Chartered Institute of Internal Auditors

Parliamentary briefing:

Protecting Pensions Through Stronger Internal Audit Requirements

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Strengthening internal audit in pension scheme governance

In 2016, the collapse of BHS after 88 years marked the end of one of Britain's great High Street institutions. The company fell into administration, resulting in 11,000 job losses, 167 store closures, and the revelation of serious governance failings, including the absence of an internal audit function. But this collapse did not just cost jobs; it left behind a pension deficit of over £570 million, putting thousands of employees' pensions at risk.

BHS managed its own trust-based pension scheme in-house, a model still used by many large private and public companies. However, unlike outsourced schemes, the companies that run these in-house arrangements, along with some master trust pension schemes, are not always required to have an internal audit function.

Internal audit provides independent and objective assurance both to the pension scheme's trustees and to the board of the wider company, typically reporting into an audit committee made up of independent directors, as recommended in the Chartered IIA's Internal Audit Code of Practice. It can provide assurance on the risks and controls specific to the pension scheme, as well as on broader business-critical risks. If those wider risks are not properly identified, managed or mitigated, and the company fails as a result, the pension scheme may also be put at risk, leaving constituents' pensions exposed.

This briefing outlines why Parliamentarians should support a stronger focus on the value of having internal audit across all pension schemes to help protect constituents' pensions from similar failures.

We urge Parliamentarians to support clearer regulatory guidance requiring large companies that run their own pension schemes to have appropriate internal audit capabilities, helping to strengthen independent assurance, reduce the risk of governance failures, and better protect hard-earned pensions.

Types of pension schemes operating in the UK today:

- **Trust-based occupational pension schemes** are run "in-house" by employers and overseen by trustees. Large organisations such as BT Group and the John Lewis Partnership manage their own pension schemes.
- **Master trust schemes** pool multiple employers into a single arrangement run by an external provider. These include widely used schemes like The People's Pension and NOW: Pensions, which serve millions of workers through automatic enrolment.
- **Contract-based pension schemes** are "outsourced" to financial services providers such as Aviva and Scottish Widows and are regulated by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

Only pension schemes run by financial services companies that fall under the regulation of the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) are required to have an internal audit function as part of their governance framework. This is because it is a requirement of the FCA Handbook and the PRA Rule Book.

By contrast, at present, The Pensions Regulator does not require the companies that run trust-based and master trust schemes that it regulates, even large and complex ones, to have an internal audit function. Internal audit remains optional, leaving some schemes without proper access to the same level of independent assurance of risk, controls, and governance.

This inconsistency creates a regulatory gap. Millions of constituents are in pension schemes run by companies that may lack the level of independent assurance needed for boards and trustees to effectively oversee risks. High-profile corporate collapses of companies that manage their pension funds highlight the real-life consequences of boards and senior management lacking sufficient independent assurance on internal controls and risk management, which an appropriately positioned and resourced internal audit function is there to provide.

Evidence of wider audit & governance weaknesses in the pensions industry

Patisserie Valerie collapsed in 2019 following a significant £40 million accounting fraud[1], leading to the closure of around 70 stores and a loss of over 900 jobs. This collapse disrupted the livelihoods of its employees and left their pensions at risk. The absence of an internal audit function may have meant the company's audit committee and board did not receive sufficient independent assurance that key financial controls and risk management processes were operating as intended. Had Patisserie Valerie had an appropriately positioned internal audit function, it might have identified these weaknesses earlier, recommending potential improvements to the controls used to prevent and detect fraud, in turn potentially reducing the risk to employees' pensions from the company collapsing.

Similarly, BHS had no internal audit function in place, despite the £570 million pension deficit and the scale of its pension arrangements. Sir Philip Green's controversial sale of BHS for £1[2], primarily aimed at avoiding pension liabilities, significantly weakened the pension scheme, leaving thousands of employees facing uncertainty about their retirement income. An appropriately resourced and positioned internal audit function could have flagged business-critical risks to the board earlier and made appropriate recommendations.

