result in additional regulatory burden as it does not expect trustees to undertake activities above and beyond those currently required in legislation.

December 2009

The Pensions
Regulator 

Internal controls

Revised guidance from the Pensions Regulator

www.thepensionsregulator.gov.uk

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Internal control and risk management - At a glance

1. Adequate internal controls contribute to raising standards of governance; they are a key characteristic of a well run scheme and play a role in securing member benefits. An adequate system of internal controls contributes significantly to the safe custody of scheme assets and protects the scheme from adverse risks.
2. This refreshed guidance¹ *provides educational support for trustees, with a view to sharing good practice and raising standards in governance.*
3. It identifies control procedures we would expect trustees to operate and illustrates their importance using a variety of examples.
4. It is designed to provide practical help to manage compliance with the obligation to establish and operate internal controls which are *adequate* for the purpose of securing that the scheme is administered and managed in accordance with:
 - the scheme rules; and
 - the requirements of the law.
5. The guidance has been structured to help users to navigate through to specific risks. The sections preceding the specific risks clarify the purpose of the guidance in more detail, exploring risk management processes and roles and responsibilities of trustees.
6. We strongly recommend the use of risk management as a tool in identifying risk and developing internal controls. As part of this exercise we would expect trustees to formally document risks in a risk register.
7. Throughout we include a number of important messages including other activities we would expect all trustee boards to undertake.
8. Content has been developed particularly with smaller trust-based schemes in mind². We are aware that trustees who represent these schemes may require additional support. It therefore provides practical assistance in risk management and internal controls, and should be read in conjunction with the regulator's code of practice on *internal controls*³.
9. Instituting a robust controls framework provides reasonable assurance that procedures are undertaken properly. For example they provide comfort that benefits are paid in accordance with scheme rules, investment risk is managed and the likelihood that funds could be misappropriated is reduced.
10. A failure to comply with the legal obligation to implement and operate adequate internal controls is a breach of law and could result in regulatory intervention.
11. Our guidance focuses on the following risks:
 - People**
 - Processes**
 - 1) A lack of knowledge and understanding;
 - 2) Conflicts of interest;
 - 3) Ineffective relations with advisers⁴;
 - 4) Poor record-keeping;
 - 5) Deterioration in the employer(s) covenant;
 - 6) Investment risk; and
 - 7) Ineffective retirement processes.

¹ This guidance supersedes previous Internal controls guidance published in February 2007.

² However, much of the content may be equally relevant to larger schemes.

³ www.thepensionsregulator.gov.uk/codesOfPractice/internalControls/index.aspx

⁴ 'Advisers' also includes those who provide services to the scheme and agents.

12. Whilst not exhaustive, these risks represent priority areas which challenge most trustee boards. Our research indicates that these are particular areas where improvement in trustee governance is required.
13. However, trustees need to be alert to all risks which could affect the running of their scheme. We will endeavour to update this guidance when further support is needed.

About this guidance

1. This guidance and associated principles has been produced for trustees and managers of occupational pension schemes and is especially constructed to assist trustees of smaller schemes. However, the principles, procedures and underlying benefits of establishing and operating adequate internal controls will be equally important to all schemes.
2. This guidance supplements information provided in our e-learning toolkit and the *Trustee Knowledge and Understanding (TKU)* framework (code of practice No 7), and the scope of knowledge and understanding documents.⁵
3. Our guidance has been developed on the basis that trustees adopt a risk management approach to implementing adequate internal controls, as recommended in the code.
4. Reference to scheme operations in this guidance includes outsourced activities, for example record-keeping and administration. Trustees need to demonstrate that outsourced functions are adequately controlled and managed, noting crucially that they are still legally responsible for these.
5. This guidance does not address every risk. It does however explore significant risks common in most trust-based defined contribution (DC) and defined benefit (DB) arrangements, risks we expect trustees to address.

Smaller schemes

6. We recognise that there may be some inherent limitations for smaller schemes due to resource and financial constraints, particularly for very small schemes. This guidance has been developed to enable smaller schemes to identify risks, prioritise risk and then navigate to more detailed guidance on systems and controls. It will, however, require judgement when assessing which risks should be addressed first and the following sections help trustees manage this process.
7. Smaller schemes may need to tailor their approach to developing controls, particularly where many or most functions have been outsourced. We would expect smaller schemes to have formalised procedures for managing risk.
8. This guidance is accompanied by an e-learning module to make the material more accessible, and provide a path through the process for smaller schemes.

⁵ See www.trusteetoolkit.com for further information.

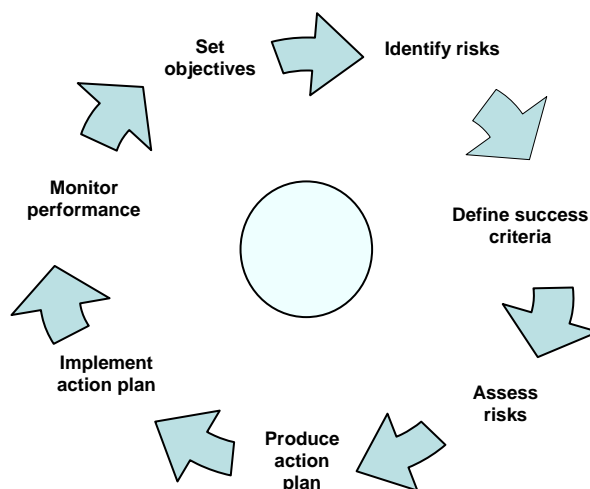
Contract-based arrangements

9. This guidance, and the *Internal controls code*, does not apply to contract-based workplace DC arrangements. Contract-based pension providers are required to establish and maintain systems and controls under the Financial Services Authority's regulatory framework. However, employers who offer contract-based pensions to their employees may find this guidance a useful partner to the voluntary employer engagement guidance.
10. This guidance will also be of interest to scheme advisers and those providing services to occupational pension schemes.

The role of risk management

11. Trustees should regularly (eg annually) undertake risk assessment exercises to identify whether their existing system of internal controls is still fit for purpose – do they prevent and detect errors in existing scheme operations, and will they help mitigate new risks?
12. Risk management is an ongoing process. Trustees should continually review their exposure to new and emerging risks, including significant changes in or affecting the scheme.
13. The code of practice on *Internal controls* and our previous guidance considered the various stages of a typical risk management cycle (see below), together with the likely outcomes for each stage.

The scheme risk management cycle



14. The stages of this process are summarised in Appendix A, but broadly, when addressing risk, this should be done in four stages:
 - (1) identification;
 - (2) evaluation;
 - (3) managing; and
 - (4) monitoring.

15. These stages have been adapted into principles (see table 1 below) which will result in a number of benefits to the scheme as well as helping to meet legal requirements. Trustees should gauge the extent to which they have addressed these principles when establishing adequate internal controls.
16. The summary of principles represents key aspects of an effective system of internal control. These principles have been developed in a manner that is consistent with other guidance issued by other financial regulators, including guidance for company directors.⁶

Table 1: Principles for developing an adequate internal controls framework

Principle 1: Understanding the importance of adequate internal controls

Trustees should:

- 1.1 be aware of their fiduciary obligations to beneficiaries and ensure that they are satisfying the legal requirements;
- 1.2 recognise that adequate internal controls contribute to raising standards of governance;
- 1.3 establish an effective system of adequate internal controls including formal procedures, eg documented controls, risk register and policies; and
- 1.4 voluntarily disclose to members a statement on their assessment of key risks and internal control procedures, for example in their annual report and accounts.

Principle 2: Identifying risk

Trustees should have a clear understanding of scheme operations and:

- 2.1 regularly consider the nature and extent of internal risks; and
- 2.2 regularly consider the nature and extent of external risks.

Principle 3: Evaluation of risk – assessing impact

Trustees should:

- 3.1 develop a process for evaluating risks;
- 3.2 consider the impact risks may / will have on scheme operations; and
- 3.3 assess the probability of a risk materialising.

Principle 4: Managing risk

Trustees should:

- 4.1 ensure internal controls are sufficient to prevent and detect errors; but
- 4.2 understand that internal controls reduce but do not eliminate risk.

Principle 5: Effective monitoring of controls

Trustees should understand that establishing effective internal controls is not a one-off exercise and therefore:

- 5.1 have procedures in place to *regularly* monitor the effectiveness of their internal control system; and
- 5.2 ensure controls are kept up to date and capable of mitigating new and emerging risks.

⁶ Internal control: Revised guidance for Directors on the Combined Code, published by the Financial Reporting Council.

17. For those schemes that already have processes in place, this guidance will be a useful tool to assess the adequacy of existing arrangements. For example, it will prompt trustees to:
- consider exposure to new and emerging risks;
 - assess exposure to specific risks;
 - evaluate the adequacy of existing controls; and
 - understand what the regulator’s expectations are in respect of developing an adequate internal controls framework.
18. An early stage of a formal risk management review (identify risks) provides an opportunity for trustees to record *all* those risks to which their scheme is exposed. Table 2 summarises underlying risks, relevant to the seven areas addressed in this guidance, which the regulator would expect all schemes to manage efficiently and effectively, with example control procedures. However, trustees must bear in mind that this summary is not exhaustive.

Table 2: Risks and control procedures

Risks	Control procedures
Function: General	
<p>Existing controls not operating effectively.</p> <p>Trustees fail to demonstrate ability to manage risk; poor information on scheme stewardship disclosed to members.</p> <p>Non-compliance with scheme rules and legislation.</p>	<p>Controls framework regularly evaluated; changes made promptly.</p> <p>Risk register used to record risks and document controls.</p> <p>Adequate internal controls developed to mitigate identified risks.</p> <p>Disclosure of risk management activities in the trustees’ report.</p> <p>Compliance review/audits and seek advice where needed.</p>
Function: Trustee knowledge and understanding	
<p>Poor scheme management (ineffective stewardship by those with delegated responsibility).</p> <p>Trustee board has inadequate skills and competencies.</p> <p>Trustees do not refresh or maintain levels of knowledge and understanding.</p> <p>The trustee board does not have necessary skills to manage a particular event.</p>	<p>Chair manages the trustee appointment and retention process to ensure trustees have or can develop necessary skills.</p> <p>Regular review of trustee skills and competencies to identify knowledge gaps (including, where possible, trustee rotation).</p> <p>Training policy and regular training is provided to develop skills. Tasks delegated to sub-committees with specific competencies.</p> <p>Regular trustee meetings; decisions and actions agreed within the formal structure of trustee meetings; minutes maintained and approved for all meetings.</p>

