

Consultation response

Revised guidance on internal controls

The Pensions
Regulator

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Introduction

The Pensions Act 2004¹ places a legal requirement on all trustees and managers of occupational pension schemes to have adequate internal control mechanisms. Specifically 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 ensuring 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 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.

On 1 December 2009 The Pensions Regulator ('the regulator') began a formal consultation aimed at providing further practical guidance to trustees, particularly those of smaller schemes, in relation to establishing and operating adequate internal controls. The updated guidance will replace the previous version² and should be read in conjunction with the regulator's code of practice on internal controls ('the code').

When we published both the code and the original guidance we made a commitment to review and update material after a reasonable period. Subsequent to a number of regulatory interventions and after analysing data gathered from our governance surveys over a period of time, we commenced our review in 2008.

Initial fieldwork included an online questionnaire, seeking views on a number of specific aspects of both the code and guidance, which were further considered and explored at a workshop in early 2009. Both these activities, in which a broad selection of key stakeholder groups were represented, helped shape the scope, format and content of the new guidance material.

The revised guidance, and other regulatory material, is part of a range of initiatives that the regulator is undertaking to assist trustees on the theme of promoting good scheme governance. Material has been produced to expand and elaborate upon standards described in the code to help support trustee compliance with legislation.

The publication of the consultation document, which included the draft guidance, formed an integral part of the regulator's first Governance and Administration campaign, which concluded in March 2010. Material from both the draft internal controls guidance and the record-keeping consultation document was used to develop 2 workshop case studies, and provoked much discussion and debate at external events held in Edinburgh, London and Nottingham.

¹ Section 249A of the Pensions Act 2004.

² Published in February 2007.

The need for updated guidance

As noted before, experience from regulation and survey trends have been influential drivers for updating our guidance. Whilst there have been improvements in certain areas of scheme governance, we continue to identify a number of important areas where gaps persist and significant improvements are necessary, particularly among smaller schemes.

In addition to sound trustee knowledge and understanding, another critical success factor for maintaining good standards of scheme governance and administration is the implementation of a robust internal controls framework. This underpins all governance functions, from managing training to keeping accurate scheme records.

However, despite the improvements there are a number of concerns. Our 2009 Governance survey indicates that when asked whether the board of trustees have effective internal controls to manage risk, only 51% (2008: 47%) of representatives surveyed strongly agreed. Furthermore, only 47% (2008: 44%) strongly agreed that the board has identified potential financial or governance risks to the scheme.

This, combined with an apparent shortcoming in key risk management tools and techniques used by trustees (eg the use of conflicts registers, risk registers and assessment procedures), raises concern.

This revised guidance therefore aims to help trustees address these concerns. Sections of the guidance explore in detail various aspects of the internal controls framework, looking more closely at matters such as:

- [The role of risk management](#)
- [The trustees' role](#)

These 2 sections consider the steps (or processes) trustees should adopt to manage and control risks. Whilst the previous guidance considered various stages of a risk management exercise, the revised material considers this more practically and illustrates how a scheme can put this into practice.

The 2 sections consider activities relating to four stages of the risk management process (principles 2 to 5 below), many of which are considered standard practice in well run schemes. For example, particular emphasis is placed on the importance of regularly reviewing risk and recording risks in a formal risk register.

To further aid trustees and help them divide the process into clearly defined and manageable stages, we have developed 5 high-level principles:

1. Understanding the importance of adequate internal controls
2. Identifying risk
3. Evaluation of risk – assessing impact
4. Managing risk and
5. Effective monitoring of controls.

Whilst the first principle is not specifically related to the risk management process, the ability of the trustee board to understand the importance of internal controls, and the extent to which they contribute to good scheme governance, is vital.

Compliance

This section emphasises the importance of trustees complying with the legal requirement to establish and operate adequate internal controls. It addresses our regulatory approach in the event of non-compliance and clearly states our expectation that trustees should be familiar with the code and guidance, and should be able to demonstrate practices identified in the revised guidance. It provides a clear message that in the event of non-compliance we will consider using statutory powers where appropriate.

Key risk areas

Seven specific risk areas are considered in detail which offer a number of risk management solutions and provide a clear steer on the controls we would expect all schemes to operate. Guidance is supplemented by a number of case examples and illustrations.

