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## BBS factsheet

### Enhanced transfer and incentive exercises to reduce pension scheme liabilities

#### KEY POINTS

- This factsheet is primarily aimed at employers with defined benefit schemes. It provides a basic introduction to the issues involved in undertaking exercises designed to reduce liabilities by offering members incentives to transfer to another arrangement or otherwise reduce benefits ('incentive exercises').
- Incentive exercises have been under close scrutiny from both The Pensions Regulator and the FSA. Consequently, any exercise needs to be undertaken carefully and in compliance with regulatory guidance.
- Our view is that such exercises are best targeted towards members for whom an offer is most appropriate and likely to be taken up. This requires careful analysis of a scheme's benefits, membership data and liability valuations.
- Employers need to work in close co-operation with the pension scheme trustees during any incentive exercise and need to pay careful attention to all potential advisory costs in assessing its viability.
- BBS can help employers assess whether there are opportunities to reduce scheme liabilities using an incentive exercise and can help manage the entire project in a cost-effective manner.

#### INTRODUCTION

For understandable reasons, many employers running a defined benefit scheme see it as a headache and a significant source of risk to their business. To list just some of the key problems facing employers:

- Employers have been faced with an increasingly stringent funding regime in recent years, with a much more hands-on regulator, and trustees being encouraged to view the pension scheme deficit as an unsecured loan to the sponsor and to negotiate more aggressively.
- Investment markets in the last ten years have often not moved in the right direction for schemes, with growth assets such as equities struggling to keep pace with bond-related liability valuations.
- Employers who wish to wind up their arrangement cannot do so without meeting the cost of securing their scheme's liabilities with an insurance company – generally a prohibitively expensive option.
- The majority of employers are required to recognise a volatile market-based assessment of their pension scheme costs and liabilities in their accounts.



Unsurprisingly, in recent years employers have considered a variety of ways to manage or reduce their liabilities. One such approach is to incentivise members to amend their benefits or transfer them from the scheme. The most common incentive exercises have been:

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| <b>Enhanced transfer exercises</b> | Members are offered an uplift to the standard transfer value payable, possibly with an additional cash incentive payable immediately. |
| <b>Benefits 'buy-offs'</b>         | Members are offered an immediate cash incentive to give up certain benefits, e.g. non-statutory future pension increases.             |

In some cases, employers have been given specific finance from their bankers or other backers to attempt to reduce their liabilities, possibly in conjunction with a wider plan to move the scheme to a position where it might be wound up.

However, such approaches have attracted a significant amount of scrutiny and guidance from both the Pensions Regulator and the Financial Services Authority ('FSA'), whilst HMRC has clamped down on certain tax advantages available from such exercises. The concerns expressed by The Pensions Regulator and the FSA in a joint statement of July 2010 and the guidance subsequently issued by The Pensions Regulator in December 2010 should be considered seriously by employers and their advisers before embarking on any incentivised plan to reduce liabilities. Only recently, the current Pensions Minister, Steve Webb has warned the pensions industry that the Government may take steps to further restrict or even ban incentive exercises.



## REGULATORY GUIDANCE

The Pensions Regulator ('the Regulator') has expressed concerns regarding the implementation of incentive exercises over a number of years. Its most recent guidance, issued in December 2010, was sceptical about the benefit of such exercises to members. The key points made by the Regulator were as follows:

- Incentive exercises may disadvantage scheme members and cases for which it can be clearly demonstrated that the offer is advantageous are likely to represent a relatively small sub-group of the membership.
- In considering their responsibilities with respect to an offer, trustees would be expected to assume that such exercises are not generally in members' interests and to proceed in an appropriately cautious way.
- High quality and fully independent financial advice should be made available to members receiving an offer. In particular, incentive exercises should generally be structured so that an offer should not be finalised before members have received such advice.
- Member communications should be presented in a transparent and appropriate way and no pressure should be placed on members to accept an offer.
- Trustees should be highly engaged with the process to ensure that members' best interests are served. This will include reviewing the nature of the offer, the communications used and the appropriateness of the advisers and their remuneration structure.

The FSA, in conjunction with the Regulator, had, in July 2010, separately warned financial services companies who might become involved in providing advice to individuals in relation to incentive offers, that:

- Advice given to individuals should take account of their personal and financial circumstances and the fact that a particular offer satisfies FSA financial tests should not, in itself, be taken as being sufficient to provide a recommendation to proceed.
- Conflicts of interest need to be recognised and appropriately managed. In particular, advisers to individuals should be separate from those advising the employer on the exercise and remuneration structures should not be linked to the number of members that accept the offer.

Taken alone, the above headlines may be enough to put off employers from considering an incentive exercise. However, in our view, the guidance actually provides a useful focus for employers and advisers considering such exercises. In particular:

- The guidance does not rule out the feasibility of incentive exercises – rather it suggests that such exercises should be better targeted towards members who might benefit from an offer. Such members may also be those for whom the benefit to the employer may be greatest (often having larger liabilities).
- The exercise needs to be undertaken properly, with due care and diligence. This will protect the employer, the trustees and the members concerned.