Function: Conflicts of interest	
<p>Decisions coloured by actual, potential or perceived conflicts.</p> <p>Biased funding negotiations.</p> <p>Lack of independence from scheme advisers.</p>	<p>Conflicts management procedures documented in a policy.</p> <p>Register of interests.</p> <p>Processes to manage advisers (eg formal appointment procedures).</p> <p>Appointment of an independent trustee.</p>
Function: Relations with advisers	
<p>Significant reliance on key personnel.</p> <p>Poor quality advice – lack of adequate expertise.</p> <p>Trustees unclear of roles and responsibilities.</p> <p>Advisers inappropriately influence decisions.</p> <p>Failure to seek advice when required.</p>	<p>Documented appointment procedures.</p> <p>Regular appraisal of performance.</p> <p>Assessment of performance against service level agreements.</p> <p>Identify situations when advice is needed; sufficient trustee knowledge and understanding to challenge advice.</p>
Function: Record-keeping	
<p>Non-compliance or maladministration by in-house admin or third party advisers, eg:</p> <ul style="list-style-type: none"> - computer system or database failures - member salary records are inaccurate - service records incomplete - employment details not recorded (important if members employed by different employers within a group scheme) - errors in investment holdings and custodian reports - manual benefit calculations - complex benefit structures (inaccurate benefits) - payments to non-beneficiaries and fraudulent claims - monthly contribution records not reconciled - ad-hoc reconciliation of member units to investment records - errors in member switches and delays in lifestyle arrangements - late investment of contributions - misappropriation of assets 	<p>Peer review of key controls by trustees and/or senior administrators.</p> <p>Presentation of administration reports to the trustee board.</p> <p>Review of service level agreements.</p> <p>Appraisal of service providers.</p> <p>Assessment of quality control review procedures adopted by third party administrators (eg independent assurance reports).</p> <p>Quality assurance procedures – management review and sign off of manual procedures (eg complex benefit calculations).</p> <p>Daily, weekly bank reconciliations.</p> <p>Reconciliation of investment transactions to investment reports.</p> <p>Segregation of duties.</p> <p>DC: frequent reconciliation of member units to investment manager totals.</p> <p>Weekly/monthly reconciliation of contributions received to payroll details; regular dialogue with payroll providers.</p> <p>Data review exercises.</p>

Function: Employer covenant assessment	
Deterioration in employer covenant. Cash flow risk to funding. Corporate transactions. Late/non-payment of contributions. Employee contributions used to alleviate cash flow. Employer unable to meet scheme cost.	Regular dialogue with employer(s). Monitor financial performance of employer/associated businesses. Procedures to alert trustees to corporate transactions – local press, agreement with employer. Statutory ‘whistle-blowing’ of late contributions.
Function: Investment	
Inactive to poor investment performance and returns. Inappropriate investment strategy. Ineffective advice received from investment managers.	Regular review of investment funds. DC: review of investment choices for members.
Function: Retirement	
Schemes do not offer OMO. ⁷ Delays in paying member benefits. No member communications in lead-up to retirement. Members not aware of impaired annuities due to ill health.	Members approaching retirement are contacted and advised of various retirement options. Scrutiny and oversight of benefit calculations/payment processing. Staged communications in lead-up to retirement. Include key information clearly in member communications.

19. Trustees should have a clear understanding of key controls in place. We recommend that these are documented.

Have key controls been documented?

The trustees’ role

20. It is vital that members’ benefits and scheme assets are not put at risk as a result of poor controls. Trustees have a legal obligation to act in the best interests of the scheme’s beneficiaries. It is essential that trustees understand their scheme rules and all relevant legal requirements in order to ensure that controls aim to secure that the scheme is administered and managed in accordance with these. If trustees are in any doubt about scheme rules or applicable law they should seek legal advice.

⁷ OMO – open-market option for purchasing an annuity.

21. As part of the development of an adequate internal controls framework, trustees must ensure that they have identified, documented and mitigated key risks. We would expect trustees to use a risk register for this exercise.

☑ Do you record risk in a formal risk register?

22. This should include an assessment of the implications of risks identified and solutions for managing that risk. Where the crystallisation of a risk has adverse financial consequences for the scheme, this will be detrimental to scheme members and potentially also to sponsoring employers. For example, inaccurate data and scheme records may result in under/over payment of benefits. Over time this will impact on the funding of a scheme.
23. Recording risks in this manner helps to formalise risk management procedures and provides trustees with a central reference point for future trustee meetings.
24. Risks inherent in smaller schemes may be quite different to those of larger arrangements; smaller schemes tend to outsource key functions and often rely on key external advisers.
25. It is not uncommon for a series of services to a scheme, including the maintenance of books and records, calculation of benefits, reconciliation of investment holdings and bank accounts and the provision of reports for trustee meetings, to be provided from one source. Where this is the case trustees need comfort that the lack of segregation of duties is suitably controlled and managed.
26. Key controls operated by the service provider should include peer review of calculations and reconciliations, as well as clear mandates for banking and investment, eg authorisation procedures.
27. Trustees need to verify both the existence and effectiveness of a control or combination of controls which should be suitably designed to prevent and detect errors which could result in the failure of achieving specified control objectives. The evaluation process will reflect on the effectiveness of controls against suitable success criteria. It should consider the impact and likelihood of occurrence of a risk. Many schemes use relatively simple approaches to scoring risks using a two-dimensional scoring model, as illustrated in Table 3 below.

Table 3: Risk scoring model

Likelihood of occurrence	High likelihood Low level of impact	High likelihood High level of impact
	Low likelihood Low level of impact	Low likelihood High level of impact
	Level of impact on the scheme (eg financial)	

28. The classification of risk, eg red, amber or green, will dictate the extent to which mitigating action needs to be taken and will be dependent upon a number of factors including judgement.

29. A risk categorised as red will require immediate attention as it represents a significant threat to the scheme. It would therefore be preferable to avoid these risks completely where possible. A practical approach for formally recording, assessing and scoring risk is considered further in Appendix B.⁸
30. Legislation requires trustees to establish and operate controls which are ‘adequate’. No attempt has been made to define what is ‘adequate’ for the purposes of satisfying the legal requirement; this will be subject to the trustees’ judgement and should be commensurate to the level of risk identified. As noted in the code,⁹ trustees will need to exercise a degree of judgement when seeking to mitigate risk, for example where longer term benefits of implementing a control exceed related costs (particularly likely for higher risk areas such as employer covenant for DB schemes). Any framework should give trustees reasonable assurance that operations are performing properly.
31. Whilst this guidance seeks to provide further support to trustees it is recognised that good governance generally, and the application of good practice, depends very much on the behaviours and culture of the trustee board. Much reliance is therefore placed on the capabilities of trustees: the chair of the trustee board needs to ensure that the scheme embraces good practice procedures. The chair also needs to help ensure that the trustee board has the correct mix of people, skills and experience and that any conflicts are identified and managed.

Other guidance to consider

The Institute of Chartered Accountants of Scotland has produced guidance for pension trustees¹⁰ on assessing and managing risks.

Raising Standards of Pensions Administration (RSPA) have developed a free risk matrix tool that will help trustees review the operation of scheme administration and carry out a high-level assessment of current risk. This tool is available at: www.raisingadminstandards.com.

References and links to materials from other bodies are provided for convenience only. The regulator is not responsible for, has not verified and does not endorse the content, viewpoints, products or services described in these materials. The fact that a reference or link is included here should not be used for advertising or promotional purposes.

32. Internal controls provide a mechanism for managing and measuring a scheme’s exposure to risk. Internal controls are an essential component of the trustee governance model and invariably assist in the protection of member benefits.
33. Trustees’ ability to mitigate key risks will provide good levels of assurance, and voluntary disclosure of a governance statement will help to demonstrate their accountability to members. Whilst trustees should seek to avoid ‘boiler plate’ statements, their commentary could include matters relevant to risk management and controls related activities, akin to the disclosure requirements for charities. Indeed our research has identified that there is good support for such reports from both trustees and scheme advisers.
- Do you disclose to members matters relating to risk management?**
34. The statement could help identify the key risks the scheme is exposed to and the efforts the trustees have undertaken to address these, including evaluation and management

⁸ Trustees need to consider the nature and occurrence of risks on a scheme specific basis.

⁹ Internal Control code, paragraph 28.

¹⁰ www.icas.org.uk/site/cms/contentViewArticle.asp?article=5648

techniques. Whilst it is probable that the natural home for a report of this nature would be the trustees' annual report and accounts, information could be included in other member communications.

Compliance with the regulatory framework

35. The legal obligation¹¹ to implement adequate internal controls is wide reaching. It covers a broad range of governance functions including operational, financial, funding, regulatory and compliance processes and risk. The need to establish adequate internal controls therefore relates to the totality of a scheme's operations.
36. Trustees need to be familiar with our internal controls code and guidance. Where we engage with trustees we may make enquiries about their scheme's internal controls framework. We would expect trustees to be able to demonstrate application of good practice identified in this guidance or explain divergence if they have sought to comply with the law in an alternative way.
37. A failure to implement adequate controls is a breach of law. Where the consequences of a breach are likely to be materially significant, for example where a persistent systemic control failure results in the underpayment of benefits, we expect to be notified under the 'whistleblowing' framework¹².
38. In some circumstances we may consider using statutory powers to rectify persistent failures which result in risks to beneficiaries. This could include the use of Improvement Notices, the appointment of an independent trustee or any other of our powers that may be appropriate.
39. Furthermore, there are certain events (such as Notifiable events¹³) which are notifiable to the regulator as soon as they occur. Trustees should have controls in place which notify them of these events so that they make a report in a timely manner.

¹¹ Section 249A of the Pensions Act 2004 as inserted by the Occupational Pension Schemes (Internal Controls) Regulations 2005 SI 2005/3379.

¹² www.thepensionsregulator.gov.uk/codesOfPractice/reportingBreaches/index.aspx

¹³ www.thepensionsregulator.gov.uk/codesOfPractice/notifiableEvents/index.aspx

Focusing on key risks

40. The trustees' primary focus in implementing an internal controls framework should be on the key risks to their scheme. These are the risks which are critical to the scheme and are likely to have a material impact on the scheme's ability to provide member benefits if not managed effectively.

Do you have a clear understanding of the key risks to your scheme?

41. When considering exposure to risk, trustees should evaluate which risks may fall within this category and implement controls which are both proportionate and pragmatic.

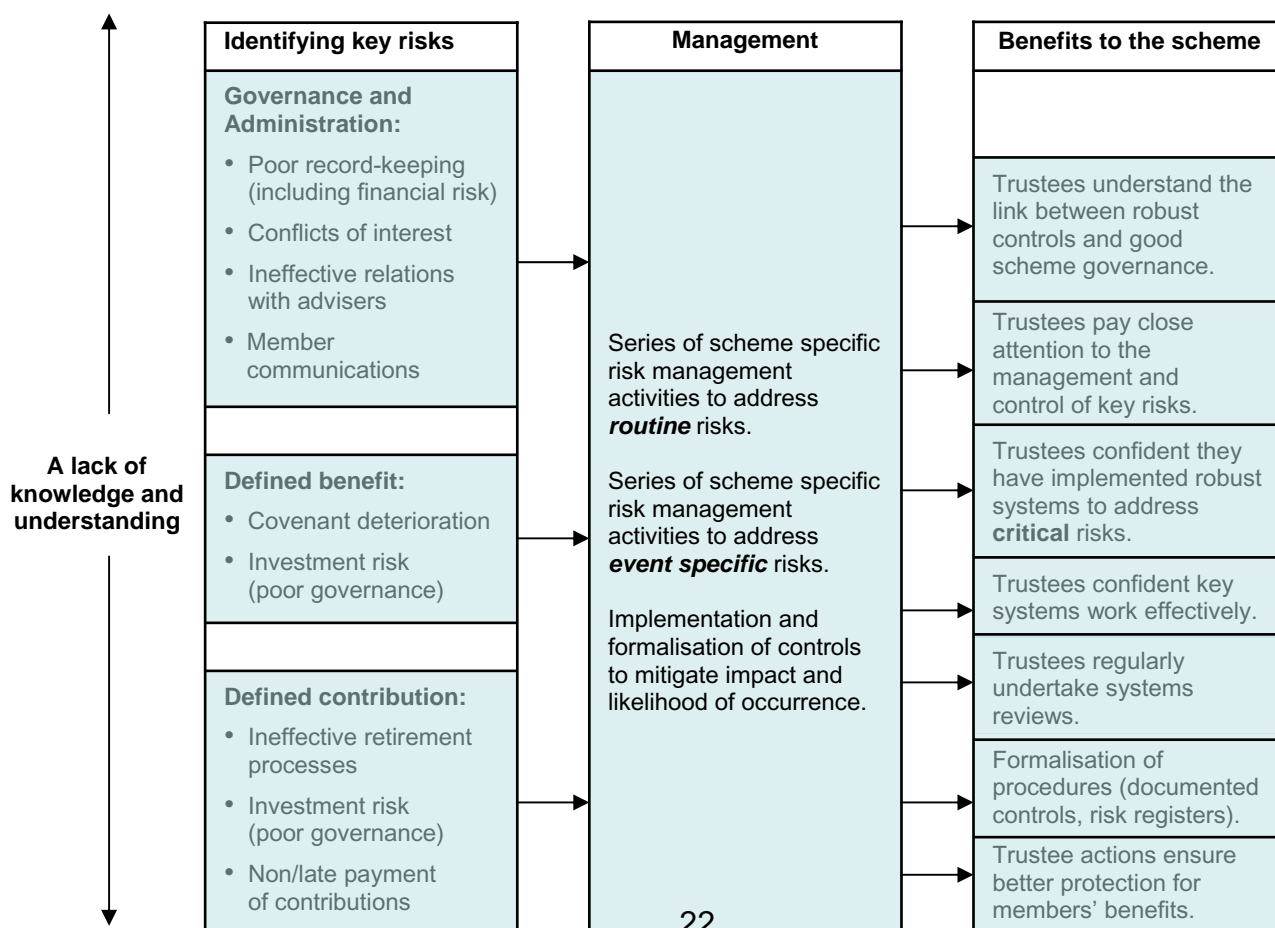
42. The evaluation process will help trustees direct limited resources to priority areas: more detail on this is provided in section entitled *The trustees' role*. The important point to note is that all risks should be addressed in a sensible order of priority starting with those which will have the greatest impact.

