

Are your internal controls sound?

Legislation due to come into force later this year will impose specific obligations on trustees to have sound administrative procedures and effective internal control mechanisms in place. The force behind the new requirements is the EU Pensions Directive¹, but echoes of the Myners principles on trustee governance and the new trustee knowledge and understanding requirements abound. Consultation on draft regulations² finished on 9 September 2005 and, on the same day, the Pensions Regulator (TPR) published its corresponding draft code of practice.

Pensions Act 2004

Trustees' duties

- The key focus of the draft regulations is to ensure that schemes are administered:
 - in accordance with their rules; and
 - in accordance with pensions and other relevant legislation.
- The ultimate responsibility lies with the trustees.

Internal controls

What are they?

- Arrangements and procedures to be followed in administering and managing the scheme.
- Systems and arrangements for monitoring that administration and management.
- Arrangements and procedures to be followed for the custody and security of the scheme's assets.

Internal controls

Why do you need them?

- Internal controls are designed to help:
 - detect and mitigate risks affecting pension schemes;
 - trustees discharge their duties effectively;
 - safeguard assets;
 - maintain adequate funding;
 - ensure benefits are paid in accordance with members' rights under the terms of the scheme;
 - avoid maladministration.

1 2003/41/EC

2 The draft Occupational Pension Schemes (Internal Controls) Regulations 2005

Internal controls

The need to understand risks

- Understanding risks that may affect your scheme is critical to the implementation of effective internal controls.
- Trustees should identify both internal and external risks associated with their various duties, functions and activities so as to help determine their internal control framework.
- For example, are there any weaknesses in any of their procedures?

The draft code of practice

Some examples of risks

- The draft code aims to help trustees meet the statutory requirement by setting out a seven "spoke" risk management cycle³.
- The draft code also highlights some key areas of risk:
 - employer covenant;
 - investment / funding;
 - fraud;
 - compliance with scheme rules and regulations;
 - sub-standard administration;
 - poor scheme management.

No internal controls?

TPR's powers

If trustees fail to implement internal controls or the controls prove inadequate, TPR can:

- impose fines;
- appoint an independent trustee;
- issue improvement notices;
- issue notices to third parties (requiring specified action).

Conclusion

- Failure to comply properly with the new requirements may land trustees in hot water with TPR and may also be of some evidential weight in any actions against trustees (such as maladministration).
- As all schemes now face more stringent scrutiny, making sure your internal controls / risk management makes the grade is vital.
- But, to finish on a note of comfort, the Government seems confident that it has pitched the internal controls threshold at a level which all occupational pension schemes should already meet.

³ Review internal controls, set objectives, define success criteria, identify risks, produce action plan, implement action plan, monitor performance

This edition of Sackers Extra News is part of a series focusing specifically on Pensions Reform to keep you abreast of the key issues throughout this period of change.