## WHEN MIGHT INCENTIVE EXERCISES BE VIABLE?

For a financial adviser to recommend acceptance of an incentive offer they will need to be satisfied that the offer is in the best financial interests of the member. This can be assessed using particular financial tests, set out by the FSA. In addition, an adviser would also need to consider the wider personal and financial circumstances of an individual before making a recommendation to accept.

Some of the circumstances in which an incentive exercise may be viable are outlined below:

|  |   |
|--|---|
| <p><b>Weak employer covenant</b></p>                   | <p>An enhanced transfer or incentivised reduction in benefits may be in members' interests where there is a relatively weak employer covenant (and there is a material risk that the scheme could enter the Pension Protection Fund (PPF) in the medium term) but its financial backers are willing to provide finance for an incentive exercise.</p> <p>Members could benefit in these circumstances if the offer is such that the overall value of the package is both appropriate given the level of a member's benefits and is also greater than the value of compensation benefits that would otherwise be payable under the PPF.</p> <p>This may be of particular relevance to members whose scheme benefits are far in excess of PPF compensation benefits and who would lose out significantly on the scheme's entry to the PPF. This group may include senior employees with pensions in excess of the PPF compensation cap.</p> |
| <p><b>Scheme overprovides for individual needs</b></p> | <p>For members who have reduced life expectancy or no spouse or dependants, it can be argued that a defined benefit scheme overprovides for their needs. Taking an enhanced transfer value, for instance, may be advantageous for such members as the part of the transfer value relating to unnecessary benefits can be used to provide additional benefits for the member.</p>  |
| <p><b>Sophisticated investors</b></p>                  | <p>Certain individuals, who may also have a wider range of investments and pension arrangements, may take the view that they would prefer to have direct control over their pension assets via an individual arrangement. Consequently, an enhanced transfer value or the release of capital from their pension fund via a buy-off may be justifiable for such members.</p>   |

The above examples again illustrate the fact that incentive exercises will typically be appropriate for a subset of a scheme's membership. Consequently, the identification of possible candidates for an offer and the financial impact if those members accept is a crucial part of any proposed exercise.



## HOW WOULD AN EMPLOYER SET AN OFFER?

The form and size of any offer will depend on the specific circumstances of the scheme and the members being targeted. Ultimately, it is a commercial decision based on the cost of the offer compared to the potential benefit to the employer. Examples of some of the key issues to consider are given below. The issues are based upon the most popular form of incentive exercise – enhanced transfer values – but the ideas also carry across to benefit buy-offs.

### *Enhanced transfer values – illustration of issues to consider in setting the offer*

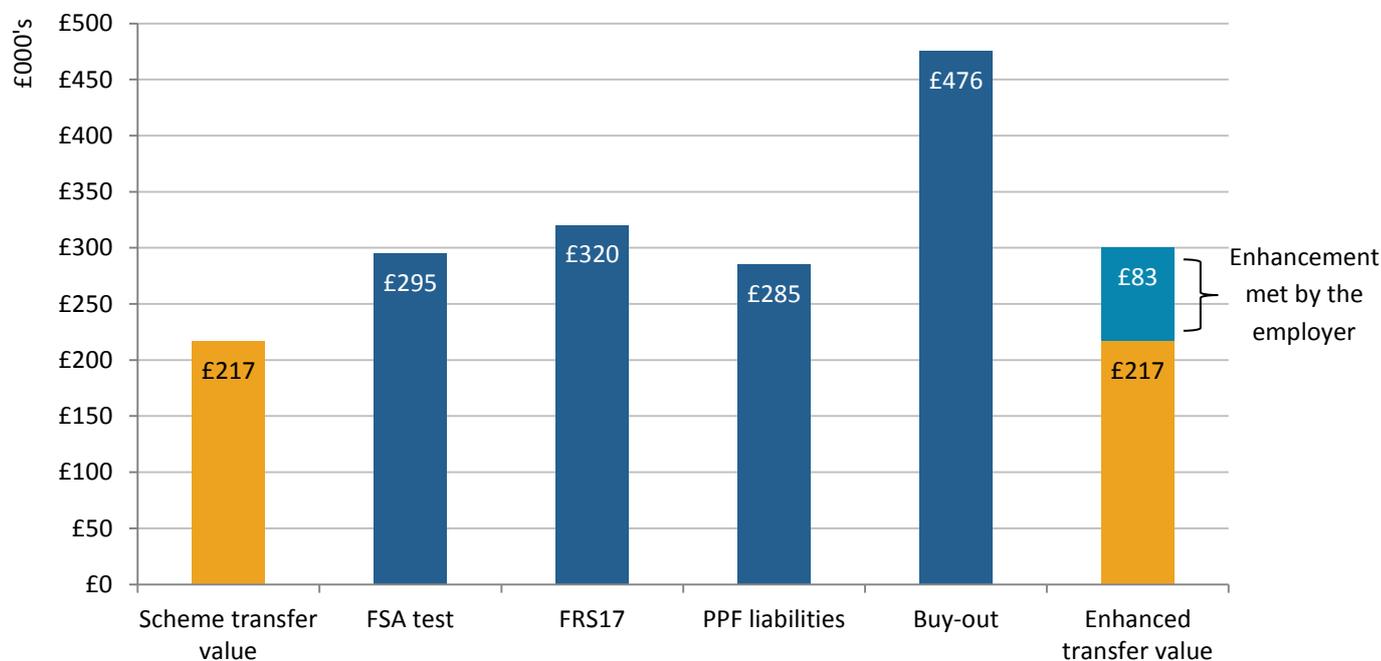
|  |  |
|--|--|
| <p><b>How are transfer values currently calculated?</b></p>                          | <p>The trustees of the scheme will have responsibility for setting the assumptions used to calculate transfer values and determining if they are paid at a reduced level to allow for any underfunding. This calculation will form the core amount payable from the scheme's assets, above which any enhancement is then paid by the employer.</p>   |
| <p><b>What level of transfer value would be required to pass FSA tests?</b></p>      | <p>As noted in Section 3, the FSA sets certain financial hurdles that a transfer value is measured against in determining whether it is of reasonable value. The enhanced transfer value would typically need to be at least as high as the amount required to meet this test.</p>   |
| <p><b>What funding measure is the employer concerned about?</b></p>                  | <p>Some employers may be focused on reducing the cost of buying out their scheme's liabilities, others may instead be concerned about managing their accounting liabilities (e.g. under FRS17). If an employer is more focused on reducing buy-out liabilities, it may be prepared to provide a higher incentive than if it wishes to reduce the (generally) smaller accounting liabilities.</p> |
| <p><b>To what extent are members' benefits covered by their transfer values?</b></p> | <p>If members' (enhanced) transfer values are in excess of the buy-out value of the PPF compensation benefits that would be payable to them, this could act as a valid incentive for them to transfer – particularly if there are concerns regarding the employer covenant.</p>  |
| <p><b>What is affordable?</b></p>  | <p>The greater the enhancement offered, the more likely it is that the offer will be accepted. However, the employer will clearly have constraints on what may be affordable. The employer will also need to consider the cost of conducting the exercise, which may be significant.</p>   |

