

– CHAPTER 6 –

Organisation and administration

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1 Administrative and organisation structure

1.1 The legal duties of trustees of pension schemes

The trustees of pension schemes have some or all of the following legal duties (depending on the type of scheme):

- to register their scheme with the Pensions Regulator and notify any changes to the scheme details
- pay the annual general levy to the Pensions Regulator and, if eligible for the fund, pay the Pension Protection Fund levies
- take decisions for the scheme: hold meetings and take records of meetings, decisions and transactions
- keep financial records for the scheme and keep member records
- keep the assets of the scheme separate from the assets of the employer
- appoint professional advisers, and obtain an auditor's statement and a valuation of the fund's investments
- approve and file the annual report of the trustees, within seven months of the end of the scheme's financial year-end
- take investment decisions in accordance with the scheme's Statement of Investment Principles
- delegate the power of making investment decisions to agents (fund managers) if this is considered appropriate
- provide information to members of the scheme
- sort out disputes involving members and their rights under the scheme
- secure the adequate funding of the pension scheme and reach agreement with the employer about the level of contributions to be paid to the scheme.

Trustees can be held liable (jointly and severally) for scheme losses, and they may also be liable to fines imposed by the Pensions Regulator for breach of duty (failure to comply with their obligations under the legislation).

An efficient organisation and administrative system needs to be in place to enable trustees to carry out all these duties. The administrative arrangements therefore need to be robust and adequately resourced.

1.2 Trustee meetings

The trustees of a pension scheme should meet regularly to carry out their responsibilities, and dates for the regular meetings should be planned in advance. The purpose of trustee meetings should be to:

- monitor the activities of the scheme, and take decisions where appropriate
- monitor the employer covenant and any transactions or corporate events proposed by the employer
- exercise the powers of the trustees, including discretionary powers over particular matters
- fulfil the duties of the trustees, in relation to matters such as providing information to the scheme members and Pensions Regulator
- ensure that the scheme continues to be operated in accordance with the trust deed and rules
- make and review periodically strategic decisions on investment
- where appropriate, appoint sub-committees to carry out particular functions, and receive reports from those sub-committees and approve any actions they have taken.

Decisions are usually taken collectively by the trustees, by majority vote. However, the procedures for reaching decisions should be specified in the trust deed or (in the case of a corporate trustee) the articles of association.

Minutes of every meeting should be taken, and decisions taken by the trustees should be recorded in the minutes.

Quorum for trustee meetings

A trustee meeting should have a quorum (a minimum required number of trustees attending). Without a quorum, the decisions of a meeting would be invalid. The size of the quorum is set out in the trust deed or (in the case of a corporate trustee) the articles of association.

1.3 Delegation of responsibilities

Trustees should have the power within the rules of the trust deed and rules of the scheme to delegate some of their responsibilities. Responsibilities may be delegated to:

- a scheme administrator, for carrying out day-to-day administrative tasks
- a fund manager
- possibly, a nominee and a custodian for scheme assets.

Holding scheme money

In addition, a pension scheme must normally have a banker. Trustees must keep the money belonging to their scheme in a suitable bank or building society account, separate from the employer's account.

A pension administrator, insurance company or other third party is permitted to hold funds on behalf of the scheme trustees, in a suitable bank or building society account.

Pension scheme solicitors

A pension scheme may appoint a firm of solicitors to act as the pension scheme lawyer, whose main tasks are usually to:

- prepare and amend legal documentation for the scheme, and
- give legal advice.

However, it is not a legal requirement that a pension scheme should appoint a lawyer, and most do not. They simply refer a legal matter to a firm of solicitors when an issue arises. However, when a legal matter is referred to a firm of solicitors, the trustees must appoint the solicitors in writing. This is because the trustees will be liable for the consequences of incorrect legal advice if they have not formally appointed their solicitors.

Secretary to the board of trustees

The trustees may also appoint a secretary to the scheme, to assist the chairman of the trustees in matters related to trustee meetings and in implementing decisions of the trustees. Where the trustee is a corporate body, the company secretary has certain prescribed duties and may act as the secretary to the scheme.

Written terms of reference

The trustees should provide written terms of reference for any person or organisation receiving delegated responsibilities to act on their behalf.

The trustees need to be aware that when they delegate authority to another person or organisation, they remain responsible for the actions of that person or organisation. They must therefore continue to monitor that person's actions and review their performance on a regular basis.