43. A scheme's risks will vary according to its nature (eg DB or DC), status (eg open or closed to new members, in wind-up), funding position and size. While there may be variances, the need to implement control procedures remains.

Key risk areas covered in this guidance

44. Trustees should address, in order of priority, all risks to their scheme. It is however important to draw a distinction between *routine* risk (matters relating to daily operations of the scheme), and *event specific* risk (risk inherent in a non-routine event, eg switching administrators, corporate activity).

Table 4: Internal controls linked to priority risks



45. Key risk areas addressed in this guidance are not exhaustive. Our research highlights the following as particular areas where improvements in standards of governance are required, so we would expect the assessment of risk to include these areas:

A lack of knowledge and understanding – the process for developing trustees' knowledge, so that they are sufficiently equipped to run the scheme, is essentially a control function.

Conflicts of interest – whilst we have published guidance¹⁴ specifically in relation to managing conflicts of interest, a number of important messages are included in this guidance which are attributable to risk management of conflicts.

Relations with advisers – scheme advisers play a key role in the trustees' ability to manage their scheme effectively. Trustees therefore need to ensure that controls are in place to manage the appointment of advisers and delivery of information, advice and services provided by advisers.

Poor record-keeping (including financial risk) – failure to maintain accurate and complete data and records will result in a risk to members' benefits and financial risk. As our guidance states, 'Effective financial controls, including the maintenance of proper accounting records, are an important element of internal control'¹⁵.

Deterioration in the employer(s) covenant – trustees, particularly of defined benefit arrangements, need to understand the strength of the employer covenant and to be alert to material changes to it (either to the employer's legal obligation to fund the scheme or to the employer's financial strength) and should introduce control procedures to help facilitate this.

Investment risk (including financial risk) – controls over investment-related activities are a vital function for all trustee boards. However, it is also important that we differentiate between risks and controls associated with DC and DB schemes. The underlying approach to investment management will be fundamentally different and, as such, so too will be the nature of risks. Many DB schemes also incorporate a DC element (AVC¹⁶ arrangements for example). It is therefore important that trustees establish adequate controls for these arrangements similar to those for a pure DC arrangement.

Ineffective retirement process – in the lead-up to a member's retirement trustees need to ensure suitable controls are in place, which may result in better pension outcomes for members. This would include the communication of clear and timely information and support for members exercising the open market option¹⁷.

A lack of knowledge and understanding

46. Our code of practice¹⁸, together with associated *scope guidance*, covers the need for robust systems and controls in a number of different areas. In addition, we have produced a number of free resources which will help trustees satisfy their legal duty to have the necessary knowledge and understanding, principally our e-learning *Trustee toolkit*¹⁹.

¹⁴ www.thepensionsregulator.gov.uk/mediaCentre/pressReleases/pn08/pn08-22.aspx

¹⁵ Source: Internal controls – Revised guidance for directors on the combined code (October 2005).

¹⁶ Additional voluntary contributions.

¹⁷ The legal requirement for members to purchase an annuity from a provider of their choice.

¹⁸ No 7 – Trustee Knowledge and Understanding (TKU).

¹⁹ www.trusteetoolkit.com

Why is this important?

47. To undertake their role effectively and achieve the best outcomes for scheme beneficiaries, trustees must have sufficient knowledge and understanding of their legal duties, their scheme and the legislative and regulatory framework. Failure to manage and develop skills will result in adverse outcomes²⁰.

What behaviours do we expect to see?

48. Training is an important feature of a well run scheme. The extent and nature of tailored trustee training should be planned and managed by doing a 'training needs' analysis and keeping a log of training attended.
49. Trustees should, with assistance from professional advisers if necessary, or using the *Trustee toolkit* and other educational and guidance materials, assess the capabilities and learning requirements of the trustee board. They need to ensure that they are sufficiently equipped to deal with new and emerging issues.
50. Trustees should consider taking advantage of the regulator's free online e-learning *Trustee toolkit* if they have not done so already.

Have you completed the regulator's free online training?

51. A number of modules refer specifically to the application of internal controls, providing illustrative example on how these may be applied. They also flag a number of important governance functions and identify potential risks that trustees need to address.

Module	Scenario	Tutorial
Introducing pension schemes	Finding out more	Risk controls
Trustees' role	Your second meeting	Administration
Pensions law		Codes and guidance
How a DC scheme works	Member complaints	Administration
Running your scheme	Review of internal controls	Business plan – planning exercises

52. The trustees of a well run scheme will have a clear understanding of how their scheme should operate. This would include familiarity with important documents such as the trust deed and rules, member booklets, any statement of investment principles, statement of funding principles, and any other policy documents relating to the administration of the scheme. It is important that documents are up to date, filed safely and securely and are readily accessible to all trustees.

²⁰ See sections 247 to 249 of the Pensions Act 2004.

What control procedures do we expect to see and what are the benefits?

53. One of the key controls for any scheme is the ability to identify existing knowledge gaps or skills required for *event specific* risks/activities (see table 2). Whilst the law requires a minimum threshold for knowledge and understanding in general, trustees also need to be equipped with the necessary skills to deal with some complex issues that may arise infrequently.

How do you control the learning needs of trustees?

54. As noted in our TKU code of practice²¹, trustees should review annually their own knowledge and understanding and undertake training as required – this could include revisiting e-learning modules.
55. Alternatively, schemes may wish to take a more collective approach to training. This could include commencing each trustee meeting with a training session. Different formats could be used including discussion on particular TKU modules or input from scheme advisers (many of whom are willing to provide training free of charge).
56. Smaller schemes place considerable reliance on key external advisers, for example, the scheme actuary, administrator or consultant. They will often provide a general steer on technical matters or help provide direction to complex discussions; they may assist in identifying where legal advice is needed. Technical training could therefore be provided prior to their input during formal meetings.
57. Many schemes assess the skill base of their trustee board and compare this to skills required over (for example) the next 12 to 18 months, recognising those critical events which may be taking place over the same period. Where gaps are identified, suitable training can be planned in advance, thus enabling the trustee board to tackle issues more effectively.
58. To help map skills and training requirements against scheme activities, trustees may wish to develop a training log to record continuing professional development and help plan future training. This would also help to designate activities to trustees with particular skills. The example below illustrates how a training record can be developed. It provides a useful tool to log and identify training requirements.

XYZ Staff DC Pension Plan
Trustee Knowledge and Understanding
 Training Log

Trustee	Date	Training provider	Course Title	Duration (hours)
A Bloggs Total hours: 38	30/11/2006	Scheme lawyers	Initial Training	7
	13/12/2006	The Pensions Regulator	TKU e learning modules - DC	21
	11/05/2007	Scheme Consultants	Investment asset classes	7
	19/09/2007	IFA	Retirement options	1
	12/03/2008	Scheme Consultants	New member booklet review	1
	26/03/2009	Administrator	Governance of a DC scheme	1
Z Smith Total hours: 33	06/12/2005	Scheme lawyers	Initial Training	7
	13/12/2006	The Pensions Regulator	TKU e learning modules - DC	18
	11/05/2007	Scheme consultants	Investment asset classes	7
	16/09/2008	Scheme consultants	Default Funds	1

Note:
 Further resources including Codes of Practice are available at www.thepensionsregulator.gov.uk

²¹ Code of practice No 7 – Trustee Knowledge and Understanding, paragraph 48.

59. Taking this a stage further, trustees may wish to develop a training policy. It is probable that some trustees are appointed because they have particular competencies which may be of significant benefit to the trustee board. This information can provide the building blocks for developing a suitable training policy which in turn should be used to assess the skills and training needs of all trustees on a regular basis.

Trustee self-assessment and appraisal: *Myners Principles*

60. As part of an ongoing process to improve investment governance and decision making, the Government commissioned a further review of the *Myners Principles* for institutional investment and, with industry, developed a refreshed set of principles²². This framework recognises constraints for smaller schemes who may find compliance more challenging. However, all trustees should be conversant with the nature and importance of control related activities which underpin good scheme governance generally.

61. Principle 4 (summarised below) pays particular attention to trustee self-assessment, which will include collective and individual performance of trustees. Having an appropriate level of knowledge is critical to the trustee model, and self-assessment is a key control.

Performance assessment	Activities	Tools
<p>Trustees should arrange for the formal measurement of the performance of the investments, investment managers and advisers.</p> <p>Trustees should also periodically make a formal policy assessment of their own effectiveness as a decision-making body and report on this to scheme members.</p>	<p>There is a formal policy and process for assessing individual performance of trustees and managers.</p> <p>Trustees can demonstrate an effective contribution and commitment to the role (for example measured by participation at meetings).</p> <p>The chairman addresses the results of the performance evaluation.</p> <p>State how performance evaluations have been conducted.</p> <p>When selecting external advisers take into account relevant factors, including past performance and price.</p>	<p>Trustee 'Key performance indicators'.</p> <p>TPR's <i>Trustee toolkit</i>.</p> <p>Assessing consultants' performance 'toolkit' eg model balanced scorecard etc.</p>

62. Whether or not small schemes undertake an assessment of the performance of trustees, it is important they consider their effectiveness as a team.

