

Inducement offers

This guidance outlines how employers, trustees and scheme members should deal with Inducement offers.

**Our regulatory guidance is designed primarily to be viewed online.
This is a print version of web content as at January 2007.**

www.thepensionsregulator.gov.uk/guidance/inducementOffers/index.aspx

Key points

- An inducement is where an employer offers scheme members a financial inducement to transfer out of a defined benefit (DB) occupational pension scheme or to accept a reduction in benefits.
- This guidance is for trustees, scheme members, managers of DB schemes and employers who sponsor DB schemes. It will also be of interest to independent financial advisers who offer advice in the area of transfers to and from DB schemes.
- Trustees and employers must give scheme members full and proper information so that members fully understand the implications of transferring out of a DB scheme.
- Trustees should consider carefully and apply a high level of scrutiny to all inducement offers.

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Introduction

This guidance relates to inducements or incentives (both referred to as inducements in this guidance) that are sometimes offered by employers to members of DB schemes to persuade them to give up accrued benefits in a DB scheme.

Inducement offers to scheme members tend to be monetary and usually involve:

- an enhancement to a transfer value; or
- a direct cash payment to the member; or
- both of the above.

The Pensions Regulator takes an interest in such inducements because one of our main statutory objectives is to protect members' benefits.

We recognise that employers may have business and commercial reasons for offering inducements to encourage members to transfer out of DB schemes, or to consent to rule changes reducing benefits (such as removing non-statutory post-retirement pension increases), and that such practices do not contravene current legislation. Employers should note, however, the Pensions Regulator's powers to issue contribution notices and financial support directions and should also consider our documents on clearance statements and abandonment.

However, we also recognise that inducement offers create risks for members and issues for trustees.

This guidance, therefore, looks at inducement offers from the perspective of the employer, the trustees and the scheme members, and sets out our recommendations on how to deal with them.

The employer's perspective

Where an employer wants to offer an inducement to try to persuade members to transfer out of its DB scheme, it is generally because the employer believes that the cost of the cash equivalent transfer value plus the inducement is less than the retained liability and/or associated costs in managing that liability. In other words the employer believes that the inducement represents a financial saving to it.

Similarly, where the inducement offer is made to a member in return for agreement to give up non-statutory post-retirement pension increases under a DB scheme in return for a cash payment from the employer, the employer is generally making the offer because this represents a financial saving to it.

Other motivating factors can include avoiding volatility in future contributions (rather than absolute costs), administrative cost savings, and achieving changes in scheme design.

The trustees' perspective

For trustees, issues raised by inducement offers relate to trust law (s67 of the Pensions Act 1995) and the Data Protection Act.

Trustees' fiduciary responsibility to act in the best interests of scheme members under trust law might cause them to question or challenge the appropriateness of an inducement offer, when they become aware that the employer is contemplating that kind of exercise.

Trustees will be aware that members face a complicated financial decision and it is important to ensure that members are given all the information they might reasonably need to be able to make an informed choice.

Modification of scheme rules

There may also be protections under scheme rules and s67 of the Pensions Act 1995 for the trustees to take into consideration. When the inducement offer is made to a member who is being asked to give up an entitlement to certain accrued benefits through a modification of scheme rules, the trustees must ensure that the provisions of s67 are complied with (in particular s67E - the trustee approval requirement, and the informed consent requirements).

Data protection

It is likely that, before an employer is able to approach deferred members with an inducement offer, the employer will need to obtain contact details from the trustees and details of members' benefits.

The Data Protection Act will be relevant here as the trustees will need to consider whether they should make those details available to the employer.

The trustees should ask why the employer is asking them to release that information and on becoming aware of an inducement exercise they should also ask to see details of the proposed inducement offer. The trustees should then be able to form their own view about whether the offer represents good value and whether or not they will co-operate with the employer.

