

OCCUPATIONAL PENSION SCHEMES

REQUIREMENT FOR INTERNAL CONTROLS

Draft regulations

JULY 2005

DWP Department for
Work and Pensions

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Preface

1. This consultation document seeks views on the Government's proposals on internal controls in occupational pension schemes.

Documents

2. Your views are sought on:

Draft Regulations – *The Occupational Pension Schemes (Internal Controls) Regulations 2005*

A draft **Regulatory Impact Assessment**

Website

3. This document is on the Department's website at:

<http://www.dwp.gov.uk/consultations/2005>

Responses

4. Please ensure your response reaches us by **Friday 9 September**.
5. Please send your responses to:

Mike Rochford
Dept for Work and Pensions
3rd Floor
Adelphi
1-11 John Adam Street
London WC2N 6HT

Tel 020 7962 8126

Email: mike.rochford@dwp.gsi.gov.uk

Consultation arrangements

6. When responding please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of a larger organisation please make clear whom the organisation represents and, where applicable, how the views of members were assembled.
7. A list of those consulted is attached. If you have any suggestions of others who may wish to be involved in this process, please contact us.
8. The information you send us may need to be passed to colleagues within the Department for Work and Pensions and published in a summary of responses received in response to this consultation along with a response from the Government. Because of the Freedom of Information Act (2000), all information contained in your response, including personal information, may be subject to publication or disclosure. By providing personal information for the purposes of the consultation exercise, it is understood that you consent to its disclosure and publication. If this is not the case, you should limit any personal information which is provided, or completely remove it. If you want the information in your response to the consultation to be kept confidential, you should explain why as part of your response, although we cannot guarantee to do this. We cannot guarantee confidentiality even if your IT systems claim it automatically. More information about the Freedom of Information Act can be found on the website of the Department for Constitutional Affairs – <http://www.dca.gov.uk/foi/guidance/exguide/index.htm>
9. The Government aims to publish a response to the consultation during the autumn. The response will be on the Department for Work and Pensions' website at:

<http://www.dwp.gov.uk/consultations>
10. Because of the technical nature of this consultation, Ministers have decided not to publish it under the Cabinet Office Code of Practice on Consultation. However it is informed by best practice from the Code.
11. The Department values feedback on how well it consults. If you have any comments on the process of this consultation (as opposed to the issues raised) please contact the DWP consultation co-ordinator. In particular please tell us if you feel that the consultation does not satisfy these criteria. Please also make any suggestions as to how the process of consultation could be improved further. Please contact:

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Introduction

1. This consultation seeks views on the introduction of the requirement that occupational pension schemes must have adequate internal controls.

Directive

2. Article 14(1) of Directive 2003/41/EC¹ requires that occupational pension schemes in Member States should have adequate internal control mechanisms.
3. The Government's policy on the implementation of the Directive is that it should be by means of legislation. Albeit that there is legislation in place to cover the key areas of pension scheme activity, there is no specific requirement on internal control mechanisms.
4. Whilst the Government is concerned that the Directive should be properly implemented, it also seeks to adopt a proportionate approach. In considering the kind of requirement that is needed, the Government has sought the views of the Pensions Regulator and the Institute of Chartered Accountants in England and Wales.
5. Internal controls are systems, arrangements and procedures that trustees and managers put in place to help give them a reasonable assurance that their scheme is being run efficiently and effectively in accordance with the rules of the scheme and the law.
6. Pension schemes will already have systems of internal controls. The Government has therefore framed the requirement for internal controls by reference to a reasonable threshold that it believes all occupational pension schemes should meet. Most occupational pension schemes will already have internal control mechanisms that are above, or well above, this threshold. But for some schemes, the legislation will mean that they will have to review their procedures and perhaps put some additional reporting mechanisms in place. The new requirement should lead to schemes being better run.

Legislation

7. During debate on the Pensions Bill, Baroness Hollis announced to the House of Lords on 13 October 2004 that the Government would introduce a requirement for internal controls by making regulations under section 2(2) of the European Communities Act 1972.
8. Section 2(2) of the Act and its associated Schedule 2 allow the Government to make provision for the implementation of any Community obligation by means of regulations. In particular the power allows the Government to amend primary legislation by means of regulations. The Government will use this regulation making power to introduce a new section, **section 249A**, into

¹ Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision.

the Pensions Act 2004. The regulations will be subject to a negative resolution made by either House.