Both collapses had a devastating impact on thousands of employees, leaving constituents affected facing uncertainty and financial hardship in retirement. These tangible examples highlight why it is crucial for large employers operating their own trust-based occupational pension schemes to have a robust, independent internal audit function—one that can provide assurance on both the governance of the pension scheme and the wider organisational risks that could ultimately undermine its ability to deliver retirement benefits.

Why having internal audit matters for pension schemes

While the current Code of Practice from The Pensions Regulator rightly stresses internal controls and risk management, it refers to internal audit only 'where it exists,' leaving its use discretionary even in large schemes. This lack of a clear mandate could result in inconsistent oversight and leave some pension schemes' governing bodies without access to the independent assurance that internal audit can provide to help protect pensions.

We believe the inconsistent use of internal audit for different pension schemes in the UK is an issue that needs to be addressed. This is particularly concerning in larger schemes, which typically manage significant pension liabilities and may face more complex governance challenges, potentially warranting stronger oversight. Without an independent internal audit function, the audit committees and boards of these companies may not be receiving sufficient assurance on their business-critical risks, both within the pension scheme and across the wider organisation, which, if unmanaged, could impact the ability of the pension fund to meet its obligations.

Internal audit can provide independent assurance to those responsible for overseeing pension scheme governance, whether that is a company managing its own scheme or a master trust board overseeing a large number of employers' pension arrangements. For in-house pension scheme providers, this helps assess whether risks are being managed effectively and whether key controls

[1] Patisserie Valerie chair cashed out £40m from failed cafe chain, The Guardian
[2] Green's 'main purpose' in BHS sale was to avoid pension liability, says watchdog, The Guardian

are operating effectively. By offering insight on how risks are being managed and where control weaknesses lie, internal audit can play a vital role in strengthening governance and protecting members' pensions.

Aligning regulatory requirements for all pension schemes

Not all pension schemes are subject to consistent internal audit requirements. Companies that run trust-based occupational and some master trust pension schemes are not currently required to maintain an independent internal audit function by The Pensions Regulator. In contrast, the Financial Conduct Authority (FCA) and Prudential Regulation Authority (PRA) require financial services companies providing contract-based pensions or master trust schemes under their remit to establish and maintain internal audit functions as an integral part of their governance framework. As a result, millions of employees' pensions may be subject to weaker internal audit requirements simply because of the type of scheme they are enrolled in and depending on which regulator regulates these companies' pensions.

Addressing this inconsistency would help close the regulatory gap and ensure pension contributors receive a consistent level of protection, regardless of the type of scheme managing their pensions. Aligning The Pension Regulator's Code of Practice more closely with the FCA and PRA rules would also help deliver on Section 249A of the Pensions Act 2004, which mandates that governing bodies of pensions schemes establish and operate an effective system of governance, including internal controls. We believe that a system of governance for internal controls can only be effective and robust with an appropriately positioned and resourced internal audit function that reports into an Audit Committee as recommended in the Chartered IIA's Internal Audit Code of Practice.

Next steps for Parliamentarians

Parliamentarians have an important role in championing stronger internal audit and governance requirements across the pensions industry to help protect pensions and ensure consistent standards.

We urge all Parliamentarians to consider the following actions:

- **Support our call for The Pensions Regulator** to amend its Code of Practice to recommend all trust-based occupational and master trust pension schemes establish and maintain an independent internal audit function as part of their governance framework. This could include writing a letter to the CEO of The Pensions Regulator.
- **Work with us to table parliamentary questions** on the issues we have raised in this briefing and with The Pensions Regulator.

We welcome Parliamentarians' support in helping ensure stronger governance and independent oversight of pensions to better protect pensions and uphold trust in the UK's pensions system.

Contact us

We hope this briefing has highlighted the importance of strengthening The Pensions Regulator's Code of Practice regarding internal controls, internal audit, and independent assurance requirements. For any enquiries regarding this briefing or if you would like to arrange a meeting to discuss how we can further support your work as a parliamentarian, please contact Gavin Hayes, Head of Policy and Public Affairs, at gavin.hayes@charterediia.org.