

EXPLANATORY MEMORANDUM TO
THE OCCUPATIONAL PENSION SCHEMES (INTERNAL CONTROLS)
REGULATIONS 2005

2005 No. 3379

1. This explanatory memorandum has been prepared by the Department for Work and Pensions and is laid before Parliament by Command of Her Majesty.
2. **Description**
 - 2.1 The regulations provide that occupational pension schemes must establish and operate adequate internal control mechanisms. The regulations also prescribe that the Pensions Regulator must issue a Code of Practice on the internal controls requirement.
3. **Matters of special interest to the Joint Committee on Statutory Instruments**
 - 3.1 None
4. **Legislative Background**
 - 4.1 These regulations implement that part of Article 14(1) of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision which requires that occupational pension schemes shall have adequate internal control mechanisms.
 - 4.2 It had been the Government's intention to include a measure on the requirement for internal controls in the Pensions Act 2004. However during a debate on the Bill in the Lords on 13 October 2004, Baroness Hollis, the then Parliamentary Under Secretary in the Lords, said that the Government would instead introduce the requirement for internal controls by means of regulations made under section 2(2) of the European Communities Act 1972. [Hansard: 13 October 2004, Col GC102 – see attached Annex.]
 - 4.3 Section 2(2) of the European Communities Act 1972 allows 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 is therefore using these regulations to insert the new section 249A into the Pensions Act 2004. The regulations are subject to a negative resolution by either House.

4.4 The Transposition Note on the implementation of the Directive is entitled *Pensions Act 2004: Memorandum Detailing the Implementation of the EU Directive on the Activities and Supervision of Institutions for Occupational Retirement Provision*. In respect of Article 14(1) and the requirement on internal control mechanisms, the Note says: “The requirement for adequate internal controls will be addressed through the regulation-making provisions of the European Communities Act 1972.”

4.5 The Government’s approach to the implementation of the requirement on internal control mechanisms in Article 14(1) is to set a basic threshold that all schemes will be required to meet. Most occupational pension schemes will already have internal controls that are at or above this threshold; some schemes may have to review their procedures to secure that they are compliant.

4.6 The scrutiny history of the Directive is as follows.

- the Government submitted explanatory memoranda to Parliament dated 11 December 2000 and 16 May 2001;

- The House of Commons European Scrutiny Committee reported on the proposal and the Government’s explanatory memoranda in Report No.2, Session 00/01 and in Report No.31 Session 01/02;

- the proposal and explanatory memoranda were sifted to Sub-Committee A of the House of Lords European Union Committee and were cleared by that Committee following correspondence with Ministers on 17 June 2002.

4.7 The draft regulations also prescribe that the Pensions Regulator must issue a Code of Practice on the requirement for internal controls.

5. Extent

5.1 This instrument applies to Great Britain.

6. European Convention on Human Rights

Stephen Timms, the Minister of State for Pensions Reform, has made the following statement regarding Human Rights:

In my view, the Occupational Pension Schemes (Internal Controls) Regulations 2005 are compatible with the Convention rights.

7. Policy background

7.1 Article 14(1) of Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision requires that occupational pension schemes in Member States should have adequate internal control mechanisms.

7.2 Internal controls are systems, arrangements and procedures that trustees and managers of pension schemes put in place to secure that their scheme is being run in accordance with the rules of the scheme and the law.

7.3 Pension schemes will already have 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 at or above this threshold. Some schemes will however have to review their procedures and perhaps put additional mechanisms in place. The new requirement should lead to pension schemes being better run.

7.4 The Government consulted on the draft regulations and nine responses were received. Respondents were concerned that the draft regulations did not seem to include the necessary measure of flexibility and proportionality that trustees or managers needed in determining the internal controls appropriate to their schemes.

7.5. The Government's approach to implementing the requirements of the Directive is that they should be set out in an objective test in legislation. The regulations require trustees or managers to establish and maintain adequate internal controls. "Adequate" is not defined in the regulations. In the first instance therefore it will be for trustees to decide what internal controls are needed for their scheme and on the nature of those controls. This will allow trustees to decide on the controls that are appropriate to their scheme and to take a proportionate and measured view about what is required to make them adequate. In practice most schemes will already have internal controls that meet this requirement; trustees may simply need to review their arrangements to confirm they are compliant.