Code of Practice

9. The Pensions Regulator will issue guidance on internal controls in a Code of Practice. The Regulator will be consulting on the Code shortly.

Regulatory Impact Assessment

10. Every proposal for regulation which has an impact on business, charities or the voluntary sector must be accompanied by a regulatory impact assessment. Views are therefore sought on the partial regulatory impact assessment included in this consultation.

Commentary on the draft regulations

1. These draft regulations introduce new section 249A into the Pensions Act 2004.

Regulation 1

2. This is a general regulation about the citation, commencement and interpretation of the regulations.

Regulation 2

3. This regulation inserts new section 249A into the Pensions Act 2004. The new section provides as follows.

New section 249A(1)

4. This subsection provides that occupational pension schemes must have internal controls which are sufficient for the scheme to be administered and managed in accordance with scheme rules and pensions and other relevant legislation.

New section 249A(2)

5. This subsection provides that the requirements in the new section 249A do not override or affect existing arrangements or other obligations on the trustees or managers in relation to internal controls.

New section 249A(3)

6. This subsection provides for certain types of occupational pension scheme to be exempted from the requirements of new section 249A. The policy intention is that the exemptions should reflect the exemptions provided for in the Directive.
7. **Paragraph (a)** ["guarantee schemes"] Schemes described in paragraph (a) are intended to reflect the exemption provided for in Article 5 of the Directive, where occupational retirement provision is made under statute, pursuant to legislation, and is guaranteed by a public authority.
8. **Paragraph (b)** ["unfunded schemes"] Schemes described in paragraph (b) are intended to reflect the exemption for schemes which operate on a pay-as-you-go basis, provided for in Article 2(c).
9. Article 5 of the Directive allows Governments to exempt schemes with less than 100 members from the requirements of the Directive. The Government has decided not to invoke this exemption because the need to have internal controls is equally important for all occupational pension schemes.

New section 249A(4)

10. This subsection provides for the definition of various terms.

Regulation 3

11. Section 90(2)(k) of the Pensions Act 2004 allows the Government to prescribe matters on which the Pensions Regulator must issue a Code of Practice. The Government has decided that the requirement for internal controls is such a matter.

STATUTORY INSTRUMENTS

2005 No. XXX

PENSIONS

**The Occupational Pension Schemes (Internal Controls)
Regulations 2005**

<i>Made</i> - - - -	2005
<i>Laid before Parliament</i>	2005
<i>Coming into force</i> -	2005

The Secretary of State, being a Minister designated⁽²⁾ for the purposes of section 2(2) of the European Communities Act 1972^(b), in relation to personal and occupational pensions, in exercise of the powers conferred by section 2(2) of that Act and sections 90(2)(k) and 318(1) of the Pensions Act 2004^(c), and all other powers enabling him in that behalf, by this instrument which contains regulations made before the end of the period of six months beginning with the coming into force of the provision of the Pensions Act 2004 by virtue of which they are made^(d), makes the following Regulations:

Citation, commencement and interpretation

1.—(1) These Regulations may be cited as the Occupational Pension Schemes (Internal Controls) Regulations 2005 and shall come into force on 2005.

(2) In these Regulations “the Act” means the Pensions Act 2004.

Amendment of the Act

2. After section 249 of the Act (requirement for knowledge and understanding: supplementary) there shall be inserted—

(2) See the European Communities (Designated) No. 7 Order 2004 (S.I. 2004/3328).

(b) 1972 c.68.

(c) 2004 c.35. Section 318 is cited because of the meaning there given to “prescribed” and “regulations”.

(d) See section 317(1) of the Pensions Act 2004 which provides that the Secretary of State must consult such persons as he considers appropriate before making regulations by virtue of the provisions of that Act (other than Part 8). Section 317(2)(c) of that Act provides an exemption to the consultation requirement where the regulations are made before the end of the six months beginning with the coming into force of the provision of that Act by virtue of which they are made. However, in this instance, before the making of these regulations, the Secretary of State has consulted such persons as he considered appropriate.