²² www.thepensionsregulator.gov.uk/pdf/IGGtools.pdf

63. Trustees could list a number of questions against which they could consider their responses to these questions, documenting any remedial action to be taken where appropriate. For example, relevant training can then be undertaken where weaknesses have been identified or where complex issues have challenged the skills of the board. Such questions could include (but are not restricted to):
- *Do we have up to date copies of, and access to, key scheme documents?*
 - *Are we conversant with them?*
 - *Are we encouraged and able to obtain identified training needs?*
 - *Do we give ourselves sufficient time to prepare for meetings?*
 - *Is sufficient time given to important issues?*
 - *Does the chair act in an impartial manner, seeking consensus without compromising integrity of decision-making?*
 - *At the end of discussion, do we sum up for the benefit of participants and the minutes what has been agreed, and what still needs to be done to carry an issue forward?*
 - *Do we review draft minutes and action points from meetings?*
 - *Is independent advice taken, and do trustees understand and debate advice received?*
 - *Is the composition of the trustee board satisfactory?*
 - *Does the chair assess the skills and capabilities of trustees prior to their appointment and thereafter?*
 - *Are conflicts actively identified, monitored and managed?*
- ☑ How do you assess the effectiveness of the trustee board?**
64. The scope of such a review should also include matters relating to the selection, appointment and retention of both lay and independent trustees.

Conflicts of interest

65. Trustees should have processes for managing conflicts of interest. In October 2008 we published material on this subject. Our *summary guidance*²³ includes key messages for managing and controlling risk. Some of these are considered below and in more detail in the full *conflicts guidance*²⁴. This section is therefore designed to complement our full guidance and should be read in conjunction with it.

Why is this important?

66. Conflicts of interest can inhibit open discussions or result in decisions, actions or inactions that are not, or could be perceived as not being in the best interest of beneficiaries. This can result in trustees acting improperly and may invalidate a decision or transaction.

What behaviours do we expect to see?

67. All conflicts of interest need to be identified and resolved sensibly. We expect all trustees to have a clear understanding of the risks associated with the poor management of conflicts. As part of this process the chair of trustees should ensure that there is a culture of openness around disclosure of conflicts by existing and newly appointed trustees and advisers.

68. When seeking to manage non-trivial conflicts of interest, and where the conflicts could have the potential to be detrimental to the conduct or decisions of the trustees, the regulator would expect the trustees to seriously consider obtaining independent legal advice.

69. If trustees are unsure how to identify conflicts, they should also seriously consider seeking independent legal advice.

What control procedures do we expect to see and what are the benefits?

70. The three key stages of conflicts management (identify, monitor, manage) fall within the scope of internal control procedures. The controls trustees adopt will be dependent on the nature of the conflict and specific circumstances of the scheme. There are a number of tools trustees should use to help identify and monitor conflicts of interest or duty including:

- *Conflicts policy* – this does not have to be complicated; it does need to be a practical working document which clearly sets out a scheme's approach to dealing with matters related to conflicts. It should be a document trustees can easily refer to and should be developed to raise particular awareness of the implications and serious nature of conflicts.

☑ All schemes should have a conflicts policy and a mechanism for recording and monitoring conflicts.

- *Maintaining a register of conflicts* (including adviser conflicts) – a register of conflicts is a simple and effective approach for recording and monitoring all conflicts.

²³ www.thepensionsregulator.gov.uk/pdf/ConflictsOfInterestSummary.pdf

²⁴ www.thepensionsregulator.gov.uk/pdf/ConflictsOfInterestGuidanceOct08.pdf

- *Trustee declaration* – upon appointment all trustees should confirm whether they are aware of any potential conflicts which may adversely affect their suitability as a trustee or affect their decision making and provide a declaration of interests, eg shareholding in the employer.
- *Include conflicts of interest as an opening agenda item* – provides an opportunity for trustees to declare potential interests and discussions about conflicts that can be minuted.
- *Advance planning* – trustees should take time to consider what key decisions may be made during, for example, the year ahead, and determine whether there are any conflicts likely to arise.

Example 1²⁵

Trustees of this DB scheme, with assets of £25m, agreed to undertake a review of conflicts of interest. Whilst this was the first time a formal review had been undertaken, they had always included conflicts as an opening agenda item, had included declarations in the minutes, but had not recorded the precise nature of the conflict. This proved problematic particularly for newer trustees as the format for recording conflicts was not readily accessible. There was a significant risk that conflicts declared previously could be overlooked particularly as these were not recorded centrally, as this limited the trustees' ability to monitor conflicts.

All the trustees were asked to provide a list of any interests they had which could (or could perceivably) colour important board decisions. Conflicts identified as part of this disclosure process were recorded in a risk register together with the date identified, the nature of the conflicts and management process. As extract is provided below:

Nature of conflict	Trustee	Declared	Management process
Relationship with beneficiary being considered for discretionary early retirement. Mrs X is being considered for ill health retirement.	Jim	4/7/09	Jim, who is directly related, will be excluded from any discussions associated with the assessment of medical information as well as overall decision on whether or not to grant this benefit. He will be entitled to review all documentation subsequently to ensure the process was handled fairly and in accordance with scheme rule requirements.
Directorship in an associated company - review of employer affordability during a scheme funding exercise.	Jane	Minuted 14/11/06	The sponsoring employer owns 40% of the issued share capital of another business in which Jane is currently a director. Whilst business connections are limited it has been agreed that Jane withdraw from any discussions which may seek to consider funding obligations.

It was agreed that the new register should be updated at least annually. The trustees agreed that this approach would enable conflicts to be recorded and monitored centrally, and therefore be more accessible.

²⁵ Examples in this guidance are for illustrative purposes only and are based on fact-dependent information.

71. Adopting control procedures similar to those above helps to demonstrate first that conflicts of interest and duty are being treated seriously, and secondly that management procedures mitigate the risk of tainted decision making.

Adviser conflicts

72. Whilst it is vitally important that trustees have control over the risk of conflicts from within the trustee board, they must also be mindful of the potential occurrence of adviser conflicts. Whilst primarily addressed in Principle 5 of the Conflicts of interest guidance – Managing adviser conflicts, trustees need to be certain that advice is independent and free from any bias.
73. There are a number of control procedures trustees can use to help identify circumstances when an adviser may become conflicted. These should be applied from the point of engagement and thereafter, and include:
- Prior to appointment, assess whether an adviser has any associations with the employer.
 - Request the adviser to provide details of its own conflicts management arrangements – how do they monitor and manage conflicts?
 - Is the adviser ethically bound to disclose conflicts of interest?
 - Require *all* terms of engagement (eg appointment letter) to include a clause for disclosing all conflicts as they arise.

The following is an extract of a clause in an auditor’s letter of engagement which could be adapted for most appointments where not already included.

We confirm that we are Registered Auditors, eligible to conduct audits under the Scheme Administration Regulations. We confirm that we will notify you immediately we become aware of the existence of any conflict of interest to which we are subject in relation to the scheme.

Source – Practice Note 15 – The audit of occupational pension schemes in the UK

Ineffective relations with advisers²⁶

74. The importance of controlling adviser conflicts is addressed in the *Conflicts of interest* section of this guidance. Trustees also need to manage and control other aspects of the adviser relationship.

Why is this important?

75. Trustees, particularly of smaller schemes, place considerable reliance on services and advice received from their advisers. It is essential that trustees manage and control relationships with all advisers efficiently and effectively.

Do you have suitable processes for appointing scheme advisers?

²⁶ ‘Advisers’ also includes those who provide services to the scheme and agents.

What behaviours do we expect to see?

76. There will be a number of questions that trustees should consider during the appointment process and afterwards to ensure that the scheme is getting the most from their advisers. These have been explored in more detail in our *relations with advisers guidance*²⁷.

What control procedures do we expect to see and what are the benefits?

77. There are a number of important controls a scheme should introduce to maintain robust professional relationships. Trustees should ensure that:
- advisers are suitably qualified and experienced to undertake the work;
 - they understand the basis for charging fees, and this has been documented;
 - they understand the terms and scope of services provided;
 - they understand the adviser's information requirements to fulfil their role;
 - they receive information from advisers in an understandable format;
 - they understand information or advice provided, and have an opportunity to question this advice; and
 - they have access to key personnel, with clear lines of communication.
78. These questions form the basis of an ongoing assessment or appraisal of advisers' performance and service. Many of these questions are also likely to appear in the scheme's risk register together with suitable controls.

Do you evaluate the quality of service provided by your advisers?

Example 2

Trustees of the LJS Pension Scheme review the terms of engagement of their advisers every three years. As part of this process they use the list of questions included in the regulator's *relations with advisers guidance* to help assess the level and quality of service provided. This includes the role of their scheme's IFA and considers questions such as:

- Ability to address complicated and contentious issues, on a timely basis.
- Value for money – quality of information or advice.
- Ability to communicate clearly.

When they identify potential weaknesses or concerns they discuss these with specific advisers. This has led to some re-tendering exercises and the appointment of new advisers, particularly where the trustees identify an element of complacency with long-standing engagements.

79. Some advisers proactively seek their clients' opinion on quality of service with a view to enhancing performance. Trustees should use this opportunity to feed back on areas where the delivery of service can be improved.

²⁷ www.thepensionsregulator.gov.uk/pdf/RelationsWithAdvisers.pdf

Poor record-keeping

80. We have undertaken an extensive review of record-keeping, with emphasis on common and conditional data requirements. Our findings have identified conclusive evidence that standards in both in-house and outsourced administration should be subject to improvement and data cleansing.

Why is this important?

81. Record-keeping is a fundamental daily activity of any scheme and is relevant throughout a scheme's lifecycle. Incomplete and inaccurate records and poor financial management controls can place significant risk on the security of scheme assets. For example, it could result in the over payment of benefits or misappropriation of funds.
82. The risks associated with inaccurate data, for example incorrect benefit calculations, can have short and long term implications for schemes and beneficiaries.

What behaviours do we expect to see?

83. Throughout a scheme's lifecycle trustees need to ensure that accurate and complete membership data and records are maintained. This includes basic information such as a member's date of birth, date of retirement, national insurance number etc. Trustees must be confident that controls ensure data is accurately recorded, regularly reviewed and all data fields are complete.
84. Trustees should measure the presence of important data items, as outlined in the *record-keeping guidance*²⁸, and take concrete steps to improve the quality of this data.

What control procedures do we expect to see and what are the benefits?

85. A framework to evaluate data should be designed to provide an indication of whether record-keeping needs further consideration in the context of risks; measurement of data accuracy is not an end in itself.
86. Where trustees are aware of or have identified data deficiencies they should develop a continuous improvement strategy in relation to scheme records. Trustees should also produce a data improvement plan, covering a reasonable time frame, with specific data improvement deliverables which can be monitored and tracked.

Does your third party administrator assess the quality of core data records?

87. A lack of control over scheme records can have member implications for both DB and DC schemes. The costs and time needed to rectify apparently simple errors can be considerable, and can be avoided easily.

²⁸ www.thepensionsregulator.gov.uk/guidance/recordKeeping/index.aspx

Example 3

The trustees of this earmarked DC arrangement have had relatively little involvement in the running of this scheme since its inception. Administrative functions have always been undertaken by the insurance company and contributions have always been paid directly by the employer.

Following a number of queries from members alleging errors in contributions, the trustees decided to undertake a review. It became apparent that neither the employer nor the insurance provider, nor indeed the trustees had undertaken any form of reconciliation exercise to determine whether contributions had been accurately calculated and summarised in monthly contribution schedules. The insurance company relied on information provided, the employer relied on payroll data and the trustees assumed the process was working.

Their investigation further identified that contribution rates recorded in the payroll software, and the basis for calculating members' pensionable pay, had not been updated, resulting in incorrect employee and employer contributions.

The implications of these errors were far-reaching, as noted by the scheme's auditors. Not only had contributions been underpaid, the members' individual holdings of investment units were also understated which in turn resulted in understated fund values in benefit statements.

As a result of these errors, the employer agreed to make good the shortfall whilst the provider agreed to retrace and allocate contributions according to the correct unit pricing at the date contributions should have been applied to each fund. The overall process took 18 months to correct and at a substantial cost incurred by the employer.

