PENSIONS INCENTIVE EXERCISES CLARIFIED

15 June 2012

Over the course of the last year, the Pensions Minister, Steve Webb, has expressed concerns about some of the "bad practices" associated with pensions incentive exercises offered to members of defined benefit pension plans. He set the pensions industry the challenge of developing a Code of Practice to improve standards and to ensure that members understand any risks associated with incentive exercises.

The voluntary **Code of Good Practice**, which has been endorsed by a wealth of pensions industry bodies and the CBI, was issued last week and will be of interest and relevance to employers, trustees and pensions professionals who are involved in incentive exercises. The Code is made up of seven principles supplemented by information on how to apply those principles. The Pensions Regulator welcomes the Code and intends to support it in its (soon to be revised) guidance. The Code does not have statutory force but the Government will consider legislation if employers do not adhere to it.

Incentive exercises explained

An incentive exercise is an offer made to a member to change the form of his accrued defined benefit pension. The offer generally comes from the sponsoring employer and has the objective of reducing the risk or cost of the pension provision. Common forms of incentive exercises involve enhanced transfer values and pension increase exchanges (which modify the basis on which pension increases are provided).

The Code is directed at specific offers that are targeted at a member or a group of members rather than at options that are routinely available through the pension plan (such as tax free cash).

No cash incentives

The Code says that cash should not be offered to members where this is conditional upon a member accepting the incentive offer. Cash payments or vouchers can be offered to encourage members to engage with the process (eg to meet with a financial adviser) but it should be clear that payment will be made irrespective of a member's decision.

Likewise, modification exercises should not involve a significant immediate lump sum. Backdating a pensions increase exercise for a short period for administrative reasons is acceptable but backdating in order to provide a substantial lump sum is not in line with the Code.

Advice v Guidance

The Code distinguishes the situations in which financial 'advice' should be offered as opposed to financial 'guidance'. Advice should always be offered for transfer exercises. However, for modification exercises, such as pension increase exchanges, guidance can be offered in some circumstances. Broadly, the Code requires a calculation of the value of the additional benefits to be offered compared with the value of the benefits to be given up. This is an aggregate calculation for all members to whom the offer is made, using the actuarial basis that is consistent with cash equivalent transfer value calculations in the pension plan. If the value of the benefits offered is less than 100% of the value of the benefits given up, members must be offered financial advice. If the value is 100% or more, financial guidance may be provided.

It may be difficult for members to understand that 100% or more does not necessarily mean that the offer on the table is in their own personal best interests.

Communications

Communications to members should be fair, clear, unbiased and use plain English wherever possible. Employers should give factual information and should not attempt to influence members. The Code stipulates the minimum information that should be communicated but employers are expected to include additional information where this would be helpful to members.

Allow sufficient time

Members should be given sufficient time to consider the offer and should not be put under any undue pressure. For example, members should normally be given three months to make their decision after receiving the full information about the offer (but this will not always be possible). Such 'consideration time' will need to be built into employers' project plans.

Reporting

The Pensions Regulator is considering whether incentive exercises should be recorded on the annual scheme return. In the meantime, any concerns about a specific incentive exercise should be reported to the Regulator.

Comment

Squire Sanders welcomes the Code of Practice as it will provide helpful guidance for employers who are considering incentive exercises. Readers should note that the Code deliberately does not address the legal responsibilities of parties involved in incentive exercises, nor does it specifically address trustee responsibilities (although there is some comment on this).

It is an interesting development that the Pensions Minister challenged a pensions industry group with producing this voluntary Code. We wonder whether this will prove to be a unique challenge or whether it is the first move by the Government towards more self-regulation by the pensions industry. It remains to be seen how other 'knotty' pensions issues will be dealt with in the future.

Help and information

If you would like more information on the Code of Practice, or legal advice in relation to an incentive exercise, please contact any of the partners listed or your usual contact in the Squire Sanders pensions team.

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