1.4 Monitoring the administration of the scheme

The trustees are responsible for monitoring the administration of the scheme, where the tasks have been delegated to a scheme administrator. It is also important to make sure that there are suitable controls over payments from the scheme's bank accounts, to minimise the risks of error and fraud.

The trustees should ensure that:

- there is a written agreement/contract setting out clearly the responsibilities of the scheme administrator
- there are clear responsibilities and lines of reporting within the organisation or department of the scheme administrator
- there are clearly-defined responsibilities for reporting by the scheme administrator to the trustees
- there are clearly-defined administrative procedures and timetables for administrative activities
- a named person, possibly the scheme administrator, is responsible for the safekeeping of the original scheme documents.

Holding original documents

Trustees must ensure that all original documents relating to the scheme are held and retained. These include:

- the trust deed and rules, including any amending deeds
- written agreements between the trustees and its agents
- most ordinary correspondence
- correspondence between the trustees and the scheme's advisers
- bank statements
- copies of other important documents, such as minutes of trustee meetings, trustee resolutions, records of training activities undertaken by trustees and member communications
- the group life policy document
- the AVC policy document.

1.5 Amendments to the scheme

The trustees may have the power to make amendments to the scheme rules. Alternatively, they may be required to approve changes proposed by the employer. The trustees should:

- take and consider professional advice before they decide on any amendment to the scheme
- make sure that any amendment is properly authorised, in accordance with the trust deed and rules, and any legal requirements
- be aware of their duty to act in the interests of all the beneficiaries of the scheme.

Modification of pension rights (DB schemes)

Schemes are able, in theory at least, to rationalise their arrangements to adapt to changing circumstances, provided that members' interests are appropriately protected.

From April 2006, the Pensions Act 2004 allows defined benefit schemes to make changes that modify their members' accrued pension rights, but only if certain conditions are met. Certain changes are not permitted unless the member has given his or her consent, the actuarial value of the members' accrued rights is preserved and the trustees have also approved the change. Changes can only be made if permitted by the trust deed and rules.

More specifically, the rules are as follows:

- From April 2006, where a change is proposed to **past service** rights:
 - A change that proposes to switch a member's benefits from DB to DC, or that reduce a pensioner's pension in payment, can only be made with the individual consent of the member concerned.
 - Other changes can only be made provided that the members are consulted (but their consent is not required) and an actuarial equivalence test is passed. Alternatively, consent can be obtained from individual members.

In both cases, the approval of the trustees is required.

- Until April 2006, a change can only be made either with the member's consent or on condition that the members are no worse off. In practice, this has been such a high test that very few changes have been made by schemes to past service rights.

Consultation by employers about proposed scheme amendments

From April 2006, the Act places a statutory obligation on an employer to **consult** prospective and active scheme members before making any significant changes in respect of future pension arrangements (future service). The members and/or their representatives should be able to express their views about the proposed changes, which should be considered by the employer before any decision to make a change is taken.

Consent of the members and actuarial equivalence are not requirements for changes to future service. The only requirement is consultation.

1.6 Professional advisers and suppliers to a pension scheme

Some advisers to the trustees of a pension scheme are known as 'professional advisers'. Trustees may only rely on advice from professional advisers who have been properly appointed.

- **Investment advisers.** There is a legal requirement for trustees to obtain and consider 'proper advice' before using their general power of investment and when reviewing the investments of the scheme's fund. (There are some exceptions to this rule; for example where the scheme is wholly insured).
- **Actuarial advisers.** In addition to having a scheme actuary, the trustees may also use actuarial advisers, to obtain additional independent advice on actuarial matters.
- **Benefits consultants.** Benefits consultants may be used to provide advice about scheme benefits for members.
- **Insurance brokers.** Insurance brokers may be used by trustees to arrange insurance (such as group life assurance policies for providing death benefits) with insurance providers. Using a broker is an alternative to the trustees negotiating with insurance providers directly. Brokers should be able to obtain the 'best deal' by negotiating with several insurance providers to obtain the best terms or lower premiums.
- **Lawyers.** Lawyers may be used to obtain legal advice and guidance.
- **Communications advisers** may be used to provide advice on matters relating to presenting communications to scheme members, or for public relations purposes.

In addition to obtaining professional advice, the trustees of a pension scheme may also delegate some responsibilities.