The trustees therefore might want to take their own legal and financial advice about the merits of a particular inducement offer and the trustees' exposure to legal liability before providing information to an employer which may help the employer to go ahead with an inducement offer.

Independent financial advice

Trustees should also ensure that where an offer does go ahead members are made aware of the importance of taking independent financial advice. And trustees should check that that message comes out strongly in the employer's inducement offer. Where the employer has not offered to meet the cost of this advice, trustees may want to seek to persuade the employer to do so, but in a way that does not compromise the independence of that advice.

Where, after the event, the trustees become aware that an employer has made an inducement offer and the trustees take the view that the inducement offer may not be in the best interests of members, the trustees should think seriously about issuing their own announcement to those members to whom the offer was made to highlight the risks for those members.

The member's perspective

A member who is offered an inducement to either transfer out of a scheme, or agree a rule change leading to a reduction in benefits, can be faced with a complicated financial decision.

For example, in the case of an inducement to transfer, the member will probably need to consider:

- whether the transfer value that he or she is offered represents good value for their DB scheme benefits;
- the type and likely amount of benefits the transfer value will secure under the scheme to which it is paid and the likelihood of those benefits being provided; and
- the value to the member of the cash inducement.

In the case of an inducement to accept a reduction in benefits, the member will need to consider the cash inducement offer compared to the value of the benefits given up.

Risk

The member's attitude to risk will also be an important consideration. Where the inducement is to transfer, the member may often be faced with a choice where the proposed transfer is from a DB scheme to a defined contribution (DC) scheme (also known as money purchase).

Benefits housed under a DB scheme enjoy the protection afforded by the strength of the employer's financial covenant, the employer debt legislation and regulations made under that, and the Pension Protection Fund. That protection would fall away under a DC scheme.

A member contemplating an inducement offer may therefore also be faced with a decision about moving from a low-risk environment where much of the risk associated with investment is borne by the employer, to a high-risk environment where the member bears all of the risk.

A member therefore has to take an overall view about the value of any inducement offer and about the financial risks involved.

Independent financial advice

A member might also want to consider what the State scheme and the social security system might provide and factor that into their decision making. Given the complexity, we strongly recommend the member taking independent financial advice.

The tax treatment of an inducement payment may also be a consideration for the member. Again, an independent financial adviser may be able to help.

Important considerations

The Pensions Regulator would be concerned to see members disadvantaged by inducement-led transfers out of DB schemes or benefit reductions.

Nevertheless, we want scheme members to retain responsibility for their own financial decisions where those decisions impact their DB scheme benefits.

It is important, therefore, that members are given enough information to be able to make an informed choice about an inducement-led activity.

The pensions community should consider the following carefully when inducement offers are proposed.

1. Trust law and data protection

Employers are likely to need to approach the scheme trustees to obtain members' names, addresses, details of the accrued benefit entitlements, cash equivalent transfer values and other personal information.

Trustees should think carefully about their fiduciary responsibilities before deciding whether or not they think it would be in the interests of members to assist an employer in offering inducements.

Trustees should also be mindful of the data protection legislation and be satisfied that they would not be breaching that legislation if they were to release any personal information about

members for this purpose. These are both areas where the trustees might consider taking appropriate advice.

2. Scheme funding

DB schemes are progressively moving to the scheme funding regime of the Pensions Act 2004, with all schemes needing to have completed their first valuation by the end of 2009. Under the new regime, schemes are required to establish a prudent reserve for accrued benefits, and if not already funded to that level, to have a plan in place to get there within a limited period.

Where a transfer inducement is being offered and the scheme is in deficit, the offer should say when the trustees expect the scheme to be in a position to offer full, unreduced, cash equivalent transfer values, and the amount of the reduction.

The information the trustees provide for the employer must state if a transfer value has been reduced because of underfunding, giving an estimate of the date by when an unreduced transfer value would be available.

