



Internal audit and pension schemes

**Update on IORP II and
the UK's Governance Regulations**

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Introduction

This article looks at the new internal review requirements for pension schemes set out in the draft Occupational Pension Schemes (Governance) (Amendment) Regulations 2018 ('the Governance Regulations') which implement the EU Directive on the activities and supervision of Institutions for Occupational Retirement Provision ('IORP II') into UK legislation.

IORP II is due to be implemented in EU member states by the 13 January 2019. The Government has recently published the Governance Regulations which achieves 'implementation' in accordance with the EU's timescales but practical implementation will then take place through regulatory codes and guidance issued by the Pensions Regulator (TPR) during 2019 and potentially beyond. Therefore whilst the immediate deadline of January 2019 is not directly applicable for trustees it will not be long thereafter that the IORP II's requirements will start to be put in place.

IORP II

IORP II requires trustees to have in place 'an effective system of governance which provides for sound and prudent management...and shall be subject to regular internal review' (Article 21.1). The IORP requires the establishment of three 'key functions' being risk management, actuarial and internal audit. The first two of these functions are already well established in current UK pension scheme governance and regulatory requirements. Not so for internal audit, which is typically only present in the largest pension schemes.

The IORP II requires that 'Member states shall require IORPs in a manner that is proportionate to their size and internal organisation, as well as the size, nature, scale and complexity of their activities, to provide for an effective internal audit function. The internal audit function shall include an evaluation of the adequacy and effectiveness of the internal control system and other elements of the system of governance, including where applicable, outsourced activities. (Article 26).

Governance Regulations

The majority of UK pension schemes do not have an existing activity that meets the general understanding of what comprises an internal audit function. Thus the requirement to introduce an internal audit function could be costly. The Government's solution to this is not to use the term 'internal audit' in the Governance Regulations but instead refer to a key function which 'internally evaluates adequacy and effectiveness of the system of governance'. It is hoped this will give flexibility to DWP and TPR in developing the governance code of practice and related guidance to minimise costs.

The exact requirements will become clearer during 2019. However, in the meantime we thought it would be helpful to trustees to explain what internal audit is and how it fits into best practice governance.

IORP II internal audit requirements:

- Trustees have a written policy in relation to internal audit (Article 21.3);
- The persons carrying out the internal audit function are fit to do so which means their professional qualifications, knowledge and experience are adequate to properly carry out the function (Article 22.1(a)(ii));
- Persons or organisations which provide the internal audit function are independent of persons or organisations that provide the other two key functions of actuarial and risk management (Article 22.2);
- If internal audit to the scheme is provided by the employer's internal audit function, assuming the UK allows this as an option, the trustees explain how they prevent or manage any conflicts of interest with the employer (Article 22.3); and
- Internal auditors are included in the regulatory whistleblowing regime (Article 22.5).

What is internal audit?

The Chartered Institute of Internal Auditors provides the following answer to the question 'What is Internal Audit?'

'The role of internal audit is to provide independent assurance that an organisation's risk management, governance and internal control processes are operating effectively.' The IIA Website September 2018

The potential scope of internal audit is therefore much wider than that of an external audit which has a relatively narrow focus on the financial statements. Internal audit can cover non-financial areas such as trustee governance and scheme management as well as operational matters such as administration and member communications. The best value can be obtained from internal audit if it dovetails with the external audit and avoids duplication of audit coverage. For example, it can check areas that give the trustees cause for concern but which are not typically covered by the external audit, for example, detailed checking of member benefit calculations or provision of management information such as administration key performance indicators.

Typically external audit coverage is focussed on the financial accounting function and the areas of the scheme which generate the largest numbers, usually investment related. Internal audit has a potentially much wider coverage and can focus on non-financial areas and items that are not financially material but may carry other significant non-financial risks such as reputational or regulatory.



How does internal audit work?

Internal audit is normally led by a Head of Internal Audit who will be responsible for developing the internal audit plan, monitoring internal audit work and reporting the results to the trustees. The Head of Internal Audit is a senior management position within the organisation. Internal audit work is performed by the internal audit team. There are typically three types of delivery model for internal audit.

Typical Internal audit delivery models

- **Outsourced** – The Head of Internal Audit and internal audit teams are provided by an outsourcer
- **Co-source** – The Head of Internal Audit and potentially some of the internal audit team are in-house with an outsourcer providing the balance of resources and expertise
- **In-house** – All internal audit is provided in-house, potentially using some external expertise and resources from time to time

The type of delivery model used by an organisation will depend on a number of factors including internal audit scope and requirements, internal resources and expertise and costs. It is expected that the UK implementation of the IORP will allow trustees to use employer internal audit resource with appropriate safeguards in place where this is available and with the right skill set.