- **Fund managers** are used to manage the scheme assets and make investment decisions.
- **Custodians** are used to administer and protect the financial assets of the scheme.
- The management of the administration of the scheme may be delegated to **administrators**.

1.7 Scheme auditor and scheme actuary

There is a requirement for pension schemes needing to produce an annual report to have a **scheme auditor**, who may be either an individual or a firm of auditors.

If the scheme is a defined benefit scheme, the scheme must have a **scheme actuary**, who must be an individual (although he or she will usually work for a firm of actuaries or an insurance company).

Scheme auditor

The role of a scheme auditor is to:

- prepare an auditor's statement about the contributions payable to the scheme, and
- if required, audit the accounts of the pension scheme.

Annual auditor's statement

The trustees of most pension schemes are required to obtain a **statement** each year from the scheme auditor. This statement should confirm whether or not, in the auditor's opinion, contributions have been paid into the scheme in accordance with the payment schedule for the scheme (defined contribution scheme) or the schedule of contributions (defined benefit scheme).

If the auditor's statement is negative or qualified, the auditor must explain the reasons why. (Note: Regulations introduced in 2005 make it clear that the auditor does not have to qualify the accounts where the problem is not material, or where contributions are paid in excess of the schedule of contributions.)

Audit of the scheme accounts

Most pension schemes require an annual audit of the scheme's accounts. The audit of the accounts is carried out by the scheme auditor.

The accounts must be prepared in accordance with a Statement of Recommended Practice (SORP) for pension schemes, and must give a true and fair view of:

- the financial transactions of the scheme during the financial year of the scheme
- the amount and disposition of assets held by the scheme at the end of the scheme year
- the liabilities of the scheme, other than the liabilities to pay pensions and benefits after the end of the scheme year.

The auditors will prepare (and sign) a report stating whether, in their opinion, the scheme's accounts do give a true and fair view, and whether they contain certain specific information required by the law.

The trustees are required to approve the audited accounts. The audit and approval of the scheme accounts must take place **within seven months** after the end of the scheme year.

Internal audit

The scheme auditor is an independent 'external' auditor. A scheme may also employ its own 'internal' auditors. Internal auditors do not have a statutory or regulatory function. Where an internal audit section or department exists, its function is to carry out investigations (audits) into the efficiency and effectiveness of internal control within the organisation. These may be:

- audits of parts of the accounting and financial reporting system (and their work may be relied on to some extent by the external auditor)
- audits into efficiency, effectiveness and economy (cost control) within operations
- audits into compliance with regulatory requirements
- special investigations (for example into any suspected fraud).

Scheme actuary

Defined benefit pension schemes must have a scheme actuary, who provides advice and opinions on all aspects of funding the scheme. Defined benefit schemes need to have sufficient assets to meet the pension liabilities to which they are committed, and the scheme actuary provides advice on the future liabilities of the scheme and the funding that is needed to meet those liabilities.

The advice of a scheme actuary therefore includes:

- advising the trustees on how to meet the minimum funding requirement for the fund ('old rules'), or how to meet the statutory funding framework – funding requirements for DB schemes are explained in a later chapter
- preparing regular actuarial valuations, at least once every three years. This is a valuation of the scheme's liabilities. The liabilities of the scheme can be compared with its assets:
 - if the assets of the scheme have a higher value than its liabilities, the scheme is in surplus
 - if the assets of the scheme have a lower value than its liabilities, the scheme is in deficit
- calculating the amount of contributions that should be paid into the scheme in the future to meet its liabilities, after taking into account the surplus or deficit
- advising on the types of investment that might be appropriate for meeting the liabilities of the scheme
- approving the methods used to calculate the transfer value of members transferring their benefits out of the scheme
- approving the methods used to calculate the value of the benefits of members transferring their benefits into the scheme
- advising the trustees of the consequences for the scheme's funding of any events affecting the scheme.

1.8 NAPF: code of governance for pension schemes

In July 2005, the National Association of Pension Funds (NAPF) issued a draft code of governance for pension schemes. ('Governance' is concerned with the way in which organisations govern themselves in the interests of their owners, beneficiaries or other 'stakeholders'.) The NAPF suggested that pension schemes should have high governance standards, just as schemes expect high standards of governance in the listed companies in which they invest.

