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BBS briefing note

Code of Practice for Incentive Exercises

A pension industry Working Group has recently issued a Code of Practice setting out good practice principles to be followed in all incentive exercises undertaken in defined benefit pension schemes.

The Code aims to ensure that incentive exercises are undertaken in a responsible manner, to ensure that scheme members are able to make informed decisions and better choices.

Although the Code is voluntary, its principles are supported by the Pensions Regulator, the Department for Work and Pensions and the Financial Services Authority and it is hoped that employers will apply the spirit of the Code in all future incentive exercises.

This *BBS briefing note* summarises the Code.

BACKGROUND

An incentive exercise involves an inducement or an offer being made to pension scheme members to modify their accrued defined benefit entitlements or transfer out of the scheme.

To be considered an incentive exercise, one objective must be to reduce risk or cost for the pension scheme or employer. In addition, the enhancement or inducement must not ordinarily be available to members.

The Code covers two types of pension incentive exercise:

- Transfer Exercises - where members are offered an enhanced transfer value or another inducement to transfer out of the scheme; and
- Modification Exercises - including pension increase conversions, where members give up future pension increases in exchange for a higher initial pension.

Although such exercises can be a legitimate tool to help employers manage scheme liabilities, there has been widespread concern that members of defined benefit

schemes are being encouraged to give up valuable benefits for less valuable ones. In 2011, the Pensions Minister, Steve Webb, called for improvements in the way that incentive exercises are conducted.

In response, an industry wide Working Group was established to prepare a Code of Good Practice, to improve protection for members and reduce the chances of a widespread mis-selling scandal.

THE OBJECTIVES OF THE CODE

The Code aims to ensure that all incentive exercises are:

- carried out fairly and transparently;
- communicated in a balanced way and in terms that members can understand;
- available with appropriate financial advice, paid for by the employer;
- able to achieve high levels of member engagement; and
- provided with access to an independent complaints and compensation process.

THE PRINCIPLES OF THE CODE

The Code sets out seven principles, as follows:

- 1) No cash incentives should be offered that are contingent on the member's decision to accept an offer. "Cash" includes anything that is not a pension benefit, for example, cash, goods and services.
- 2) Independent advice, paid for by the employer, should be provided to the member. Adviser remuneration should not be related to take-up rates or include commission.
- 3) Communications with the member should be fair, clear, unbiased and straightforward.
- 4) Records should be retained by all parties involved so that there is an audit trail that can be examined in the future. This includes recording, and reporting to all other parties, members who take action that is contrary to that recommended by an adviser. Record-keeping will help to protect all parties from



- future challenge and reputational damage, and will also assist in resolving any disputes or complaints.
- 5) Exercises should allow sufficient time, at least three months from receiving final information, for members to make their decision, with no undue pressure applied. In addition, a two week cooling off period should apply from the point a member returns their option forms.
 - 6) Exercises should only include pensioners over the age of 80 on an "opt-in" basis. In respect of members who might be particularly vulnerable by virtue of age, health, understanding etc, advisers should adhere to the requirements set out by the Financial Services Authority.
 - 7) All parties involved should ensure that they are aware of their roles and responsibilities and act in good faith in areas over which they have direct control. Employers should engage with the scheme trustees at an early stage.

The Code includes details of how the principles should be applied and the Working Group has also produced Practitioner Notes, providing examples of good practice and commentary, to ensure that advisers are clear on what is expected of them.

Whilst the Code is voluntary, the Pensions Ombudsman and the Financial Ombudsman Service will have regard to the Code when dealing with incentive exercise complaints.

MONITORING OF THE CODE

An independent Monitoring Body will be set up to maintain the Code, review its effectiveness and recommend legislation if necessary. Indeed, Steve Webb has not ruled out future legislation on incentive exercises if employers fail to voluntarily follow the Code.

The Monitoring Body will not, however, have an advisory role, i.e. they will not clarify what is meant by the Code or confirm whether specific actions are in line with the Code.

THE PENSIONS REGULATOR'S STATEMENT

Following the publication of the Code, the Pensions Regulator has replaced its 2010 Guidance on incentive exercises with a short statement, focusing on the role and responsibilities of trustees. The statement stresses that trustees should start from the presumption that incentive exercises are not in most members' interests.

Trustees should act fairly in relation to all members, consider the impact of the exercise on the employer covenant and take advice where necessary.

The statement confirms that the Regulator will investigate reports of poor practice and use its powers where appropriate.

BBS VIEW

Incentive exercises can be of benefit to both members and scheme sponsors, but only if they are carried out properly. We, therefore, support the introduction of the Code of Practice.

Whilst the principles-based Code provides employers some flexibility in how they deliver their incentive exercise, the Code includes a host of good practice requirements which, if followed, will restrict the scope of such exercises in the future.

Our concern, however, is whether a voluntary Code will materially alter the approaches taken by those involved with exercises that fall short of the principles laid out. It is also unclear whether the Monitoring Body will be effective in identifying those exercises that fall below the desired standards.

At BBS we will continue to take a holistic view with our clients regarding their defined benefit arrangements, bringing together investment and funding strategies including risk reduction strategies as appropriate.

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