

Incentive exercises

Introduction

An incentive exercise (IE) is where an employer connected to a defined benefit (DB) scheme seeks to reduce risk or cost associated with this DB scheme by offering members the option to transfer out of the scheme or modify their benefits. This statement is addressed to employers considering an IE, the trustees of the affected DB schemes and those who advise them.

It does not cover proposals to close a DB scheme to future accrual or other modifications which only affect the future accrual of benefits. However, our statement: **'Employer duty to consult on scheme changes'** may be relevant.

The regulator's view of incentive exercises

The Pensions Regulator (the 'regulator') has long taken an interest in IEs because of our statutory duty to protect members' benefits.

Members may be disadvantaged by IEs. Poor choices can have an adverse effect on the amount of a member's pension. This is especially so if the IE is not conducted in a manner which ensures that it is likely that most of the members will make properly informed choices. In response to these concerns, we first issued detailed guidance with regard to IEs in January 2007, and this was most recently updated in December 2010.

'Poor choices can have an adverse effect on the amount of a member's pension.'

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Industry code

In response to concerns about the conduct of IEs, in June 2012 the pensions community's Industry Working Group produced 'Incentive exercises for pensions: a code of practice' (the 'Industry code') (www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/incentive-exercises-industry-code-of-practice) and 'Incentive exercises for pensions: boundary examples and other examples' (www.tpr.gov.uk/-/media/thepensionsregulator/files/import/pdf/incentive-exercises-industry-code-examples) setting out good practice for IEs. This approach is well aligned with our earlier guidance. For these reasons we support the **Industry code** and the accompanying practitioners' notes. We commend employers and their advisers to follow the good practice set out in the **Industry code**. Trustees should also be mindful of the **Industry code** in the exercise of their duties. The regulator will have regard to the **Industry code**, wherever relevant, in the conduct of any regulatory proceedings relating to IEs.

Because of the alignment between the **Industry code** and our approach, we consider that our December 2010 guidance can be significantly curtailed. However, the concerns we have expressed with regard to IEs remain – we believe that the principles contained in our December 2010 guidance are still relevant. We have, therefore, withdrawn the more detailed guidance and replaced it with this statement focusing on the regulator's principles and views.

'We commend employers and their advisers to follow the good practice set out in the Industry code.'

Risks associated with incentive exercises

Where a member accepts an IE offer, an employer's pension liability or risk is likely to be reduced. Conversely, for members the risk that they will suffer a loss in the long run will usually increase if they accept an offer. Losses could be due to factors specific to the individual (eg life expectancy or investment choices) or the overall economic and market environment in future. An IE offer is often set at below 'cost-neutral' terms in order to reduce an employer's pension liabilities, and in this situation there is a heightened risk that members will be worse off.

A minority (and, very possibly, a small minority) of members may have personal circumstances which result in them being in a better position through accepting an IE offer

IE offers can create risks for trustees and employers as well. These include legal and reputational risks materialising many years after the IE has taken place.

IEs can be costly. There is the cost of the incentive itself. Also there is a cost to obtaining advice (legal, financial, and actuarial). Designing IEs to meet appropriate standards (including those in the **Industry code**), can present significant challenges which come with a cost implication.

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Trustee role

The **Industry code** refers to the need for all parties involved in an IE to ensure that they are aware of their roles and responsibilities. It does not address trustee responsibilities in detail, but recommends that they obtain advice, where necessary. Trustee responsibilities fall within the regulator's remit.

Trustees should start from the presumption that IEs are not in most members' interests. Therefore they should approach an IE cautiously, making sure they understand the extent of their legal obligations (including under legislation, trust law and their scheme's governing documentation). This will involve taking advice, where necessary, and acting in accordance with these obligations. To discharge these obligations trustees will need to ensure they fully understand the IE and its structure as well as how it achieves the level of good practice recommended in the **Industry code**. Trustees need to pay attention to the requirement for them to act fairly in relation to the members, including between any members transferring out and those remaining in the scheme; and to the impact on their scheme's funding position.

Trustees should also:

- **Engage** – Not only should an employer consult with the trustees when considering an IE, the trustees should actively engage with the proposal from the start to so that members are properly informed and treated fairly. Sound internal controls should inform trustees of potential IEs through increased data requests from third-party advisers.
- **Manage conflicts** – See our conflicts guidance for more information.
- **Be aware of and meet their data protection duties**
- **Consider the funding impact** – There are potential implications for the strength of the employer's covenant to the scheme (and its ability to fund the scheme) where its capital is used for an IE. See our monitoring employer support guidance and the scheme funding code of practice for more assistance.

Trustees are not expected to make the member's decision for them, and they should be careful not to advise members where they are not authorised to do so.

Where trustees are unable to resolve concerns with the employer in relation to an IE, they may wish to refer the issue to the regulator or Pensions Ombudsman.

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The regulator's role

The regulator will investigate reports of cases where behaviours give us cause for concern. Where appropriate we will consider the use of our powers. Examples of issues that would concern us include:

- Selective offers to certain scheme members which are seeking to advantage one section of membership over another
- Any attempt to exploit the protection of the **Pension Protection Fund (PPF)**
- Funding exercises in a way that could have an adverse effect on the employer's ability to fund the scheme deficit (and any future deficit) in accordance with the existing recovery plan
- Coercing or placing undue pressure on members to transfer or give up their benefits.

Where an IE warrants review by the regulator, this review will take into consideration the trustees' involvement in the exercise. Where the regulator has concerns as to the ability of the trustees to act in accordance with their trustee duties and to demonstrate sufficient knowledge and understanding, this may result in a much wider review of the general administration and governance of the scheme. Where significant concerns exist in this area, the regulator has powers to intervene (such as the removal of trustees or the appointment of an independent trustee).

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The regulator's principles

We expect our principles to be the minimum standard by which exercises would be conducted:

Principle 1: Clear, fair and not misleading

An offer should be made in a clear, fair and not misleading way, to enable members to understand the implications and make decisions that are right for them.

Principle 2: Open and transparent

The offer should be open and transparent, so that all parties involved in the process are made aware of the reasons for the exercise and the interests of the other parties.

Principle 3: Manage conflicts of interest

Conflicts of interest should be identified and appropriately managed in a transparent manner and, where necessary, removed.

Principle 4: Trustee consultation

Trustees should be consulted and engaged from the start of the process, with any concerns arising through the exercise alleviated before progressing.

Principle 5: Independent financial advice

Fully independent and impartial financial advice should be made accessible to all members and promoted in the strongest possible terms. In almost all circumstances, the structure of the offer should require that members take financial advice. In some circumstances (such as some Pensions Increase Exercises) financial advice may not be required; however, the structure of the offer should provide detailed guidance instead.

If conflicts are appropriately managed, trustees are engaged throughout the exercises, and the principles in the **Industry code** are followed, then exercises should fulfill and be consistent with our principles.

We will review the information that is produced by the **Industry code's** monitoring body on adherence and standards under its code, and keep our position under review.

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Statement from The Pensions Regulator

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