The draft NAPF code of governance sets out certain principles of good governance, such as:

- the trustees should meet sufficiently regularly to ensure that the scheme is being well run, and they should keep a record of all meetings
- the trustees are responsible for ensuring effective communications with scheme members and the scheme employer
- the trustees should use sub-committees to carry out their responsibilities efficiently, and sub-committees should have clear written terms of reference
- the trustees should have proper procedures in place to acquire the skills necessary to execute their duties (for example, procedures for identifying a skills gap, and formal training programmes for trustees)
- there should be procedures for considering the fitness and properness of individuals before their appointment as new trustees.

The code of governance would be voluntary. The NAPF has recommended that pension schemes should adopt the code of governance and report to scheme members each year on a 'comply or explain basis'. In other words, the trustees should report to its members (in their annual report) whether they have complied with all the requirements of the code, and if not, to explain their reasons.

Contributions

- The '19 day rule' for employees' contributions
- Payments schedule and schedule of contributions
- Reporting late payment or non-payment of contributions

2 Contributions

The trustees of a scheme are responsible for ensuring that the money that should be paid into the scheme is actually paid in, and that it is paid in at the right time.

For defined benefit schemes, there is also a requirement to make sure that the rates of contribution are sufficient, and that there will be enough money in the scheme (scheme 'assets') to provide the benefits promised to members under the rules of the scheme (the scheme's 'liabilities').

2.1 The '19 day rule' for employees' contributions

Contributions **by employees** must be paid to the trustees of the scheme by the employer by the 19th day of the month following the deduction of the contributions from the employee's pay. For example, contributions deducted from pay during September 2005 must be paid to the trustees by 19 October 2005.

There are no exceptions to the 19-day rule. An employer who breaks this rule is therefore breaking the law.

It is the responsibility of the trustees to monitor the payments of these contributions.

2.2 Payments schedule and schedule of contributions

To help them to monitor the payments of contributions, the trustees of a scheme must produce a schedule showing the contributions payable and when.

- For a money purchase scheme, this is known as a **payment schedule**.
- For a final salary scheme, it is called a **schedule of contributions**.

Contributions payable by the employer as well as contributions from employees must be included in the schedule, but it does not have to include AVCs. There is no rule about when the employer's contributions are payable. However, once the payment dates have been chosen, the contributions must be made to the trustees on time.

Trustees must monitor that the payments schedule or schedule of contributions is complied with, and that the correct amounts of payments are made on time. Where there appears to be a problem with late payment or non-payment, the trustees should discuss the matter with the employer.

They may also be required to notify the non-payment to the Pensions Regulator and the scheme members.

2.3 Reporting late payment or non-payment of contributions

The requirements for trustees to report non-payment or late payment of contributions are due to change from April 2006 for money purchase schemes. For defined benefit schemes, the new rules will apply from the time when the scheme first becomes subject to the new scheme funding regime (i.e. between December 2005 and December 2009). This change is not a change of substance – both before and after the change, the Pensions Regulator only wants to be informed of significant non-payment or late payment of contributions.

Existing requirements

The Pensions Regulator's Briefing Number 1 sets out the circumstances in which the Regulator expects trustees to report late payments of contributions before the new rules come into force.

The legislative requirements are that:

- all pension contributions specified in the schedule of contributions or the payment schedule must be paid by the due date specified and
- employees' pension contributions must be paid within 19 days from the end of the calendar month when they were deducted from their pay.

Although legislation sets out strict requirements for the timescales in which reports should be made, the Pensions Regulator (following the approach of its predecessor Opra) has indicated that it does not expect a report to be made in all cases.

The aim of the Pensions Regulator is to focus action on late payments that pose a significant risk to members' benefits. The Pensions Regulator therefore only expects trustees to report employers whose contributions remain outstanding 90 days or more after their due date unless there is a more serious or wider problem. However, trustees must comply with the continuing legal requirement to notify members when contributions are paid 60 days or more after the due date.

The trustees need not report a late payment of contributions if it is an isolated incident and the matter has been put right (with action taken to prevent late payments again in the future).

Requirements from April 2006: money purchase schemes

At the time of writing, a draft code of practice has been issued by the Pensions Regulator dealing with the reporting of late payments of contributions (members' and employer's contributions) to occupational money purchase schemes. The code of practice is expected to come into force from April 2006.

The requirement is that the trustees must report late payments of contributions (to a money purchase scheme) to the Pensions Regulator where the late payment is likely to be 'of material significance' to the Pensions Regulator in the exercise of its functions.