The scope and nature of internal audit is set out in the internal audit plan. There is no prescribed content for an internal audit plan and it is normally developed by the Head of Internal Audit taking into account factors such as the nature of the scheme, its operating model, the trustee key risks (as set out in their risk register), existing independent assurance, external developments and exposures and so on. The plan will normally be approved by the trustees. The plan is typically developed in detail for the coming year and at an outline level for the next two years.



As there is no fixed content or timeframe for internal audit reviews the extent of internal audit work performed in any one year will be based on judgement reached after considering the scheme's requirements. This should allow trustees to take advantage of the IORPs requirement that internal audit is 'proportionate to their size and internal organisation, as well as the size, nature, scale and complexity of their activities' to achieve an internal audit that balances assurance requirements with efficient cost management.

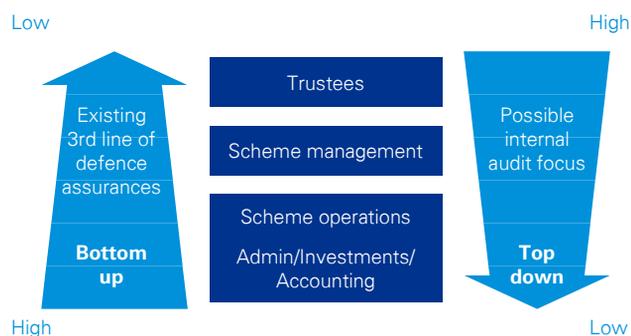
How does internal audit fit into best practice governance?

So how do these new requirements for internal audit fit into best practice governance? Using a popular governance model termed 'the three lines of defence' is helpful in demonstrating how the IORPs governance requirements, including internal audit, fit into best practice governance, as illustrated below.

Line of defence	What does this mean?	IORP requirements
1st Line of Defence Day to day processes and related operational controls	<ul style="list-style-type: none"> — Administration — Investment management — Scheme accounting 	<ul style="list-style-type: none"> — An effective internal control system which includes administrative and accounting procedures — An internal control framework — Appropriate reporting arrangements
2nd Line of Defence Oversight and monitoring controls	<ul style="list-style-type: none"> — Trustee and pension management reviews — Risk management assessments — IRM (DB) — Chair's Statement (DC) 	<ul style="list-style-type: none"> — A risk management function — Own-risk assessment — An internal control framework — Appropriate reporting arrangements
3rd Line of Defence Objective and independent assurance	<ul style="list-style-type: none"> — External audit — Internal audit — Internal control reports from service providers — Ad hoc assurance, for example independent benefit reviews. 	<ul style="list-style-type: none"> — An effective internal audit function — An internal control framework — Appropriate reporting arrangements

Trustees already receive third line of defence independent assurance from the external audit, internal control reports prepared by their outsourcers and ad hoc assurance exercises over specific areas, for example, benefit checks. However, only the largest pension schemes in the UK typically have internal audit assurance in place. The existing third line of defence assurance for most schemes tends to focus on operational matters, with little attention on the higher governance functions of trusteeship and scheme management.

The diagram below gives our view of the current state of play and where a scheme internal audit function could usefully focus its attention.



As part of the internal audit planning the extent of existing third line assurance can be assessed and any assurance gaps over the first and second lines can also be built into the internal audit plan, for example, a deep dive on pension administration for complex benefit structures, as well as focussing on scheme management and trusteeship.

How can internal audit add value?

So how will internal audit add value to the governance of pension schemes? After all, most schemes have got by until now without it! We believe there is value to be had if it is focussed on the right areas which we think are areas that traditionally have not received much third line of defence challenge or are particularly complex. The tone at the top is crucially important for good governance so an internal audit service that focusses on this rather than diving straight into operational detail is likely to yield the most value.

Examples of where internal audit could add value

Defined benefit schemes – the trustees' approach to the TPR's Integrated Risk Management (IRM) covering interaction of trustees and advisers, compliance with TPR guidelines, roles and responsibilities and execution and implementation.

Defined contribution schemes – the provision of the statutory annual Chair's statement is becoming increasingly onerous with TPR recently issuing fines where they found statements lacking. An independent assessment of the statement could provide valuable assurance to trustees that their statement is compliant with TPR guidelines.

TPR is ramping up general trustee governance requirements through its 21st Century trustee initiative. An internal audit review to benchmark trustee governance against best practice requirements would give trustees a valuable insight into areas they may need to improve to meet TPR's expectations.

'A well planned and executed internal audit can give trustees early warning of weaknesses in governance and controls.'

Next steps

The final requirements of the IORP in the UK in relation to internal audit will depend on the detailed implementation through the Regulator's codes and guidance which are expected to be developed during 2019. There is no need for trustees to have put arrangements in place to comply with the IORP by its implementation deadline in January 2019. However, shortly thereafter we will start to see how the detail is emerging. In the meantime if you have any questions regarding internal audit and your pension scheme please do not hesitate to contact the KPMG specialists set out on the back of this publication.

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