“Requirement for internal controls

249A.—(1) The trustees or managers of an occupational pension scheme must establish and operate internal controls which are adequate for the scheme to be administered and managed—

- (a) in accordance with the scheme rules, and
- (b) in accordance with pensions legislation and any other relevant legislation.

(2) Nothing in this section affects any other obligation of the trustees or managers of an occupational pension scheme to establish or operate internal controls, whether imposed by or by virtue of any enactment, the scheme rules or otherwise.

(3) This section does not apply to trustees or managers of—

- (a) an occupational pension scheme for which a relevant public authority has—
 - (i) given a guarantee in relation to any part of the scheme, any benefits payable under the scheme rules or any member of the scheme, or
 - (ii) made any other arrangements for the purposes of securing that the assets of the scheme are sufficient to meet any part of its liabilities, or
- (b) an occupational pension scheme under which there is no requirement to set aside in advance resources related to the intended rate or amount of benefits.

(4) In this section—

“internal controls” means—

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

“pensions legislation” means any enactment contained in or made by virtue of—

- (a) the Pension Schemes Act 1993 (c.48),
- (b) Part 1 of the Pensions Act 1995 (c.26), other than sections 62 to 66A of that Act (equal treatment),
- (c) Part 1 or section 33 of the Welfare Reform and Pensions Act 1999 (c.30), or
- (d) this Act;

“relevant legislation” means any enactment relevant to the administration or management of an occupational pension scheme;

“relevant public authority” means—

- (a) a Minister of the Crown (within the meaning of the Ministers of the Crown Act 1975 (c.26)),
- (b) a government department (including any body or authority exercising statutory functions on behalf of the Crown), or
- (c) the Scottish Ministers.”.

Codes of Practice

3. The discharge of the duty imposed by section 249A(1) of the Act is a prescribed matter for the purposes of section 90(2)(k) of that Act (codes of practice).

Signed by authority of the Secretary of State for Work and Pensions.

[Name]

Minister of State,

Department for Work and Pensions

Date

EXPLANATORY NOTE

(This note is not part of the Regulations)

These Regulations amend the Pensions Act 2004 (c.35) (“the Act”) by adding section 249A (requirement for internal controls). Section 249A implements the requirement in Article 14(1) of the European Union Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision (Directive 2003/41/EC) (“the Directive”) that the trustees or managers of an occupational pension scheme must have adequate internal control mechanisms.

Regulation 2 inserts section 249A into the Act. Subsection (1) of section 249A imposes a duty on the trustees or managers to establish and operate internal controls. Subsection (2) provides that the duty established by subsection (1) does not affect any other obligation on the trustees or managers, whether statutory or otherwise, to establish and operate internal controls. Subsection (3) lists the occupational pension schemes to which the requirements of section 249A do not apply. Subsection (4) provides for interpretation in respect of section 249A.

Regulation 3 provides that the Regulator must issue a code of practice relating to the duty imposed by section 249A(1) of the Act.

As these Regulations are made before the expiry of the period of six months beginning with the coming into force of the provisions of the Pensions Act 2004 by virtue of which Regulation 3 is made, the requirement, for the Secretary of State to consult such persons as he considers appropriate does not apply. However, in this instance, before the making of these regulations, the Secretary of State has consulted such persons as he considers appropriate.

With the exception of the part of Article 14(1) which concerns adequate internal controls, Article 14(1) is already implemented by the legislative provisions detailed in the Transposition Table that accompanied the Act. A copy of that Table has been placed in the libraries of both Houses of Parliament. Copies may be obtained from the Department for Work and Pensions, Better Regulation Unit, 4th floor, Adelphi, 1-11 John Adam Street, London WC2N 6HT.

A Regulatory Impact Assessment of the impact on business, charities or the voluntary sector of the provisions in these regulations has been carried out, and a copy placed in the libraries of both Houses of Parliament. Copies may be obtained from the Department for Work and Pensions, Better Regulation Unit, 4th floor, Adelphi, 1-11 John Adam Street, London WC2N 6HT.