The trustees must report to the Pensions Regulator and the scheme members within a 'reasonable period' if either the members' contributions or the employer's payment has not been paid on time and the trustees have reasonable cause to believe that the non-payment is material.

Non-payment would be material, for example, when:

- the non-payment appears to involve dishonesty and the misuse of the contribution money (for example, where the payment has been withheld by an employer in order to overcome cash flow difficulties)
- there appears to be a fraudulent evasion of the requirement to make the payments
- the payment is overdue by 90 days
- the trustees have become aware that the employer does not have adequate systems in place to ensure that contributions are paid on time
- the trustees believe that there is no early prospect that the overdue payments will be received, for example due to the financial circumstances of the employer.

A report should be made to the Pensions Regulator within a reasonable period of the trustees becoming aware that the late payment is of material significance. A 'reasonable period' is normally within 5 days.

The scheme members should also be notified within a reasonable period after the due date (e.g. within 5 working days of the end of the 90-day period).

New requirements for defined benefit schemes

At the time of writing, a draft code of practice has been issued by the Pensions Regulator dealing with funding defined benefit schemes. This code of practice will apply to defined benefit schemes from the date when they first become subject to the new scheme funding regime (usually their first triennial valuation after December 2005).

The requirement is that the trustees must report late payments of contributions (to a DB scheme) to the Pensions Regulator where the late payment is likely to be 'of material significance' to the Pensions Regulator in the exercise of its functions. In this respect, the requirement is exactly the same as for reporting late payment of contributions to money purchase schemes.

The circumstances in which non-payment or late payment are of material significance are also the same as for money purchase schemes.

Other aspects of record-keeping and administration

- The requirement to keep records
- Other documents to retain
- DC schemes: administration arrangements

3 Other aspects of record-keeping and administration

3.1 The requirement to keep records

The scheme must have up-to-date information about its current and past members and all transactions relating to them. This is a requirement, for example, in order to:

- identify the rights or benefits that members have built up within the scheme
- account to HM Revenue and Customs for any tax due or any tax deducted from benefits paid to members.

The members' records must include:

- details of the member: name, address, date of joining the scheme, etc
- details of the contributions received
- all payments to and from the scheme
- details of transfers of members' benefits into and out of the scheme.

The trustees are responsible for making sure that proper records are kept, even if a pension scheme administrator or an insurance company keeps the records on behalf of the scheme and its trustees. **Records must be kept for a minimum of six years**, but in practice are often kept for much longer.

3.2 Other documents to retain

Other documents relating to individual members should also be kept. These include:

- option forms
- 'expression of wishes' forms
- ear-marking orders or pension sharing orders.

Option forms

Scheme members may submit option forms, indicating their preference when they have a choice from one or more options. For example, option forms may be submitted by a member who:

- wishes to opt out of the scheme or withdraw from the scheme
- take up an offer from the employer to switch from a defined benefits to a defined contributions scheme.

'Expression of wishes' forms

A scheme member may want any death in service benefits, in the event of his or her death before retirement, to go to a particular individual or individuals, rather than to the individual's next of kin. The member can indicate this wish in an 'expression of wishes' statement or form, submitted to the trustees.

The trustees of a scheme are not obliged to comply with the member's wish, and an expression of wishes form might include wording such as:

'I understand that any lump sum death benefit will be distributed at the absolute discretion of the trustees, but I would like the trustees to consider the person(s) listed below as possible recipients of any capital distribution. I understand that in exercising their discretion, the trustees will not be bound by this expression of my wishes.'

The trustees may decide to exercise their discretion, and go against the member's expressed wishes, in cases where they consider that the person nominated is not the most appropriate recipient of the benefits.

Divorce settlements: earmarking orders and pension sharing orders

When a member of a pension scheme is divorced, there are three different ways in which a divorce settlement might be reached with regard to the member's pension rights/benefits.

Offsetting

In an offsetting arrangement, all the matrimonial assets are split between the divorcing couple by the court in a manner that the court regards as fair. The matrimonial assets include the pension rights/benefits of the scheme member. The offsetting arrangement might provide for the scheme member to retain all his or her pension rights, and that the other ex-spouse will receive some other matrimonial assets of equivalent value, such as savings or investments in shares. When the court makes an offsetting settlement, there is no requirement for the pension scheme to make any record, because the scheme member retains all his/her rights and benefits.