New material therefore provides trustees with further educational support and resource and gives a clear indication of the activities the regulator would expect trustees and managers to undertake in fulfilling their legal duties.

The consultation process

The formal consultation process commenced on 1 December 2009 following the publication of our consultation document. Consultation ran for 12 weeks, closing on 1 March 2010. We received 27 responses from a broad cross-section of stakeholders including trustees, pensions managers, insurers, legal firms, professional and trade bodies, consultants and administrators. A full list of the respondents is attached in the Appendix on the last page of this document.

One response, from the Pensions Management Institute (PMI), represented the views of 74 PMI members who contributed to a survey based on questions included in the consultation document.

We are extremely grateful for all the responses received, which have helped us considerably in finalising guidance and sharing industry practices and views.

While respondents were free to provide comments on any aspects of the draft guidance, we specifically sought comments on the following questions included in the consultation document:

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 risk in manageable stages – do you agree that this 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.

In addition to responses to the consultation document, we also engaged with a number of scheme trustees to actively gauge views on the revised material, in terms of its usefulness, clarity and scope. These meetings were very productive and highlighted a number of consistent views and concerns ranging from general support to aspects of the guidance where improvements should be made. We are extremely grateful for both the time and input provided by participants in this consultation process.

Main points raised in responses

The responses raised a number of interesting stakeholder viewpoints covering a wide range of matters addressed in the guidance. Generally comments were positive and while a number of views were expressed on different aspects of the guidance, in terms of offering other practical material or highlighting important omissions, many respondents supported our initiative to update our guidance.

A number of responses did however note the prescriptive nature of the guidance and the level of detail and length of the document which may overwhelm trustees, particularly those of smaller schemes. These are valid points, and were factors that we considered very carefully throughout the development of this guidance. At an early stage of product development we engaged with key stakeholders to understand precisely what type of resource model (structure, format, content etc) they we're looking for in relation to operating and establishing adequate internal controls.

As a result of these discussions the general consensus was that: firstly, the principles-based code was still fit for purpose; secondly, guidance should seek to explore in more detail the principles contained in the code; and thirdly, we should give a clear indication of the types of activities and controls trustees should be operating to meet our expectations and fulfil legal requirements. For example, a number of stakeholders who attended our workshop last year on behalf of their professional bodies were particularly keen to see the risk and controls summary included in the code expanded and unpacked in revised guidance. This recommendation has been incorporated; we have compiled a detailed list of risks and controls (Table 2) which will support user needs and provide clarity around the types of risks and controls we would expect schemes to manage.

Revised guidance has been developed in a manner which is consistent with the needs and requests of key stakeholders and provides a clear steer on principles contained within the code. We are also pleased to note that a number of respondents still welcome the level of detail noting that this would be particularly useful for trustees of smaller schemes.

The acid test for this and other guidance we produce, however, is whether it does add value, whether it can be embraced by all schemes and whether it does contribute significantly to scheme stewardship. We have therefore made a commitment to delivering guidance which is more accessible and provides an opportunity for risks to be addressed in manageable stages. This is considered in more detail below in question 5 (Format) and in the last section of this document.

Comments raised specifically in relation to questions asked in the consultation document are detailed below.

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?**

The majority of responses to this question noted that the material would be useful for trustees of smaller schemes, with many also noting that the material would be equally relevant to schemes of all sizes. It was noted that many respondents welcomed the level of detail, suggesting that it presented a practical basis for achieving good governance for all schemes, not just smaller schemes.

In response to this particular view we have noted in the 'At a glance' section that the material is applicable to all schemes, although we still state that it has been drafted with smaller schemes in mind.

Comments were also made in respect of the length of the document and the potential risk that trustees will not engage – our response to this and similar points is included in the following paragraphs in this section of the document.

PMI's surveyed response to this particular question resulted in 81% of respondents satisfied that the guidance would be of particular use to trustees of smaller schemes.

One respondent noted that a lack of resource for smaller schemes should not mean that different standards apply. We do agree with this statement but recognise the inherent constraints and the need to provide additional support. Our guidance (paragraphs 7 – 10) acknowledges this and sets out our expectations.