REGULATORY IMPACT ASSESSMENT

THE REQUIREMENT FOR OCCUPATIONAL PENSION SCHEMES TO HAVE INTERNAL CONTROLS

Introduction

1. The Occupational Pension Schemes (Internal Controls) Regulations 2005 SI 2005/ XXXX provide that occupational pension schemes must have internal controls. The Pensions Regulator's guidance on the requirement for internal controls is contained in the Internal Controls Code of Practice. The introduction of the requirement for internal controls is the subject of this regulatory impact assessment.

Purpose and intended effect of the measure

(i) Objective

2. The policy objective is that occupational pension schemes must have internal controls which are sufficient for schemes to be administered and managed in accordance with scheme rules and in compliance with pensions legislation and any other relevant legislation.

3. Internal controls are the systems, procedures and arrangements that trustees put in place to help satisfy themselves that their scheme is being run in accordance with the scheme rules and the law.

4. A pension scheme's system of internal controls has a key role to play in the identification and management of risk. A sound system of internal controls contributes to the protection of members' interests and to the safety and security of scheme assets.

5. Schemes will already have some form of internal controls. The Government's objective is to set a threshold which all occupational pension schemes should meet. The trustees and managers of each scheme will determine their own internal controls in the light of the particular circumstances of their scheme and with guidance from the Pensions Regulator in a Code of Practice.

(ii) Background

6. Article 14(1) of Directive 2003/41/EC³ requires that occupational pension schemes in Member States should have adequate internal control mechanisms. The Government's policy on the implementation of the Directive is that it should be by means of legislation.

(iii) Risk assessment

7. Albeit that there is legislation in place to cover the key areas of pension scheme activity, there is no specific requirement on internal control

³ Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision.

mechanisms. The Regulator has found that some breaches of the law have been compounded by the lack of adequate internal controls. In some cases and mainly in smaller schemes, the lack of internal controls has meant that trustees have not been aware that a breach has occurred, sometimes long after the event. This has been an issue, for example, in relation to the monitoring of receipts of contributions and reconciliations in defined contribution schemes.

Options

8. In considering how to address Article 14(1) the Government considered two options:

Option 1 - Do nothing

Option 2 - Regulate to introduce a requirement that schemes must have internal controls and provide guidance via a Code of Practice.

Option 1

9. The Government is required to comply with the requirements of the Directive. Occupational pension schemes do have internal control mechanisms. However there is no specific provision in UK pensions legislation that they must have them. Also there is evidence from the Pensions Regulator that the lack of adequate internal controls is a contributory factor in some breaches of pensions legislation. Doing nothing might mean that the Government would be in breach of the Directive.

Option 2

10. In coming to a view about the nature and extent of regulation, the Government is mindful that schemes do already have internal controls. Any legislation needs to be proportionate and the Government has decided that the most sensible way forward is to set out a threshold requirement in legislation that all schemes would be expected to meet.

11. The nature of internal controls will vary from scheme to scheme according to the particular circumstances of each scheme. It would not be appropriate to set out in legislation a detailed requirement on internal controls. The requirement is therefore set out in broad terms and will be complemented by practical guidance from the Pensions Regulator in a Code of Practice. The Code will link risk assessment to internal controls.

Business sectors

12. The business sector covered by these proposals is that of occupational pension schemes and their associated employers. However for the great majority of schemes the proposals will have little or no effect because they will already have an adequate system of internal controls in place.

Costs and benefits

13. Schemes will already have some form of internal controls in place: without them the trustees cannot know whether their scheme is being properly

run in accordance with the scheme rules and the law. These proposals, in effect, reiterate the importance of doing something they must already be doing and, on that basis, they could be said to be cost neutral. In practice however, some schemes will need to take some kind of action, perhaps to review their procedures or to put new procedures in place. The Government estimates that this will give rise to a one off cost across all schemes of around £2 million. In subsequent years, any review and changes in procedure will be wrapped into the general costs of administering the scheme.

14. Schemes will also see a benefit from any improvements they make in their internal controls. Not the least, savings should arise from any improvements in the safekeeping and custody of assets and in any improved accuracy of benefit calculations. Such savings are difficult to quantify.