Earmarking

The court may make an earmarking order as part of the settlement of a divorce case. In this type of arrangement, the pension rights or benefits of the scheme member are not shared between the ex-spouses until retirement. A percentage of these rights or benefits is earmarked by the court for the member's ex-spouse. The amount that is earmarked is left to the discretion of the judge.

The pension must keep a record of the earmarking order, so that when the member retires, the trustees are aware how the pension rights/benefits should be divided. The rights are not divided until retirement.

Pension sharing

Pension sharing is an alternative to offsetting or earmarking that has been available since 2000. With a pension sharing order, the pension rights of the divorcing scheme member are split at the time of the divorce (rather than at retirement), as part of the overall divorce settlement.

When the court makes a pension sharing order, the ex-spouse who is not a scheme member must be offered suitable pension provision. This could involve:

- an internal transfer of benefits to the ex-spouse within the scheme, in which case the ex-spouse is treated as an early leaver within the rules of the scheme (a 'pension credit')
- a transfer of benefits to an external pension scheme, such as a personal pension plan for the ex-spouse.

When a pension sharing order is received, the trustees must keep a record of how they have complied with the court order.

3.3 DC schemes: administration arrangements

The trustees of a DC scheme are not directly responsible for the investment choices of their members. However, they do have a responsibility for ensuring that the scheme is efficiently and properly managed and administered. A key risk is that the scheme will fail to maintain accurate records of the accumulated benefits of DC scheme members. This risk must be avoided by means of efficient administrative processes.

- Contributions received on behalf of each scheme member should be invested promptly in the funds selected by the member.
- There must be controls in place to ensure that the money received on behalf of each member is properly invested. A reconciliation process should be used to compare money received for each member with the value of the investments acquired (for example the number of units purchased in each investment fund, and their price).
- There must also be systems to ensure that accurate records are maintained for the individual fund or account of each scheme member.

Internal controls

- The need for risk management
- Definition of internal control and internal controls
- Internal controls
- Trustees' responsibilities for internal control
- Draft code of practice on internal controls
- Internal controls of professional advisers: FRAG21

4 Internal controls

4.1 The need for risk management

The risks facing pension schemes must be managed, and the trustees are ultimately responsible for risk management. There are many potential threats to the security of the assets of a pension scheme, as well as risks that the trustees could become liable for breach of duty. The trustees should ensure proper governance to ensure that risks are properly managed and that the interests of the scheme beneficiaries are protected.

The requirement for trustees to ensure that there are adequate internal controls for their pension scheme will be introduced by new regulations made under the Pensions Act 2004. A draft of the new regulations was issued for consultation (by the DWP) in July 2005. The Pensions Regulator issued a draft code of practice in September 2005 about internal controls.

Trustees of occupational pension schemes must establish and operate internal controls which are adequate for the scheme to be administered and managed:

- in accordance with the scheme rules and
- in accordance with pensions legislation and any other relevant legislation.

There are different ways of analysing risks. One approach is to consider risks as:

- financial risks
- operational risks, and
- compliance risks.

For a pension scheme, the main **financial risks** are:

- Risks to the assets of the pension scheme. The investment assets of the scheme should provide an appropriate balance between risk and hoped-for returns, and any risk to loss of market value of the investments should be acceptable within the overall investment strategy of the fund.
- For defined benefit schemes, the risk that the assets of the fund will be insufficient to meet the scheme's liabilities.
- Financial risks also arise from the possibility that funds will be invested in an inappropriate way, and the possibility of fraud.

Operational risks are risks that the activities of the scheme will be inefficient due to weaknesses in operational systems and controls – or poor management.

Compliance risks are the risks that could arise from failure to comply with laws and regulations.

5.2 Definition of internal control and internal controls

A system of internal control is a system for controlling risks of error and fraud within the operating, recording and reporting systems of an organisation. An internal control system should have three elements:

- It should help the organisation to operate effectively and efficiently and to respond to any significant risks that may occur. These might be operational, financial, compliance and other risks. The controls within the system should be sufficient to ensure the completeness and accuracy of all processing of transactions and records relating to scheme beneficiaries. The objectives of an internal control system should also include the safeguarding of assets from inappropriate use, loss or fraud.
- It should ensure the quality and reliability of reporting.
- It should help to ensure compliance with laws and regulations and also with the scheme's internal policies concerning the conduct of its operations.