This administrative burden could have been avoided if the employer and trustees had undertaken monthly reconciliation procedures. For this particular arrangement, the insurance provider was at liberty simply to rely on contribution data provided.

88. This example illustrates the risk and consequences of not undertaking even the most basic of control procedures. Both the employer and the trustees need to make sure that contributions are accurately calculated and paid over to a scheme promptly. Clearly one of the key benefits of introducing controls will be the avoidance of unnecessary costs.
89. Where payments are made directly to the provider, this does not negate the need to monitor this process.

Example 4

The trustees of this DC scheme wanted to in-source their investment administration. When they began exploring how individual records held by the investment manager were going to be reconciled, they found the manager could not provide an accurate breakdown of unit totals at a member level. The contract was unclear as to who was actually responsible for this. The trustees had to commission an exercise to reconstruct records costing in excess of £100,000.

90. The responsibility to assess the quality of scheme data is not reduced when administrative functions are outsourced to employee benefit consultants, third party administrators or insurers.

91. Trustees need to have a clear understanding of the nature of services outsourced, agreed responsibilities of the service provider and whether service levels are fulfilled. However, they should be mindful that meeting a service level is not an indication in itself that scheme data is good.

Independent assurance reports

92. An increasing number of service providers, particularly administrators, are obtaining independent assurance reports to help demonstrate their ability to deliver quality administration services. Whilst the assurance framework is subject to much debate, many of these reports are currently produced in accordance with explicit guidance issued by the Audit and Assurance Faculty of the Institute of Chartered Accountants in England & Wales²⁹ (commonly referred to as AAF reports).

Does your third party administrator obtain an assurance report on internal controls?

93. Whilst assurance reporting provides trustees with a degree of comfort, there are limitations. The reporting accountant's understanding of the control objectives, evaluation of key assertions and tests of control are tested at an organisational level, not a scheme level. Trustees should ask their service providers whether they operate 'adequate internal controls' for the services provided. This would include compliance with the internal controls code: administrators should be prepared to demonstrate how they comply.
94. Trustees should take time to consider the scope of these independent reviews and investigate whether limitations have been identified by the reporting accountant in their report, including action taken by the service provider to rectify material control failures.

Are you aware of many fundamental weaknesses?

95. Whilst these reports, and those which are or will be prepared under similar frameworks, give trustees a view on how disciplined their third party administrator's processes are, they are no guarantee that their particular scheme's records are accurate and complete. This can only be achieved through evaluation of the records.

Example 5

An employer with a medium sized DB scheme was struggling to pay an annual administration fee of £110,000. The administrator had recently commissioned an independent review of its internal controls. When the trustees investigated why fees were so expensive, the administrator admitted that scheme data was unsatisfactory – to the extent that member records were not on the admin system. All calculations were therefore being performed manually including the benefit statement run which was extremely labour intensive.

As a result of the poor level of service the trustees put out to tender the administration of their scheme including a separate fixed cost data cleansing exercise. The successful administrator completed the data cleanse in six months for a fee of £60,000 and then moved to a fixed annual administration fee of £30,000. The employer was happy to meet this one-off cost because it delivered a significant overall saving. The trustees were reassured because they had a clearer understanding of the state of member data and complaints had reduced.

²⁹ Assurance reports on internal controls of service organisations made available to third parties – AAF/01/06.

96. Trustees should ask their administrator to confirm which calculations are automated and which are prepared manually as this is a good indicator of the completeness of their data.

Example 6

A DB scheme had historically been administered in-house, but outsourced in early 2000. Over a period of time it became apparent there was a problem with the records. Members regularly came forward to claim pension benefits but there was no corresponding membership record. The problem was eventually tracked down to the loss of a box of member files mislaid when the scheme was outsourced. No one could be specifically identified as responsible for the loss. The trustees had to accept any claim for benefits which could be supported by proof of contributions.

97. Trustees are responsible for all member records, both paper and electronic. We recommend trustees evaluate the completeness of data on a change of administrator. It is also good practice to use an independent check to ensure all data is passed across in whichever form it is held.

☑ Trustees should ensure that a data review is undertaken.

98. For many schemes, the full extent of poor records only crystallises at the point a scheme commences wind-up. In order to achieve wind-up of a scheme within the two year target, record-keeping concerns need to be addressed before wind-up is triggered³⁰. This is crucial to ensure that the winding up proceeds in an orderly manner, the correct benefits are secured for members and that, particularly for DB schemes, the employer's obligations to fund the scheme (including the employer debt) are properly assessed and demanded³¹.
99. There are tools available to help trustees and administrators to reconcile members' contracting out benefits, both before³² and after³³ wind-up is triggered.
100. Trustees need to be mindful of their responsibilities during periods of corporate activity, such as mergers and acquisitions, ensuring member interests are best protected. In order to be clear about what benefits they are protecting, they need to know the records are up to date, complete and accurate. In some circumstances these records may need to be reconstructed where data is very poor.

Example 7

During an acquisition a company may assume responsibility for accrued benefits of a group of employees. Where records are incomplete and there is uncertainty over membership and scheme liabilities, financial records can be used to help reconstruct missing information. Payroll records, NISPI (National Insurance Services to the Pensions Industry) tools, AGLS (accrued GMP liability service) and COCIS (Contracting out Contributions/Earnings Information Service), showing who has contributed to the scheme together with pensionable salary details, will help trustees reconstruct member records.

³⁰ Winding Up: avoiding delays – www.thepensionsregulator.gov.uk/pdf/WindingUpGoodPractice.pdf

³¹ See sections 75 and 75A of the Pensions Act 1995.

³² www.hmrc.gov.uk/nic/forms/ni_services-form.htm

³³ www.hmrc.gov.uk/shared-workspace/en/aboutsharedworkspace.htm

101. Whilst poor record-keeping may lend itself to inadvertent errors in member benefits, a poor system of internal control will also result in an increased risk of fraud.

Financial risk management – misappropriation of assets

102. Trustees must ensure that the ability of individuals to misappropriate funds from a scheme is mitigated. Areas where the potentials risks are greater may be those relating to the payment of benefits or transfer of monies. Trustees must ensure that persons responsible for granting or authorising benefits are separate to those issuing payment (segregation of duties). Transactions should be approved prior to payment and should be signed off by at least two trustees. Further controls could be adopted when payments relate to larger sums of money, for example the payment of lump sums on retirement or death in service payment.
103. Other types of controls help mitigate the risk of fraudulent activity. These include regular reconciliations of bank accounts, investment transactions and holdings, membership records etc (including pensioner existence checks) and peer reviews.
104. Peer reviews and sign-offs have a dual purpose. First, by their very nature they will help identify potential errors in complex calculations, and secondly they act as a deterrent to making fraudulent payments. This could include payments to fictitious members.

Deterioration in the employer(s) covenant

105. The regulator's code of practice *No 3 – Funding defined benefits* notes the importance of trustees forming an objective assessment of the employer's financial position³⁴ for the purpose of scheme funding.
106. This has been supplemented by further detailed guidance about assessing employer covenant in the *clearance guidance*³⁵.
107. The employer covenant consists of both:
- the employer's legal obligations to fund the scheme (both current and in the event of discontinuance), and
 - its financial position (both current and prospective), ie the employer's ability to meet its legal obligations to fund a scheme.
108. Whist particularly relevant for DB schemes (where the employer covenant supports ongoing deficit repair and discontinuance funding) there are also risks for DC schemes.

³⁴ See paragraph 57.

³⁵ The regulator's Clearance Guidance is a primary source for further information on covenant assessment – www.thepensionsregulator.gov.uk/employers/corporateTransactions.aspx (Appendix A and paragraphs 24–82).

Why is this important?

109. A deterioration in the financial health of a sponsoring employer will weaken its ability to maintain prudent funding levels and may result in the non-payment of contributions. It may also result in insolvency and scheme wind-up, in which case the employer debt would become payable to the DB scheme. In any of these cases, members may not receive all their benefits.
110. The health of the sponsoring employer(s) is therefore vitally important for a scheme's future.

What behaviours do we expect to see?

111. The trustees need to understand what covenant is currently provided to the scheme by the employer. This requires the trustees to identify the employers and the extent of their legal obligations.
112. The employer's main legal obligations are likely to arise from funding requirements in the deed and rules and in statute (including any schedule of contributions); from employer debt on scheme wind-up or employer insolvency; or, in certain circumstances, from the withdrawal of an employer from a multi-employer scheme. In some cases former employers may still have obligations to the scheme. In a multi-employer scheme trustees may also need to understand the proportion of scheme liabilities that each employer may be responsible for.
113. Employers may also have payment obligations under the deed and rules or in associated deeds or agreements, for example to meet scheme expenses including the PPF levy. Trustees should also consider any contingent assets or security, and whether any non-employer parties, such as parent companies, have entered into agreements or guarantees in favour of the scheme. Further information is available in the *clearance guidance*, and trustees are likely to require legal advice to fully understand the nature and extent of the legal covenant.
114. Once trustees have identified those parties with legal obligations to fund the scheme, they need to consider the financial position of those parties so that they can consider the likelihood that those legal obligations will be met, either in an ongoing or discontinuance situation (ie scheme wind-up or employer insolvency or withdrawal). Both the current and prospective financial position will be relevant. Trustees may require professional advice to perform this exercise.
115. Trustees will be seeking answers to questions, including:
 - What is the ability of the employer to generate cash?
 - What are the longer term trading prospects?
 - Are there any significant capital expenditure programmes planned?
 - Are there planned sales or transfers of substantial assets?
 - What are the employer's legal obligations to fund the scheme?
 - What is the effect of the employer's corporate group structure?
 - What is the employer's ability to meet ongoing demands as they fall due?

- What is the employer's ability to stand behind any adverse experience in an ongoing situation, including investment risk taken by the scheme?
- What would be the scheme's position on insolvency of the sponsor?
- Are there options to obtain security for the scheme?
- Does the employer continue to demonstrate a willingness to support the scheme?

116. The financial assessment will need to consider a range of information including:

- the position of the employer, including its financial strength;
- intra-group relationships and policies, eg management charges;
- management reports and future business;
- the nature of the sector in which the employer operates; and
- the employer's position within the industry.

117. As well as estimating what value might flow to the scheme on insolvency of the employer, the assessment should examine the likely future performance of the employer (which may be based on past and current information and trends).

118. While trustees may also consider the employer's willingness to fund the scheme as part of their covenant assessment, they should be aware that assurances from the employer or other parties that are not legally binding may not offer any real protection for the scheme.

119. If the employer covenant does not seem strong enough to support the scheme, trustees should discuss this with the employer to explore ways in which the covenant may be improved or restored.

What control procedures do we expect to see and what are the benefits?

120. Once trustees have assessed the current employer covenant, they need to continually analyse and evaluate the strength of the employer covenant for material changes. They need to be alert to potential risks associated with any corporate transaction, particularly where this may be materially detrimental.³⁶

121. It is therefore extremely important that trustees have an up to date understanding of the employer covenant and business activities.

122. Assessing changes in the employer covenant can be complex. Our *clearance guidance* provides an overview of how to go about this³⁷. For more complex situations, and those which are event specific, the trustees may determine that they have insufficient skills to quantify the potential risks to their scheme. Where this is the case we would expect trustees to obtain independent professional advice, which could include the preparation of a legal and financial covenant assessment.

³⁶ Materially detrimental – as described in the Clearance Guidance (paragraph 29 for scheme related events and paragraph 31 for employer related events).

³⁷ Appendix A and paragraphs 24 to 82.