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?

In the majority of cases respondents agreed that the guidance clearly sets out expectations and that they are reasonable. Limitations for smaller schemes in relation to time and financial resource was noted: however, the need to manage and control risk is a vital stewardship function, and ultimately should result in potential cost savings, as noted in a number of the case examples.

One respondent noted that examples in Table 2 on page 16 of the consultation document, outlining controls for managing certain risks, were particularly helpful.

Again, responses to PMI's survey were very positive: 89% of respondents agreed that revised guidance was clear in setting out the regulator's expectations.

Interestingly though, the views of one respondent differed by comparison. They stated that '... expected activities and controls are set out in certain areas at a dangerously high level of detail. Trustees may be unnecessarily alarmed that non-compliance with any one detail would put them at risk.'

As noted previously, the scope of the guidance has been shaped to address the needs of users. Users wanted more clarity around the regulator's expectations regarding activities and controls, and this has been addressed and welcomed by most.

3. Do you feel able to extract information relevant to your scheme, and will this guidance help you develop robust control procedures?

Generally there were very mixed views on this particular question. One respondent noted that the guidance will essentially act as a benchmark once finalised, and trustees will be able to compare their practices to regulatory guidance. Another stated that the material 'will facilitate a review of where we are with controls and risk management.'

One response stated that '... it is not structured in a way that trustees can readily access information on issues they may consider relevant to their circumstances...'

We have considered this point and other related comments and believe that the ability to extract information will be clearer once we make final formatting changes and publish final material. The guidance needs to be considered within the spirit for which it has been drafted. Our expectation is that trustees address each of the seven risks in order of priority, and over a sensible and realistic timeframe. We accept that it is unlikely that trustees will read the guidance from start to finish and draw out and remember all key action points at once; that is why the guidance is modular based.

We also acknowledge that for a number of schemes there will need to be an investment of time. However, we consider that this would be a valuable investment and should result in a better governed scheme, with better outcomes for members.

Particular reference was also made about the difficulty to filter out messages specific to either defined benefit (DB) or defined contribution (DC) schemes and the risk that trustees of DC schemes will only focus on the areas which specifically relate to DC, assuming other areas are not relevant. In particular, reference was made to the section covering employer covenant risk.

The general view may be that covenant risk is predominantly associated with DB schemes, but we do note at the beginning of this section that trustees of DC schemes should be mindful of the risk of non/late payment of member and employer contributions by an employer, which could suggest a deterioration in financial health – we also include a case example (9) to explore this further.

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Additionally, other than investment risk where we do differentiate between controls specific to DC and DB, we believe that the information (and selection of risks as covered in question 4) is relevant to all trust-based schemes, and indeed many contract-based arrangements.

It is therefore important that trustees consider how each of the risk areas applies to their scheme and do not simply discount a section on the basis that it may not be relevant.

We did also consider whether separate guidance should be produced for DC and DB arrangements. It was felt that this would result in a number of overlaps in areas which were not mutually exclusive to a scheme type. It was also felt that guidance would be cumbersome and future updates would be difficult to track.

Results of the PMI survey were generally positive in relation to extracting relevant information which will help develop robust control procedures. Responses were as follows:

Very helpful	31%
Quite helpful	61%
Not very helpful	6%
No help at all	2%

4. The guidance considers 7 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?

The overwhelming majority of responses to this question agreed that the 7 risks are appropriate and represent problematic areas for DC and DB schemes.

In addition to the seven risk areas covered, a number of respondents suggested that the guidance could also address communications, or the risk of poor communications with members and other stakeholders. We agree that good communications are a vital stewardship function. That is why we produced separate guidance on effective member communications³ in September 2008. Whilst references are made to the importance of quality member communications, we do not feel that it is necessary to dedicate at this time a section addressing poor member communications.

At least 2 respondents also noted that more attention could be given to financial risk and fraud. At this stage we feel that we do go into enough detail to prompt certain activities and would expect trustees to take matters further where they felt this was appropriate for their scheme.

As noted in the guidance, the risks we have identified are not exhaustive; trustees should also be mindful of other scheme specific risks. However, the structure of the guidance provides an opportunity for us to add further risk areas, or indeed remove risk areas over time. This could include poor member communications.