The internal control system includes control activities, communication processes and processes for monitoring the continued effectiveness of the system.

5.3 Internal controls

Many risks can be controlled by means of checks and restrictions that are given the general description of 'internal controls'. Internal controls are specific measures for internal control. Internal controls are controls within an organisation to ensure that its systems are operating properly.

The draft regulations issued by the Department for Work and Pensions defines internal controls for pension schemes as:

- arrangements and procedures for administering and managing the scheme
- systems and arrangements for monitoring the administration and management of the scheme
- arrangements and procedures for the custody and security of the assets of the scheme.



Example

There are risks that a sum of money may be removed from the scheme without authorisation (perhaps as a result of fraud) or that incorrect benefits might be paid to a scheme beneficiary.

Internal controls may therefore be needed to ensure that:

- the cash paid to a fund manager is actually received by the fund manager, and cash from the fund manager is actually received by the trustees: reconciliation procedures to compare accounting figures for cash paid and received might therefore be appropriate

- benefits are paid only to proper beneficiaries: controls may be applied in the form of authorisation procedures for the payment of benefits, and checks on the identity and eligibility of individuals to benefits from the scheme. There must also be procedures for capturing and maintaining correct member and payroll data.

Examples of internal controls include:

- **Procedural controls.** These are rules about the procedures that must be taken to perform a particular task. They are rules about what should be done, and how it should be done.
- **Supervision.** Staff carrying out particular functions should be supervised, to make sure that they are doing their work correctly.
- **Management.** Management have overall responsibility for planning, monitoring and controlling the activities of an organisation or an operation.
- **Accounting controls.** Controls are applied by accounting systems, to make sure that all transactions of a financial nature are properly recorded and accounted for.
- **Organisation controls.** Controls are also applied by an organisation structure. For example, controls over decision-making by trustees are imposed by the requirement for certain decisions to be taken collectively at a trustee meeting with a quorum of trustees attending.
- **People.** Selecting people of a suitable calibre for the tasks they are required to perform.
- **Segregation of duties.** Making sure as far as possible that the duties of different individuals are divided so that one person can act as a check on another. For pension trusts, for example, investment advice and actuarial advice could be segregated.

For a pension scheme, handling large amounts of contributions and investments, accounting controls are an important element in the system of controls. One way of trying to check that the accounting system is being maintained properly is to carry out non-routine checks. Checks of accounting systems (and other operational systems and compliance systems, if required) can be carried out by internal auditors. **Internal auditors**, who may be full-time employees or staff from an external audit firm, carry out investigations into systems and operations, particularly accounting systems, and produce reports to management on any weaknesses they have found, together with recommendations for improving controls in order to reduce risks.

5.4 Trustees' responsibilities for internal control

The 2003 European Directive on the activities and supervision of occupational pension schemes placed an obligation on trustees and managers of schemes to have 'sound administrative and accounting procedures and adequate internal control mechanisms'. The Directive was introduced into UK legislation by the Pensions Act 2004.

The internal controls of a pension scheme must therefore be adequate for the scheme to be administered and managed in accordance with:

- the scheme rules and
- relevant legislation and regulations.

The trustees of a scheme are ultimately responsible for the adequacy of the internal control system, and the internal controls that are applied. Examples of trustee responsibilities for internal control are set out below:

- They should make sure that there are systems and procedures in place for holding cash securely, and for ensuring that money due to the scheme is properly received and that all payments of money by the scheme are properly authorised.
- They must ensure that the money and assets of the scheme are identified and kept separate from the money and assets of the employer.
- They must make sure that proper controls exist over the bank accounts of the scheme. The trustees must themselves authorise the opening or closing of any bank accounts. They must also approve all bank mandates (instructions to the bank, for example notifying the bank of individuals who are authorised by the scheme to make payments out of the scheme bank account).
- They must also ensure that cash flows to and from the fund managers for the scheme are properly monitored and controlled.

The trustees must also ensure that members' contributions and benefits/entitlements are properly administered.

- They must ensure that the contributions of active members are calculated correctly and paid into the scheme by the due date each month.
- They must also ensure that reliable systems are in place for recording the entitlements or benefits of scheme members.
- They must be satisfied that when payments are made to beneficiaries of the scheme, the amount of each payment is correct and the payment is made to the correct beneficiary.
- For defined contribution schemes, there must be procedures to ensure that investment units are correctly allocated to individual members in accordance with their contributions.