123. Often, changes to the legal covenant itself may not be possible without the agreement of the trustees, in which case trustees need to fully understand the immediate and long-term implications of consenting. These events are likely to be scheme-related rather than employer-related, and examples are provided in the *clearance guidance*³⁸. Where consent is not required these events may still be materially detrimental and trustees should discuss their impact and any possible mitigating steps with the employer, and trustees may raise any remaining concerns with the regulator.
124. Information about how to assess changes in the employer's financial position is included in the *clearance guidance*³⁹.
125. Trustees should also be aware of the types of decisions or events which could substantially alter the covenant of the employer. As part of their controls framework they may want to seek agreement with employers to discuss these activities before undertaking them, or report to the trustees as soon as they happen. This could include events such as:
- taking on new borrowing;
 - acquiring or selling major assets;
 - substantial bad debts;
 - loss of key contracts; or
 - substantial legal claims.
- Further examples are included in the *clearance guidance*⁴⁰.
126. Ongoing robust covenant assessment is likely to include:
- Detailed covenant assessment at least triennially for scheme valuations and for any potentially detrimental events.
 - Indication of particular risk areas associated with the employer, its market sector, trading history, etc, which should be monitored as part of the ongoing covenant review.
 - Management information requirements for regular monitoring.
 - Quarterly updates from employer/other information sources.
 - Agreements for information or negative pledges before the employer undertakes specific events.
127. Trustees should seek regular updates from their employer about covenant issues and will want to maintain robust dialogue with them about the issues above and other specific issues that may affect the ability of the employer to support the scheme now or in the future.

³⁸ Paragraphs 63 to 79.

³⁹ Paragraphs 174 to 181.

⁴⁰ Paragraph 56.

128. There are a variety of sources of financial information available to trustees. Publicly available information such as credit ratings, profit warnings, trade reports, which can contribute to covenant assessments, should be used where possible. However, these may be limited for smaller companies by virtue of their size and filing exemptions available.
129. The process for smaller schemes is likely to be a more reactive approach – the importance of regular dialogue with the employer is therefore probably one of the most important control features.
- ☑ Do you maintain regular dialogue with your employer?**
130. For many small schemes the finance director will be a member of the trustee board, providing a valuable source of information and expertise. However in certain circumstances their role in the sponsoring employer will create conflicting duties with their role as a trustee. Consideration of matters relevant to covenant assessment is a good example of this, and inherent conflicts will need to be carefully managed.
131. In this situation trustees and sponsoring employers may decide to draw up a confidentiality agreement. This may help to enable the flow of confidential and sensitive financial information to assess and monitor covenant issues.⁴¹
132. Where the employer covenant (legal or financial) is weakened, trustees should take action to mitigate this and ensure the security of members' benefits is not prejudiced. It may also be necessary to reconsider the terms agreed in, for example, the schedule of contributions and recovery plan. The trustees' response to employer liquidity risk will depend upon the magnitude of the problem at hand.
133. Trustees will need to identify a clear plan of action and firmly negotiate their position with the employer.

Example 8

The trustees of this small engineering company's DB arrangement were starting to plan for the forthcoming scheme valuation. During the 12 months it was apparent that the employer had been adversely affected by market conditions which had resulted in reduced trading and staff redundancies. Despite this the trustees failed to regularly engage with the directors and discuss potential implications for the scheme.

Only after calculating the scheme's technical provisions did the trustees decide to meet with company officials to agree a suitable timeframe for paying the deficit. Whilst one of the trustees had market sector experience, collectively they had limited knowledge of the company's financial health.

During funding negotiations, discussions were primarily led by the employer, trustees having limited information to challenge the robustness of statements made by the managing director. The trustees were informed that whilst the company had suffered a poor period of trading, business projections indicated that this was soon to change, although management information was strictly private and confidential and could not be shared. The trustees decided to rely on these unsubstantiated remarks and agreed to a back end loaded schedule with nominal contributions payable in the first four years.

⁴¹ However, we would refer you to paragraphs 81 to 86 of the *Conflicts of interest guidance*.

Following submission of the recovery plan to the regulator, the trustees were asked to justify the basis for adopting the proposed funding strategy, without having undertaken any due diligence. The trustees were unable to justify their position and were advised to obtain an independent business review (IBR) and recommence discussions with the employer. The trustees approached their scheme auditors (a local firm) who introduced them to the business finance partner for financial covenant advice. As a result of subsequent discussions the trustees were able to renegotiate a sensible schedule of contributions, balancing both employer affordability and member protection.

134. This example illustrates a number of important features of a financial covenant review. First, whilst the trustees were aware of potential constraints of the employer, they decided to defer the problem until much later – trustees should engage with their employer as soon as they become aware of potential problems. Although informal controls were in place to highlight liquidity risk, the trustees failed to respond to these warnings. Secondly, the outcome of the funding process was influenced by the employer; the trustees, not having undertaken any due diligence, were unable to challenge statements made by the company. And whilst management information was considered confidential, no attempt was made by the trustees to acquire this information⁴², which could have been provided under a confidentiality agreement.
135. Where not forthcoming from the employer, we would expect trustees to obtain publicly available information including statutory accounts and reports from credit rating agencies; although this information will be historic, it will help provide an understanding of financial performance and trends.
136. In the next example we look at the actions of another trustee board following a period of late paid contributions to their DC scheme.

Example 9

This unitised DC arrangement has 14 active members paying contributions ranging from 4% to 10% of basic pay. The employer, a small research company, pays matching contributions.

The employer had always paid contributions within legal due dates but recently there has been a continual trend of late payments. The trustees raised this with the employer and have noted changes in staff and payroll services which could have resulted in administrative problems.

The trustees decided to look closely at possible financial difficulties the employer might be experiencing. Their concern was not limited to the late contributions, but included the employer's ability to fund administration costs outsourced to their third party administrator.

Upon further investigation, which included a review of management information and dialogue with the employer's finance team, the trustees identified short-term cash flow difficulties, although the employer had clear business plans in place to contain operational costs.

The trustees were given assurance that whilst contributions had been a little late over a six-month period, the employer was committed to meeting ongoing costs of the scheme and paying contributions at agreed levels on time. The employer agreed to meet regularly with the trustees and provide regular financial updates.

⁴² Code of practice No 3 – Funding defined benefit obligations states that the employer is obliged, on request, to provide trustees with such information reasonably required for the performance of their duties.

Investment risk

137. The nature of risks and internal controls associated with investment strategies for DC and DB schemes may vary considerably. Whilst this may be the case, there will be a number of areas of investment governance where there are similarities and where objectives will be the same.
138. Most investment strategies involve taking a degree of risk. However, this guidance seeks to address those risks which underpin the management of a particular strategy and does not seek to identify the most suitable investment strategy for a scheme.

Why is this important?

139. Security and safe custody of scheme assets is the key control objective for all trustees.

What behaviours do we expect to see?

140. Trustees should approve and periodically review the adequacy of procedures and controls for undertaking investment decisions to ensure these are consistent with their longer term investment strategy.

What control procedures do we expect to see and what are the benefits?

Control common for all schemes

141. Institutional investment introduces a number of challenges for trustee boards. It is important that all trustees have a sufficient level of knowledge upon which to make informed investment decisions. Much of this basic knowledge can be accessed through our e-learning toolkit.
142. More detailed aspects of institutional investment and decision making are embedded in the refreshed *Myners Principles*⁴³.
143. One of the key controls for trustees will be the ability to adapt to new and emerging risk. For example, this could include processes to identify and react to market trends and potential market disasters and failures. Trustees need to be clear about what their underlying investment portfolio consists of: does it include exposure to credit risk or private equity, for example?
144. Trustees will need to consider a number of important control points when managing their investment strategy. This will include pertinent questions such as:
 - What is the membership profile of the scheme?
 - What should the scheme invest in?
 - Do we understand the nature of our investment choices?
 - How *do* we make investment decisions?
 - How *should* we make investment decisions?

⁴³ www.thepensionsregulator.gov.uk/pdf/IGGtools.pdf

145. Most trustees have a modest knowledge of investment governance and place considerable reliance on investment managers and consultants. When considering matters relating to investment the trustees will therefore need input from their investment advisers. Trustees should be sufficiently trained to understand and question the advice given. Trustees also need to be confident that their advisers are suitably qualified and capable of delivering clear advice. Trustees need to be clear on what information is provided and in what format: is the format acceptable to the trustees?
146. Trustees should regularly review and assess investment performance. For many schemes the investment consultant will present investment information included in the latest investment reports. As part of their review trustees should compare investment returns to industry benchmarks to gauge overall performance of both the funds and the investment manager(s).

Example 10

The trustees of this pooled DC scheme regularly review information presented by their investment consultant at quarterly trustee meetings. Discussions always include a detailed assessment of investment performance over the period including a review of the suitability of investment fund choices and compliance with the Statement of investment principles.

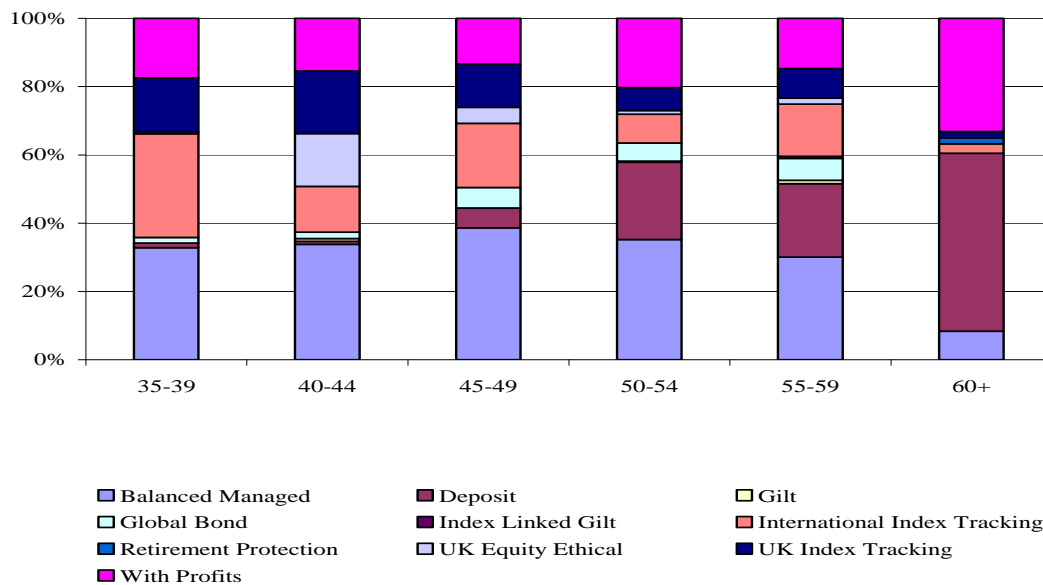
The trustees understand the volatility of certain funds, and consider performance against industry benchmarks spanning a period of time when assessing strategic asset allocation.

The trustees are provided with sufficient information and independent advice to help make well informed important investment decisions which are in the best interests of their members. An extract of the investment report is included in Appendix C.

Controls specific to DC

147. Investment reports should provide sufficient management information to provide an understanding of how an investment strategy is developing and whether it still remains fit for purpose. Investment analysis should help to identify other potential risks, for example significant exposure to investment risk for members approaching retirement.