Further, if an employer is designing an inducement offer in a way that would mean the transfer value the scheme pays is greater than it would have paid if there had been no inducement (that is, it is more than the cash equivalent), then there could be an immediate reduction in the security of the benefits of the remaining members. This could then give rise to additional scheme funding considerations for the employer and the trustees, particularly if the scheme does not satisfy the statutory funding objective. However, it would be unusual for trustees to agree to pay an enhanced transfer value if there is no associated payment into the DB scheme from the employer.

3. Communications and independent financial advice

Where an employer proceeds with an inducement offer, the offer should be clearly expressed. It should:

- explain the nature of the benefits being given up in exchange for the inducement. In particular, where inducement-led reductions in pension increases are involved, it should explain the potential loss in inflation protection;
- explain, where a transfer out of a DB scheme is involved, that the scheme which accepts the transfer value may not provide the same level of benefits;
- explain, where a transfer out of a DB scheme is involved, the risks inherent in and the guarantees offered by the member's DB scheme. This should cover the risk of employer insolvency, the protection afforded by scheme wind-up legislation and the Pension Protection Fund (PPF). It would also be helpful if members were given an indication of the likely cost of replicating the PPF level of benefits;
- explain, where a rule change leading to a reduction of benefits is involved, the likely cost of making good the lost benefit;
- explain that there may also be tax implications for the member if he or she accepts an inducement payment;
- recommend that the member takes independent financial advice before making any decision about the possible transfer-out of his or her benefits from the DB scheme;
- specify the amount of the inducement being offered to the particular member concerned;

- say whether the inducement is a cash payment (and if so how and when it will be paid), an increase to the transfer value that would otherwise be paid by the scheme, or a combination of these, and if the member is able to pick and choose from these options;
- say if the amount of the inducement is affected by any member choice (for example, if the member chooses to accept a cash inducement instead of an enhancement to the transfer value);
- say how long the offer will be open;
- say why the employer is making the offer. It would be helpful if the impact that acceptance would have on the employer's accounts could be quantified in relation to the particular member concerned; and
- make clear that the member does not have to accept the offer and that the member may retain his or her benefit entitlement under the scheme. The communication to the member might also usefully mention that there is very little consumer protection available to the member under the law with this type of financial transaction.

How to deal with inducement offers

Employers

Whenever an employer is contemplating an exercise to offer an inducement to members then, in addition to any separate messages of its own, its communications to members should include the key messages outlined in 'Communications and independent financial advice'.

Trustees

Whenever the trustees of a DB scheme become aware that the employer is contemplating, or has begun, an exercise to offer an inducement to members, the trustees should check the employer's communications material for the key messages described in 'Communications and independent financial advice'.

If any of the key messages are missing the trustees should point this out to the employer. Trustees should also consider issuing their own communication to members to ensure the key messages do reach members who are then able to make a more informed decision.

Trustees do, however, need to take care that they do not find themselves giving financial advice to members if they are not authorised to do so.

Trustees have a fiduciary responsibility to act in the best interests of scheme members under trust law and they should consider if that causes them to question or challenge the appropriateness of an inducement offer. For example, trustees should also consider the impact of the use of employer resources in this way on the funding plan relative to improving the funding of the DB scheme directly.

Trustees should also bear in mind the data protection aspects before they agree to release members' personal information to an employer for use in an inducement exercise. Again, trustees might find it helpful to take their own legal advice.

Members

In all communications about transfers or benefit reduction exercises members should be reminded about the importance of taking independent financial advice. This is particularly important when an inducement offer is involved.

If members receive any communications from the employer about transfers or benefit reductions they should always check to see if it includes a reminder about the importance of taking independent financial advice.

Where an inducement offer is involved, before making any decisions members should consider checking with the scheme trustees if they are aware of the inducement offer having been made. Members should also ask the trustees if the employer consulted them before the offer was made.

Where the employer has chosen not to consult the trustees, or the trustees have decided not to be associated with the offer, the member might also want to take that into consideration before making a decision about whether or not to accept any offer.