It is appropriate for the trustees to take professional advice from a firm of accountants about the measures that they should take to review and approve the internal controls of their scheme.

5.5 Draft code of practice on internal controls

The Pensions Regulator has issued a draft code of practice on internal controls in pension schemes.

This code sets out the expectation of how occupational pension schemes should satisfy the legal requirements of the Pensions Act 2004.

Internal controls are divided into three categories:

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

The aim of risk control within a DB pension scheme should be to:

- Safeguard the assets of the scheme
- Maintain suitable funding levels

- Ensure that members receive the benefits to which they are entitled
- Ensure that the scheme operates within the law and in accordance with the trust deed and rules.

The draft code sets out a ‘high level’ approach to risk management and control within a pension scheme. This high level approach consists of a continually-repeated four-stage cycle.

- **Stage 1.** Identify risks (internal and external).
- **Stage 2.** Assess the risks. Decide on appropriate control measures and formulate and implement an action plan. (Agree the need for controls, and design and implement controls.)
- **Stage 3.** Monitor performance.
- **Stage 4.** Review the effectiveness of the controls, and alter or replace them as appropriate.

The draft code of practice also recommends that **controls should be proportionate**. This means that the controls should be proportionate to the level of the risk that they are designed to control. Key factors in designing proportionate controls will be the cost of implementing the control and the expected benefits from the control measure. Smaller pension schemes must have adequate controls, just like larger schemes; however the control systems in smaller schemes are likely to be less formalised.

The draft code also provides examples of the nature of risks and controls that might be appropriate for dealing with them. Some of these are set out in the following table.

Risk	Controls
That controls will not operate effectively	Regular reviews of control procedures – perhaps carried out by internal auditors
Risk of fraud	Segregate duties and reconcile balances regularly
That the financial position of the scheme employer will deteriorate. (This is ‘corporate risk’.)	Monitor the financial position of the employer and the corporate risk.
That the investment strategy of the scheme is inappropriate. (This would be funding risk and/or investment risk.)	Review investment strategy regularly Obtain an independent ‘peer review’ of investment advice from another firm of investment advisers
That the scheme will fail to comply with regulations. (This is compliance risk.)	Carry out compliance audits. Obtain compliance reports from third parties.
Non-compliance or mal-administration by third party advisers or external administrators for the scheme (where administration is outsourced). For example, the risks from poor record-keeping.	Carry out a review of key controls of the external administrator Apply suitable authorisation procedures Frequent meetings between the trustees and the service provider Regular reviews of service level agreements
Computer system and database failures	System recovery plan Data back-up procedures Use of passwords to prevent unauthorised access to systems and files
Poor scheme management (ineffective stewardship)	Regular trustee meetings Proper training Prepare minutes of all meetings Use sub-committees with specific responsibilities

Certificates of existence

One basic check against fraud is to ensure that pensioners receiving benefits from a defined benefits scheme are still alive.

Scheme members in a defined benefit scheme should be asked occasionally to confirm that he or she is still alive by completing and returning a certificate of existence. This should be countersigned by a doctor, care home supervisor, accountant, lawyer or someone similar.

In theory, certificates of existence should provide a check that a scheme is not paying out benefits by mistake – or as a result of fraud – when it should no longer be doing so. In practice, it may be difficult to be sure that a certificate of existence is genuine and has not been fraudulently prepared.

An alternative measure is to carry out checks of pensioner details against the register of deaths. This service is available from specialist service providers, and is fairly inexpensive.

Trustees should also ensure that they verify the identity of beneficiaries before starting to pay benefits. For example, an original birth certificate and (where appropriate) a marriage certificate, should be seen before paying retirement or death benefits.

5.5 Internal controls of professional advisers: FRAG21

At present, FRAG21 (*Reports on internal controls of investment custodians made available to third parties*), issued by the Institute of Chartered Accountants in England and Wales, provides guidelines to investment custodians and their auditors/reporting accountants as to how:

- the directors of a custodian organisation might report on their internal controls to third parties, and
- the auditors/reporting accountants of a firm of custodians might review the report of the directors on their internal controls and provide an opinion on the report.

A replacement FRAG21 is in preparation, which will extend the guidelines to cover other professional advisers, including pension scheme administrators.