It is evident that any employer considering an offer would need to consider assessments of the value of the member's benefits under a range of different actuarial measures in order to arrive at the transfer offer.



The following chart illustrates how these funding measures might compare for a 45 year old male with a deferred pension of £20,000 per annum and how the enhancement to the transfer value might be arrived at.

#### LIABILITY MEASURES THAT NEED TO BE CONSIDERED TO DETERMINE ENHANCED TRANSFER FOR A 45 YEAR-OLD



In this hypothetical example, the enhanced transfer value offer for the member has been set as £300,000, the reasons being:

- The offer of £300,000 exceeds the amount required to pass the FSA test.
- It is less than the corresponding FRS17 liability of £320,000, which would lead to a funding gain of £20,000 under FRS17 if the offer were accepted.
- The amount exceeds the buy-out value of the member's PPF liabilities, meaning that the member should be able to secure higher benefits in the market than those that would be payable to him if his sponsoring employer became insolvent and the scheme entered the PPF.
- The amount is less than the £476,000 cost of securing the members' full liabilities in the market, meaning that, if accepted, the offer would improve the scheme's solvency on buy-out by £176,000.
- It is assumed that the enhancement to the scheme transfer value of £83,000 is affordable from the employer's perspective (or otherwise from its financial backer's perspective).

The above example illustrates that the determination of an appropriate offer to members requires careful actuarial analysis.



## DEALING WITH THE TRUSTEES

In order to successfully progress any incentive exercise, an employer will need to work with the pension scheme trustees closely and constructively. Some of the key concerns the trustees might have are:

- Is the offer viable from the perspective of the scheme's trust deed and rules?
- Is the offer reasonable and fair to members?
- What impact will the acceptance of the offer have on the security of the benefits remaining in the scheme?
- Could the money be better used to fund scheme benefits as an additional contribution?
- Are the communications to members transparent and not misleading?
- Will the company provide adequate and appropriate financial advice to members?
- Will the company pay for the trustees' advisory and administration costs in undertaking the exercise?

Any employer undertaking such an exercise should obtain an accurate assessment of both the trustees' and its own costs, so that these can be factored into the assessment between the analysis of the costs of the exercise and its potential benefits.

## HOW BBS CAN HELP EMPLOYERS

BBS's experienced actuarial and consultancy team can help employers analyse their membership data and benefit structures to identify possible opportunities for reducing their liabilities, including the determination of appropriate offers to members.

Because we work closely with a wide range of trustee clients, we understand their requirements and can anticipate potential problems that might arise from their perspective (and the likely costs involved).

We have particular expertise in drafting communications to members that are easily understandable but explain complex ideas and demonstrable project management skills to see the exercise through on time and on budget.

Please contact Jude Bennett (details below) if you need more information on how we can help.

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