Table 5: Investment fund distribution by age – self select funds



148. The above report is one of a number included in an investment governance report provided to trustees by one particular investment consultant. This and other demographic reports help trustees analyse the investment profile of their scheme. This provides a powerful tool to help control a number of investment functions.
149. This particular report indicates the categories of investment, by age range, of all members of a self select (DC) fund. Table 5 above helps to highlight the shift from volatile investments as members progress to retirement. This particular scheme, as a matter of good practice, regularly communicates the importance of reviewing investment choices and the potential risks a volatile investment strategy may have on the investment fund at retirement.

Are members regularly advised to review and consider their investment choices?

Financial risk management – cash flow

150. The above paragraphs concentrate on controls associated with investment performance. However, trustees need to ensure that controls are in place to manage processes related to investment. For DC schemes trustees need to ensure that suitable controls are in place to monitor and manage the timeliness and accuracy of contributions invested.
151. The report below illustrates the information trustees should expect to receive to provide comfort that controls associated with the deduction and investment of contributions are working effectively.

DC contributions						
Period 1 January to 30 June 2009	Employees' contributions £	Employer's contributions £	Date interface received	Date contributions received	Date client queries resolved	Date investment instruction issued
January	19,430.03	100,134.21	30/01/08	05/02/08	06/02/08	08/02/08
February	20,482.92	104,371.39	28/02/08	10/03/08	10/03/08	12/03/08
March	24,986.23	103,647.85	28/03/08	14/04/08	14/04/08	15/04/08
April	19,736.81	115,377.14	29/04/08	13/05/08	13/05/08	15/05/08
May	20,720.09	114,020.84	29/05/08	10/06/08	10/06/08	16/06/08
June	21,164.94	116,453.53	30/06/08	04/07/08	04/07/08	09/07/08

152. Trustees must be mindful of the need to physically receive contributions within legal due deadlines. All trust-based DC schemes are required by law to produce a Payment Schedule⁴⁴ which must clearly state the rates of contributions for all employees and the employer(s), as well as indicating the legal due deadline for monthly / weekly contributions.
153. This document provides an important control for trustees who should expect and ensure that those responsible for payroll ensure contributions are calculated, deducted and paid over accordingly – see case example 11 below.

⁴⁴ See section 87 of The Pensions Act 1995.

Example 11

Trustees of this hybrid scheme receive quarterly administration reports showing a cumulative summary of contributions for both the DB and DC sections. They are particularly conscious of the need to invest DC contributions on a timely basis. With their investment consultant they developed a number of controls to ensure this process is operated effectively.

The employer's payroll team are provided with clear instructions outlining how member and employer contributions should be reported, and this has been agreed with the investment manager's contribution collection team. Monthly exception reports are generated when either the receipt of or investment of contributions exceed pre-agreed deadlines. Until March the process worked well. During the next three months the exception reporting mechanism highlighted a number of delays in investing contributions and an increase in client queries.

A meeting was arranged with the trustees, the employer's payroll manager and a representative from the investment manager. The representative noted concerns that reports were no longer in the format agreed, and often contributions summarised in the reports differed from amounts actually received. This resulted in significantly more queries. The payroll manager noted that there had been a change in the payroll software. The pension report was still being developed but should be completed in time for the June payroll.

This commitment was fulfilled and timeframes for investing contributions were improved.

Controls specific to DB

154. Some smaller DB arrangements separately employ the services of a global custodian, or use services provided by the investment management company, to provide an extra layer of control over the trustees' ownership and security of scheme assets.
155. The custodian will keep a record of a client's investments, settle its market transactions and may also collect income. For example the custodian may safely hold share certificates and collect dividend income.
156. When reviewing investment holdings detailed in investment reports (for example the number of shares held in a particular company), trustees should ensure that they reconcile these to the holdings as stated in the Custodian Report.
157. Trustees should maintain accounting procedures which reconcile movements in investment holdings and trading activities, for example sales and purchases. This would also include regular reconciliations of investment cash accounts and transfers of cash to trading accounts.
158. Trustees need to ensure that controls are in place to avoid the risk of employer related investments (ERI). There are legal restrictions on the extent to which the trustees of a scheme may make investments that are related to the employers that participate in the scheme⁴⁵. Although a few small schemes⁴⁶ may be exempt from these restrictions, generally trustees must not:

⁴⁵ www.thepensionsregulator.gov.uk/trustees/schemeInvestments.aspx#legalRequirements

⁴⁶ See regulation 1(2) of The Occupational Pension Schemes (Investment) Regulations 2005 (SI2005/3378), which defines 'small scheme'.

- invest more than 5% of the value of the scheme's assets in employer-related investments, which includes shares or securities issued by the employer, land occupied, leased to or used by the employer, other property used for the purpose of the business of the employer and certain insurance policies;
 - make any loans to the employer (including debt securities, loan arrangements that are contingent on the employer, guarantees, security for loans to the employer and unpaid debts owed by the employer to the scheme); or
 - make any employer-related investments at less than their market value.
159. These restrictions also apply to investments made in respect of anyone connected or associated with the employer.
160. A breach of the ERI restrictions is a criminal offence, and may lead to the imposition of a fine or imprisonment or both. The regulator will therefore look very closely at cases where possible ERI has been identified. Accordingly, it is very important that trustees ensure that controls are in place to limit, for example, the investment in shares of an employer or its associates to permissible levels, and to prohibit transactions at undervalue and loans to an employer or its associates. The information above is only a summary, the ERI restrictions can be complex and trustees may need to seek legal advice if they are unsure whether an investment contravenes them.
161. Even if ERI restrictions are respected, the trustees must ensure that any investment in the employer or its associates is nevertheless a sound investment and complies with their scheme's Statement of Investment Principles.

Ineffective retirement processes

162. Trustees should assess the adequacy of their scheme's retirement process.

Why is this important?

163. In the lead-up to retirement, members will make some potentially life-changing financial decisions on matters that will affect the quality of their life after retirement: most of these decisions are irreversible.

What behaviours do we expect to see?

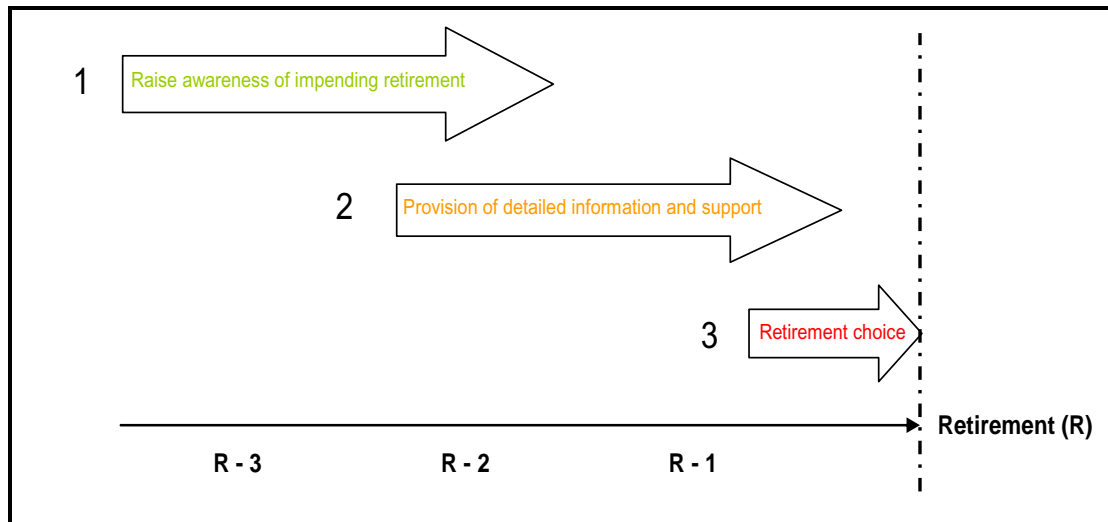
164. A member's decision making process should be supported by the trustees' ability to send 'the right information at the right time'.
165. Trustees must ensure as far as possible that members receive their entitlements without unnecessary delay.
166. Trustees must make retiring members aware of their legal right to exercise an open-market option⁴⁷ (OMO), where appropriate. This area is highlighted in more detail in our report published in October 2009⁴⁸.

⁴⁷ Members must be made aware of their legal right to purchase an annuity from a provider of their choice.

⁴⁸ www.thepensionsregulator.gov.uk/pdf/RetirementInfoDCMembers.pdf.

What control procedures do we expect to see and what are the benefits?

167. A key control in managing a member's retirement process will be the quality of communications in the period leading up to retirement. A fundamental decision will be when communication of this process should begin.



168. The chart above illustrates the key control points at which communication should commence and develop, crystallising at stage 3, when a member must make a decision.

Do you communicate with members about retirement options as they approach retirement?

169. When members approach retirement, it is particularly important that trustees have sufficient controls in place to manage their disclosure responsibilities.
170. Failure to effectively control the retirement process can result in members receiving a lower income in retirement than they could otherwise achieve. This can occur when members make inappropriate choices due to unclear information and are unaware of the options available to them.
171. Whilst the member's final decision will be ultimately beyond the trustees' control, they should implement controls which result in providing information which helps inform a member's decision making process. Invariably this would include a clear statement in literature on the availability and exercise of an open-market option for annuities.
- Are members aware of the ability to exercise an open-market option?**
172. Scheme insurers and advisers play an important role in the DC retirement process. Often they provide material for trustees to issue to members. Trustees must ensure that when delegating aspects of the retirement process, roles and responsibilities are clearly defined, the key control objective being the best outcome for members.

173. Specific internal controls related to the retirement process may include:

- Provision of independent support, eg access to an IFA.
- Data integrity; ensuring administrators have accurate data to identify and contact both active and deferred members approaching retirement.
- Robust controls in place to calculate benefit entitlements accurately, particularly for schemes with multiple benefit structures.
- Controls to trigger alerts for issuing retirement letters and information.
- Processes for monitoring take-up of open-market options.
- Assessment of service standards for processing member retirement choices – for example, controls over the payment of an annuity and promptness of first payment after retirement.

Appendix A: Typical stages in a risk management review

Set objectives

When undertaking a risk management review, trustees should have a clear understanding of what the process is aiming to achieve.

Identify risks

Trustees will need to consider all the key operations of their scheme and identify actual or potential risks which could be detrimental to their performance. We would expect trustees to use a formal risk register.

Define success criteria

Trustees need to take a proportionate approach to managing risk and recognise that risk cannot be completely eliminated. Trustees need to consider to what extent risks can be absorbed by the scheme and which risks they must manage.

Assess risk

Trustees need to evaluate each risk identified and categorise it depending on its impact (eg financial) and likelihood of occurrence: see appendix B.

Produce action plan

After evaluating the different classes and categories of risk, trustees need to decide on the best approach for managing (or controlling) these. This will include identifying responsibilities and timescales for delivering internal controls. Whilst this could be recorded in an action plan, the risk register could also capture this information.