As we continue to review scheme governance we will continue to use this empirical evidence to gauge whether further material should be produced.

³ See www.thepensionsregulator.gov.uk/guidance/guidance-member-communications.aspx

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 risk in manageable stages – do you agree that this format will help to meet this objective?**

Whilst there was general support for delivering the seven key risks in a series of web-based modules, it was noted by a number of respondents that there should be capability for simply downloading relevant material.

One respondent noted that, as currently drafted and formatted, material could be off-putting to trustees of smaller schemes who may not have the time to review material in detail.

In response to this and other similar comments received, we have restructured each of the seven risk areas into more clearly identifiable sections that are easy to find, browse and print. We have also concluded each risk section with a summary of the key controls we would expect all schemes to operate.

It was suggested that material would be off-putting to trustees and time-consuming to review. We do not consider this to be the case. In isolation each risk area considered, which includes case examples and illustrations, is addressed in a relatively short chapter. Poor record-keeping is covered in 5 pages; however, we recognise that the application of material will be challenging for many schemes who do not currently have adequate procedures in place.

Also, as noted in the guidance, we are expecting trustees to address all these risks in order of priority and over a reasonable period of time.

Again, results of the PMI survey were also very positive in relation to the role of web-based material and the ability to deliver material in manageable stages. Responses were as follows:

Very helpful	50%
Quite helpful	42%
Not very helpful	8%
No help at all	0%

As noted above, we have also made available sections which can be downloaded to address different styles and preferences for education and development.

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.**

The regulator frequently uses case examples and illustrations to provide further context to guidance and help demonstrate how schemes may apply good practice and fulfil standards described in codes of practice. This approach in the past has been generally welcomed by users and the majority of respondents still find these additions helpful: for example, they 'highlight the importance of effective internal controls'.

Two respondents, who were supportive of the use of case examples, suggested moving these to a separate appendix. We have reconsidered this approach but given that the examples are very specific to the flow of text in each section we felt that they could become less meaningful. Risk sections also commence on new pages to sectionalise the document more clearly; we therefore believe that this will also support the flow and navigation of material, with case examples included.

One respondent raised concerns that 'if examples in the guidance are seen as setting an expectation for all schemes ... trustees of smaller schemes might be discouraged and resign'. Clearly this would be a very undesirable outcome, but not one we would expect to occur, particularly given that the majority of respondents viewed the expectations set out in the guidance, which are demonstrated in the case examples, as reasonable.

It was also noted that particular sections did not include specific case examples. Whilst this may be the case it was our view that other illustrations effectively supported the application of good standards of governance, and case examples were not deemed necessary in all cases.

However, having considered this point further we agreed that, particularly in relation to ineffective retirement processes, a case example would add value – we have therefore introduced a new case example.

General comments

In response to a number of other issues raised and practical comments, we have re-examined the content of our original drafting and have made changes where appropriate. This has been mainly in relation to some subtle drafting clarifications and adding further material where it was thought to be beneficial, ie where certain issues needed to be further addressed. For example:

- **Table 2** – now includes further risks and controls relating to information technology and investment.
- **The trustees' role** – further material has been added to address design, implementation and operational effectiveness of controls as part of the risk management process.
- **A lack of knowledge and understanding** – reference has been made to the important role of the scheme secretary and pensions manager in developing robust governance frameworks.
- **Poor record-keeping** – we have added material to help clarify the role of the actuary in relation to assessing the accuracy of core data.
- **Investment risk** – the section headed 'Why is this important?' has been enhanced to provide greater clarity to trustees regarding the significance of poor control over investment-related activities and decision making. We also now consider risks associated with stock lending.
- **Ineffective retirement processes** – additional case example added to help clarify controls relating to the pre and post decumulation process.

The way forward

The focus of our recent governance campaign and the scope of our Corporate plan⁴ demonstrate clearly the importance we place on good scheme governance and administration.

We have emphasised that a robust governance model will be underpinned by a strong system of internal control. Our guidance will provide trustees with a tool to enable the establishment and operation of adequate internal controls.

