

Technical Briefing

No. 42

Internal Controls

Introduction

One aspect of the Pensions Act 2004 is a requirement that all trustees of occupational schemes should establish and operate adequate internal controls to monitor their overall performance and any potential risks to which they may be exposed to. The Pensions Regulator (“the Regulator”) has published a code of practice (No.9) to cover this concept which is one that many trustees already deal with in an informal way.

As time has passed, the typical approaches taken by trustees have developed with the benefit of experience. This Technical Briefing outlines a systematic approach to identifying and controlling risks in a structured manner which is consistent with the Regulator’s code of practice.

Internal Controls

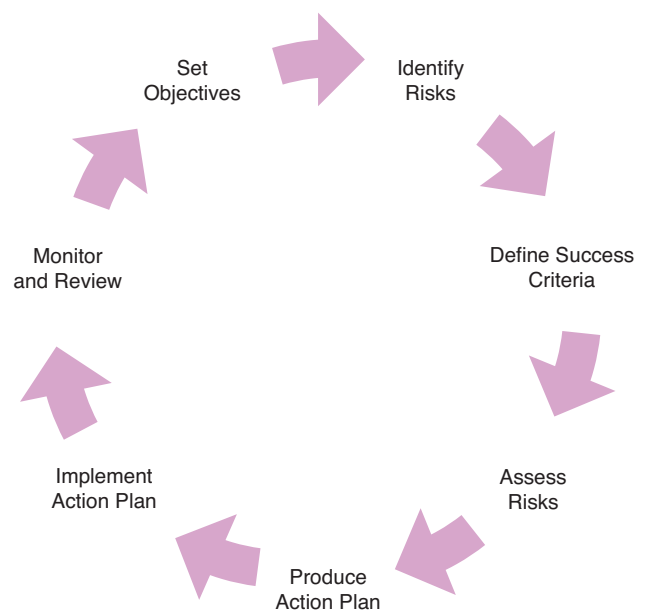
The key principle advocated by the Regulator is that the trustees of a scheme should formulate a set of internal controls which are specific to their particular scheme and their own circumstances. Importantly such a set of internal controls should be risk-based and proportionate.

This means that the key risks which are likely to have the greatest impact on a scheme, in terms of both likelihood and severity, should be given greatest importance. This can be assessed by completing a risk-review.

Risk-Review

Before putting a set of internal controls in place, trustees should consider the various functions and activities in running a scheme and identify the main

risks for each of these. One way to consider such risks is through a risk-review cycle which could be derived from following a process as outlined in the following diagram:



The key steps in such a risk-review are as follows:

- Setting the key objectives of the trustees, for example; minimise funding risks, operating the scheme at maximum efficiency etc.
- Then identify what potential risks the scheme may be exposed to.
- Assess each risk both in terms of the likelihood of its occurrence and the severity of its impact if it were to occur.
- Produce an action plan to reduce or mitigate those risks.
- Implement that action plan.
- Monitor and review performance against the identified risks on a regular basis.





No. 42

Examples of Typical Scheme Risks

Some examples of typical scheme risks and potential mitigating internal control strategies are outlined below:

Example Risk	Potential Mitigation
Corporate risk (employer covenant)	Regular discussions with the employer and review of any independent rating information and audited accounts.
Investment risk	Consider appropriateness of the strategy in conjunction with with scheme funding and the employer covenant. Also consider compliance with the Statement of Investment Principles and regular reviews of investment managers.
Fraud	Consider processes for payments and pensioner payroll. Review of investment mandates and clear limits on any third party authorisation. The requirement for a regular scheme audit covers many such points.
Computer systems failure and data security	Consider systems used, off-site back up and procedures for storing and transporting data in encrypted format only.
Compliance and regulatory risk	Consider the frequency of trustee meetings, appointment of experienced professional advisers and access to legislative updates.
Maladministration	Consider the performance of administration systems and procedures used.
Scheme management	Ensure trustees have regular meetings and receive appropriate training. Maintain minutes and records of decisions reached as well as the evidence and rationale behind those decisions.
Longevity risk	Consider what steps might be taken to hedge longevity risk such as an annuity buy-in.

Summary

The issue of internal controls is one that many trustees have dealt with successfully on an informal basis to date. However by considering a more structured review of this issue trustees can not only document their approach to this requirement but also potentially identify some fresh mitigation ideas that will reduce the long-term risks that they may be exposed to.

A documented approach to addressing internal controls can also make the process of regular review much more straightforward and transparent.

Please contact your usual **cprm** consultant if you have any questions on the contents of this Technical Briefing or would like some additional information.

June 2010