Equity and fairness

15. The proposals will be of general benefit to members of occupational pension schemes because any improvements in internal controls will mean that the scheme is more efficiently and effectively run.

16. The proposals will not disadvantage any particular group of people and it will not have any race equality aspects.

Competition assessment

17. The proposals will have a small effect on some firms' costs because of the need to make improvements to their pension scheme's internal controls. However these costs would be marginal and should not, in themselves, have any effects on competition.

Small firms' impact test

18. The great majority of pension schemes are administered by insurance companies and the adequacy of their internal controls should not therefore be an issue. There may be a very limited effect on some other small schemes.

Enforcement and sanctions

19. Enforcement of the proposals will be by the Pensions Regulator. The Pensions Regulator has a range of sanctions at its disposal including the power to issue improvement notices and third party notices where necessary (sections 13 and 14 of the Pensions Act 2004). If these notices are ignored, then under section 10 of the Pensions Act 1995, financial penalties can be applied by the Pensions Regulator.

20. In practice, sanctions will not generally be imposed directly against a lack of adequate internal control mechanisms, but due to the consequences that follow from such failure. Usually breaches in other areas will highlight inadequate controls and it is those breaches that will be the primary subject of sanction. The requirement to have adequate internal controls will support the need for sanction but will not be the primary source of sanction.

Monitoring and evaluation

21. The Pensions Regulator will expect trustees to identify and put in place internal controls that are appropriate for their scheme. The Pensions Regulator will consider the adequacy of a scheme's internal controls as part of any investigation into a scheme or if specifically alerted to their inadequacy.

22. Feedback from the Pensions Regulator will provide the main means by which the policy is evaluated.

Consultation

23. The views of the Institute of Chartered Accountants in England and Wales were sought on an early draft of the regulations. The Pensions Regulator held a number of workshops with the industry in December 2004.

Summary and recommendation

24. The need for pension schemes to have internal controls is not a new issue for those managing and advising on pensions. A good system of internal controls should already be in place to facilitate the smooth running of an occupational pension scheme. In most schemes therefore it is envisaged that there will already be an adequate system of internal controls.

25. The regulations will set out a basic threshold that schemes will be expected to meet. The Code of Practice, produced by the Pensions Regulator, will provide clear guidance on how the Regulator will expect the requirement to be implemented.

26. In some cases, schemes will have to introduce new procedures and these will result in an estimated one-off cost of £2 million. Improvements in internal controls will provide benefits to schemes, for example in terms of greater security for scheme assets and greater accuracy in benefit calculation. There will be savings to schemes but these are difficult to quantify.

List of those consulted:

Addleshaw Booth & Co
Aries Pensions and Insurance Systems
Association of British Insurers
Association of Consulting Actuaries
Association of Independent Financial Advisers
Association of Corporate Trustees
Association of Pension Lawyers
Association of Pensioner Trustees
Auditing Practices Board
British Chambers of Commerce
Cabinet Office (Better Regulation Executive)
Confederation of British Industry
Construction Company
Consumers Association
Department of Health
Engineering Employers Federation
Equal Opportunities Commission
Faculty and Institute of Actuaries
Federation of Small Businesses
Financial Services Authority
Government Actuaries Dept
HMRC
HM Treasury (MOCOP)
HSBC
Industry Wide Pension Schemes Group
Inland Revenue
Institute of Chartered Accountants in England and Wales
Institute of Chartered Accountants in Scotland
Institute of Directors
Investment Managers' Association
Law Debenture
Law Society
Law Society of Scotland
Legal & General
Linklaters
Mayer Brown Rowe
National Association of Pension Funds
National Consumers Council
National Pensions Convention
Office of Fair Trading
Pensions Management Institute
Pensions Ombudsman
Policy and Legal Division DHSS Northern Ireland
Prudential
Punter Southall
Scottish Equitable
Scottish Executive
Small Business Service

Society of Pension Consultants
Standard Life
Technical Connection
The Pensions Advisory Service
The Pensions Regulator
Trades Union Congress
Watson Wyatt
Welsh Assembly