Implement action plan

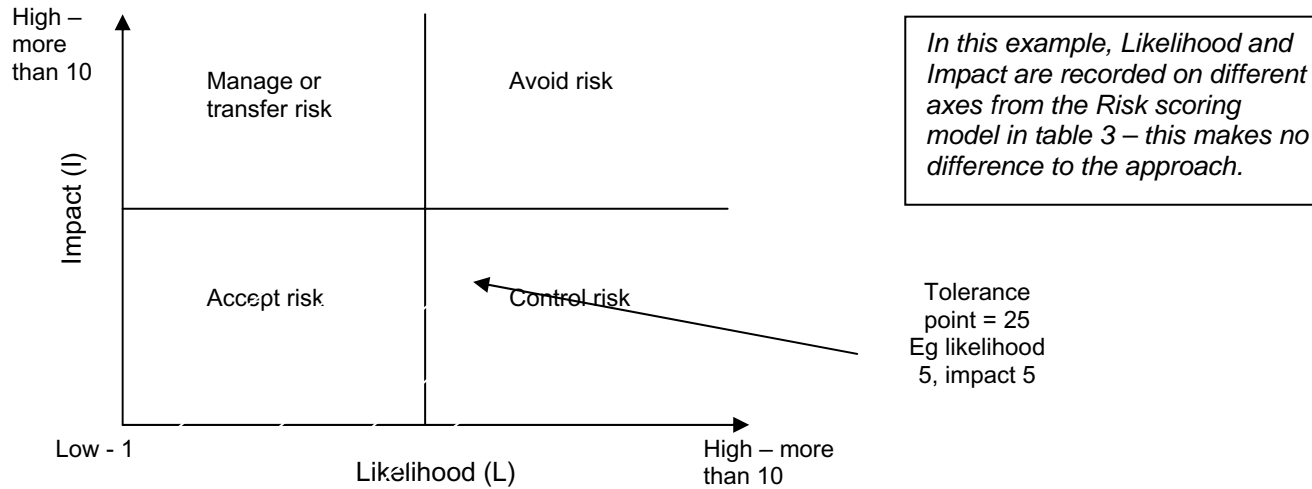
Trustees need to ensure that performance against the action plan is monitored and those responsible for certain activities deliver within agreed timescales.

Monitor and review

The design and implementation of an internal controls framework is not a one-off exercise. Trustees need to continually monitor the effectiveness of controls to ensure they are still adequate, and periodically review their scheme's exposure to new and emerging risks.

Appendix B: Developing a formal risk register

Risk matrix



Scheme risk register				Key: Green - Developed controls, Blue – Existing Controls, Red – Controls to be agreed			
Risk area 1 - Operations	L	I	Score	Control	Owner	Test	Time
1. Contributions incorrectly deducted	7	7	49	Mechanism to ensure contributions correctly reflect salary increases. Agreement with company for a sample of weekly/monthly reconciliation of deductions checked annually by auditor.	PS/LS	1/4ly	Q1 10
2. TPA Process failure/ maladministration	6	8	48	Formal agreement in place with TPA. Ensure authority levels are clearly agreed and kept up to date and regularly reviewed.	VS - input from DC	Annual	Q2 10
				Develop and manage relationship with TPA, carry out due diligence checks.	PS	3 yearly	Q2 12

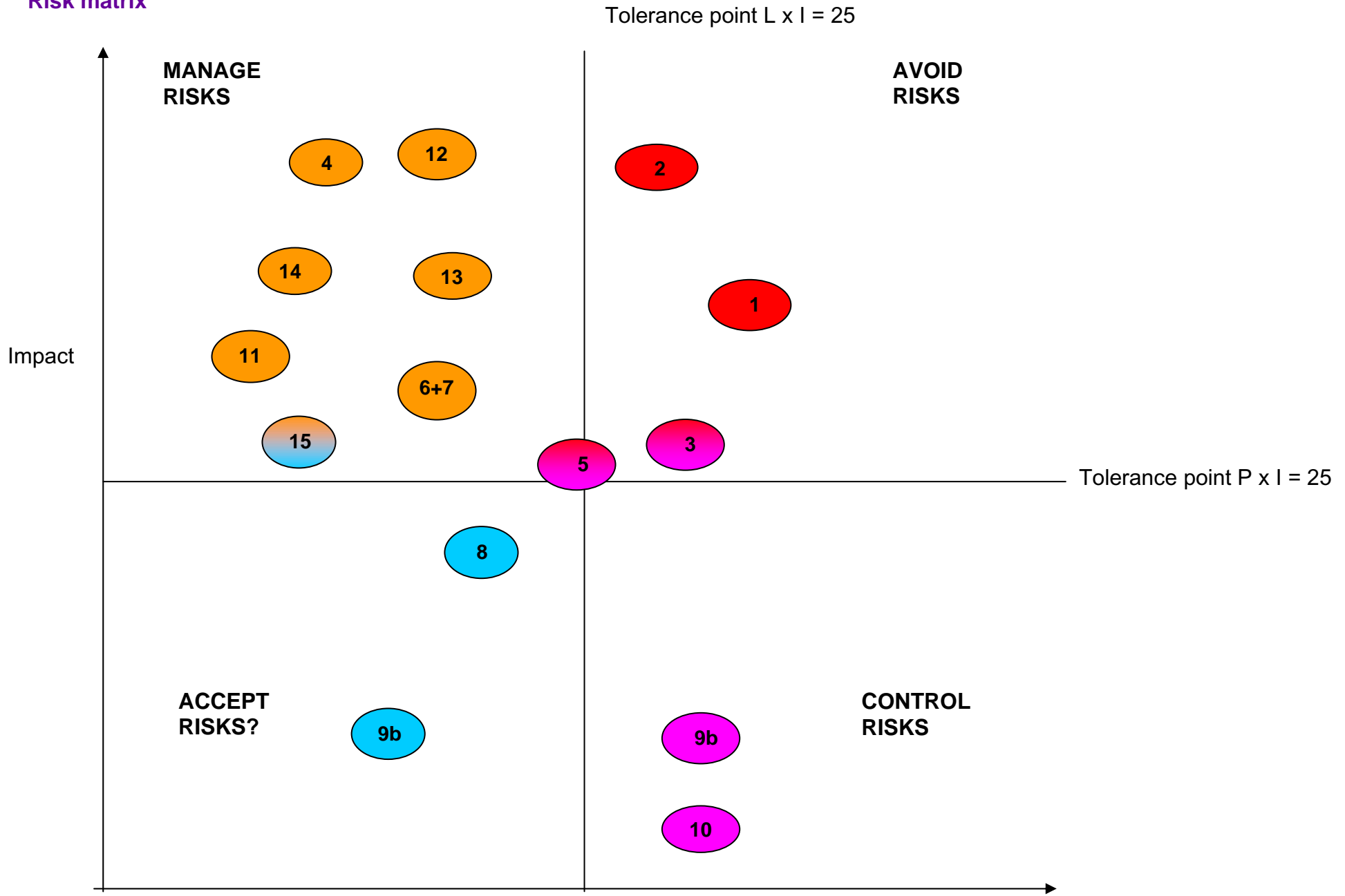
3. Admin problems at AVC provider leading to incorrect or lower benefits than expected	6	5	30	Monitor administration and investment performance of AVC provider and any subsequent replacement(s) using investment valuation and performance reports.	All	Half yearly	Q2 10
4. IT Failure	2	8	16	Proof of up to date TPA disaster recovery and business continuity plan, certified and tested.	MH/SS	Annual	Q4 09

Risk area 2 – Financial	L	I	Score	Control	Owner	Test	Time
5. Delays in investment	5	5	25	Monitor time taken by inv manger from fund receipt to investment – dealing times/days etc.	ALL	1/4ly	Q2 09
				Monitor instruction protocols (email/mail) for delays in investing funds.	ALL	Annual	Q2 09
6. Incorrect monies sent to/received from managers for investment/disinvestment	4	6	24	Review 1/4ly Admin Report showing contributions made and dates paid - paid on time?	MH/AW	1/4ly	Q1 10
				Reconcile cash flows to/from investment managers. Evaluate Custodial procedures – reconcile inv manger holdings to custodian reports.	ALL	1/4ly	Q1 10
				Reconciliation of contributions to amounts invested and units	ALL	1/4ly	Q1 10
7. Payment of incorrect invoices to suppliers.	4	6	24	Formal arrangements with the company for checking / authorising invoice payments. Review expenses against budget.	MH/VS	1/4ly	Q2 10
8. Loss of independent statutory audit.	4	4	16	Maintain separation of company and scheme auditor.	Chair	Annual	Q4 09
9. Risk of fraud by paying pensions to ineligible individuals	6	2	12	Pensioner eligibility and existence checks (eg aged 85 plus).	JS	3 yearly	Q2 10
	3	2	6	Verification tests on deferred records for transfers to pensioner status – ensure legitimate employment.	VS	3 yearly	Q3 10

Risk area 3 – Funding	L	I	Score	Control	Owner	Test	Time
10. Weak employer covenant	6	10	60	Confidentiality agreements renewable triennially. PS to present to trustees on company strength annually. Half yearly review of business performance – input from PS.	All	Annual	Q1 10
11. Inappropriate investment or actuarial advice	2	6	12	Check 1/4ly Investment Reports. Review service level agreements.	All	3 yearly	Q2 09
				Check public indemnity levels of appointed advisers.	All	3 yearly	Q4 10
				Review investment strategies regularly.	All	3 yearly	Q2 09

Risk area 4 – Regulatory and Compliance	L	I	Score	Control	Owner	Test	Time
12. No procedures for appointing new trustees.	4	8	36	Develop criteria for appointing new trustees including a list of key requirements to be met for successful candidates.	Chair	Once	Q1 10
13. Company bias in trustee decision making	4	7	28	Balanced approach to trustee appointment concentrating on specific requirements of the schemes.	All	Once	Complete
14. Failure to interpret Rules or legislation correctly	2	7	14	Up-to-date and documented trustee training log, complete the regulator's <i>Trustee toolkit</i> , Challenge advice. Complete training needs analyses.	All	Annual	Q3 09
				Independent trustees – expect a higher level of proven knowledge.	All/Co	Annual	Q4 09
15. Conflicts arising in decision making	2	5	10	Comply with the regulator's conflicts guidance. All trustees to complete a declaration of interest (review every 2 yrs). Conflicts of interest recorded in a conflicts register (review annually).	All to Monitor/declare conflicts	Annual	Q1 10

Risk matrix



Appendix C: Example of an investment performance report

Investment performance

The following table gives a summary of the investment performance of the scheme's funds. The figures are presented against the relevant benchmarks.

Fund name	Returns as at 30 September 2008		
	1 year %	3 years % pa	5 years % pa
Winterthur BGI Over 15yr Gilt 3 Pen	6.26	2.01	4.15
FTSE Gilts Over 15 Yr TR GBP	5.43	2.38	4.37
<i>ABI UK Gilt</i>	<i>5.34</i>	<i>2.17</i>	<i>3.46</i>
Winterthur Aberdeen GI (ex UK) 3 Pen	-10.81	2.70	8.88
Aberdeen Overseas Composite Index	-14.78	2.63	8.45
<i>ABI Global Equities</i>	<i>-18.64</i>	<i>0.18</i>	<i>6.31</i>
Winterthur BGI All Share Tracker Pen	-24.58	-1.03	6.63
FTSE AllSh TR GBP	-22.25	0.01	7.65
<i>ABI UK All Companies</i>	<i>-24.05</i>	<i>-1.02</i>	<i>6.38</i>
Winterthur Schroder Equity Pen	-22.52	-0.75	6.75
FTSE AllSh TR GBP	-22.25	0.01	7.65
<i>ABI UK All Companies</i>	<i>-24.05</i>	<i>-1.02</i>	<i>6.38</i>
Winterthur Threadneedle Property Pen	-13.15	1.12	7.25
<i>ABI UK Direct Property</i>	<i>-18.64</i>	<i>-0.16</i>	<i>5.50</i>
Winterthur Deposit 3 Pen	5.77	5.04	4.76
BBA Libor 1 Week GBP	5.52	5.25	4.84
<i>ABI Money Market</i>	<i>4.43</i>	<i>4.26</i>	<i>4.06</i>

Source: Morningstar

Notes

1. Performance figures are net of additional fund management charges.
2. The value of unit-linked investments can fall as well as rise.
3. Past performance is no guarantee of future returns