7.6 Concern was also expressed about the interpretation of the requirement on internal controls where the trustees or managers delegated responsibilities to third parties. Trustees or managers continue to have overall responsibility for the safe running of their scheme, notwithstanding that some activities have been delegated to third parties. Trustees or managers must ensure that their arrangements with third parties are sufficient so that they can continue to discharge their responsibilities. The Government is again content that the regulations meet the policy requirement.

8. Impact

8.1 A Regulatory Impact Assessment is attached to this memorandum.

8.2 Public sector pension schemes are exempted from these regulations; as such there should be no impact on this sector.

9. Contact

Mike Rochford at the Department for Work and Pensions Tel: 020 7962 8126 or e-mail: mike.rochford@dwp.gsi.gov.uk can answer any queries regarding the instrument.

Explanatory Memorandum - Annex

Lords Hansard

13 Oct 2004 : Column GC102

Baroness Hollis of Heigham:

I am grateful that the noble Lord, Lord Hunt, raised internal controls, because I am glad to have the opportunity to tell the Committee where we have got to with our thinking. As this is one of the more technical issues, it is right that an equally technical question should hang on it. I gave an undertaking—I hope and expect—that we will bring forward a government amendment on Report to require schemes to have adequate internal control mechanisms to ensure compliance with Article 14(1) of the EU pensions directive. I remember that the noble Lord, and the noble Lords, Lord Oakeshott and Lord Lucas, were very impressive on insisting that we should take that forward.

In the limited time available, we have not been able to reach an agreed provision acceptable to all the stakeholders in terms of the Bill. It is particularly important that the wording of the provision is compatible with that used by the accountancy profession in its own tried-and-tested material on internal controls. Basically, I have run out of time to do what I had hoped to do. I am glad to have the opportunity to undertake instead to make regulations under Section 2(2) of the European Communities Act 1972 to introduce that requirement. In taking that route we will have more time to take on board the views of the Institute of Chartered Accountants for England and Wales, which has been responsible for pressing the Government to introduce a provision on internal controls into domestic legislation.

I am sorry that I am not able to do that in this Bill, but we will do it by another route. Clearly, we need more consultation and consent on the precise form in

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which we do it than we have so far managed to achieve in the time available. I hope that Members of the Committee will find that assurance helpful.

REGULATORY IMPACT ASSESSMENT

THE REQUIREMENT FOR OCCUPATIONAL PENSION SCHEMES TO HAVE INTERNAL CONTROLS

The Occupational Pension Schemes (Internal Controls) Regulations 2005

Introduction

1. The Occupational Pension Schemes (Internal Controls) Regulations 2005 (SI 2005/3379) provide that occupational pension schemes must have internal controls. The Pensions Regulator's guidance on the requirement for internal controls is contained in the Code of Practice on Internal Controls. 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 accordance with the requirements of the law.
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/EC¹ 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.

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.

(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 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. For the reasons discussed in this paragraph, the Government has discounted this option.

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.

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 small 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.

24. The Government also consulted on the draft regulations and nine responses were received. The main issue raised in the consultation was a concern that the regulations did not contain the necessary measure of flexibility and proportionality that trustees considered they needed. The regulations set out an objective test and in the first instance, trustees or managers are required to establish and maintain adequate internal controls. This approach will allow trustees to decide on the controls that are appropriate to their scheme and to take a measured and proportionate view about what is required to make them adequate. In the Government's view, this provides pension schemes with an appropriate measure of flexibility and proportionality. No changes have been made to the regulations.

Summary and recommendation

25. 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.

26. 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.

27. In some cases, schemes will have to introduce new procedures and these will result in an estimated one-off cost of £2 million across all schemes. 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.

Ministerial Declaration

I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.

Signed *Stephen C. Timms*

Date 8 December 2005

STEPHEN TIMMS MP

Minister of State for Pensions Reform

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