We also recognise that a number of schemes already have adequate systems in place; for these schemes, our guidance will provide them with an opportunity to assess the adequacy of existing controls and benchmark their arrangements against the controls we expect schemes to put in place.

However, we do recognise that such an exercise can take a reasonable period of time to complete. Risk mitigation is an ongoing process, and trustees need to be continually aware of changes in the circumstances of their scheme which will invariably introduce new risk. Trustees need to respond to these new or emerging risks and ensure that existing controls are sufficient; where this is not the case trustees will need to enhance existing controls or introduce new control procedures.

Our expectation is that trustees adopt the approach we have identified in a risk-based manner. As part of the risk assessment and evaluation process, we would expect trustees to focus on areas that require more urgent attention. Over a reasonable period of time, however, this would include attention to all the seven risk areas we have identified in our revised guidance. Of course, there may be other areas which also require attention and we would expect trustees additionally to build these into the scope of their review as appropriate. As previously noted, it would be our intention to update the guidance as and when we identify new areas where trustees need support.

We are very conscious of the important role that scheme advisers and service providers play in this area. Throughout the development of this guidance we have engaged with a number of organisations and professional bodies to establish whether and to what extent their scheme-related activities involve the assessment of controls, help identify and ultimately result in the communication of weaknesses or failures in internal control systems.

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⁴ Published 30 March 2010: www.thepensionsregulator.gov.uk/press/pn10-05.aspx

The way forward continued...

In particular we have engaged with the audit profession to assess the extent to which the statutory audit process will highlight weaknesses in the design and operation of controls we have identified in our guidance, particularly those relating to record-keeping and financial management.

We note that auditing standards require the auditor to obtain an understanding of internal controls relevant to the audit when identifying and assessing the risks of material misstatement in financial statements. We are keen to explore further, for example, whether and to what extent the incidence of poor quality member data is assessed and evaluated as part of the statutory audit process. Errors in certain data fields can result in incorrect payments from a scheme, and these transactions are reported in the financial statements. We therefore intend to progress discussions with the audit profession and to identify areas which are mutually compatible.

We will also continue to assess the extent to which trustees have embraced processes and controls described in the revised guidance and have implemented adequate internal controls. This will be done in a number of ways. We will gauge the effectiveness of this guidance through research gathered from our annual governance tracker survey. Through the work undertaken by our practices, we will also be able to identify to what extent schemes have identified risk and have established adequate controls to manage those risks. Where we deem internal controls to be inadequate, this may result in further regulatory intervention and/or scrutiny. In some circumstances we may consider using our statutory powers.

Our expectations remain that:

- we expect to see a marked improvement in the management and control of risk;
- this guidance will continue to promote the importance of good scheme governance;
- the material expands and elaborates upon standards described in the code;
- it shares arrangements for managing risk and identifies controls we would expect trustees to apply and adapt for their scheme in seven key areas of governance; and
- whilst we have provided material which should be accessible and actionable for smaller schemes that do not have large resources, the levels of member protection must be of a good standard. If small schemes cannot reach these standards under their current configuration, they should look at alternative solutions such as sourcing or supply arrangements.

Appendix

The following organisations provided responses to the consultation:

Aon Consulting
Arc Benefits Limited
Association of Consulting Actuaries
Association of Pension Lawyers
Aviva
Baker Tilly
Capita Hartshead
EDF Energy Plc (Pension Services)
Electricity Supply Pension Scheme
eShare
Eversheds LLP
Hewitt Associates Limited
Institute of Chartered Accountants in England and Wales
Institute of Chartered Accountants of Scotland
Investment Management Institute
KPMG LLP
Lloyds Banking Group (Group Pensions)
Mayer Brown International LLP
Mercer
Pensions Management Institute
Pensions Research Accountants Group
Railways Pension Trustee Company Limited
Royal Mail Pensions Trustees Limited
Sacker & Partners LLP
Shell International Limited (Trustee Services Unit)
Society of Pension Consultants
Standard Life Assurance Limited

How to contact us

Napier House
Trafalgar Place
Brighton
BN1 4DW

T 0870 606 3636

F 0870 241 1144

E customersupport@thepensionsregulator.gov.uk

www.thepensionsregulator.gov.uk

www.trusteetoolkit.com

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