Institute and Faculty of Actuaries

Professionalism Resource Material

Enhanced Transfer Values

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Member Incentive Exercise

Ethical issues around member incentive exercises were debated at the autumn series of “Current Issues in Pensions” (CIPs) seminars. This article reflects on the debate.

Background

Member incentive exercises vary in detail and each needs to be assessed in the light of its specific circumstances.

In a typical enhanced transfer value exercise the sponsoring employer of a defined benefit scheme offers members an incentive, on top of the standard transfer amount, to transfer their benefits into another pension arrangement. These incentives could be in the form of an enhancement to the transfer value or an immediate, taxable, cash payment, or a combination of both (noting that the Pensions Minister, Steve Webb, has voiced his view that cash payments should not form any part of such an offer). Transfers will usually be to a defined contribution arrangement, so a member accepting an offer swaps defined benefits underwritten by the scheme sponsor for benefits that depend on investment performance and the cost of buying an annuity. With good investment performance such a member may end up with a higher pension. However, the transfer of risk from the employer to the member means that, in the pursuit of required investment returns, the individual is exposed to investment risk and to the risks associated with the variable prices of annuities, and so could end up with a lower pension.

A pension increase exchange is where retired members of a defined benefit scheme are offered an increased pension in lieu of future pension increases. These exercises potentially raise some extra issues - comments at the CIPs seminars observed that IFA involvement was less prevalent in these exercises, despite the guidance from the Pensions Regulator, which centres on the following five principles:

- The offer should be clear, fair and not misleading
- The offer should be open and transparent
- Parties involved should identify and manage any conflicts of interest that arise
- The company should engage the trustees at the outset, and consult the trustees on the process
- Members should have access to independent financial advice.

The roles actuaries play

Actuaries have no statutory role in these exercises, but without the work of actuaries the majority would not get off the ground. So whilst actuaries don't determine whether an incentive exercise should proceed, their advice is key, and in the court of public opinion we are unlikely to be exempt from criticism if an exercise is not judged a success. Hence, we must be conscious of our professional responsibilities, as articulated in the Actuaries' Code. Particular considerations are:

- What public interest issues arise?
- Who is the client?
- What is the scope of the exercise, are there any limitations on the advice to be given by the actuary, and have the parties who can rely on the advice been identified?
- Is due regard being given to the members of the pension scheme who may be affected by the advice?
- Have potential conflicts of interest been identified and addressed?
- How will advice be communicated and, particularly where the advice is made available to other parties (for example, trustees or pension scheme members, where the actuary is acting for the employer), is the communication clear?

The role of the scheme actuary is significant. The guidance from the Pensions Regulator recommends trustee involvement in any proposed exercise at an early stage. Without help from the scheme actuary it is unlikely that the trustees will be able to fully interrogate and assess any proposals from the employer. The scheme actuary can create a framework to test potential outcomes, at the individual member level and at pension scheme level, to help trustees form an objective view whether, and in what circumstances, any proposal might not be in members' interests.

Alternative views

Some members of the profession hold the view that member incentive exercises are initiated to save the sponsoring employer money or transfer risk, and so are usually to the detriment of members. The Pensions Regulator's guidance to employers and trustees, and FSA guidance to financial advisers, both start from this premise. The Pensions Regulator's guidance cautions trustees to "start from the presumption that such exercises are not in most members' interests". Observers may point to the asymmetry of knowledge between the sponsoring employer (who would be expected to have commissioned actuarial advice) and the pension scheme members.

The alternative view is that facilitating choice increases members' options. Some members might benefit from taking an enhanced transfer value – for example, unmarried members wishing to convert the reserve for contingent spouses' pensions; impaired lives who can buy a higher pension from an insurance company; or sophisticated investors who fully understand the nature of the risks. Issues like sponsor covenant and the likelihood of the pension scheme being able to deliver the promised benefits are also relevant.

Both positions have a logical coherence. Is our role as actuaries to use our knowledge and experience to tell individuals how to act (by helping to construct rules that prevent certain outcomes) or is our role primarily to educate, to enable others to make informed decisions? The note on enhanced transfer values published by the profession in November 2011 observes that our role is the latter, with the clear objective that "pension scheme members get a fair deal whether they opt to take up the enhanced transfer value offered or not".

<u>**Communication and Advice**</u>

At all levels, it is clear that communication is key. In structuring communication it is helpful to consider how the success (or otherwise) of a member incentive exercise will be measured. The temptation is to measure "success" by the reduction in cost or risk, for which the proxy might be the proportion of eligible members opting for the enhancement/exchange. Often, in the feasibility study prior to engaging in a member incentive exercise, the employer identifies the take-up percentage that needs to be achieved in order to justify the cost of the exercise. The clear danger is that, by narrowing the scope of the success criteria, wider issues are missed. Over time, if it transpires that members who opted to accept the offer have been disadvantaged, retrospective judgement on all parties involved will be unfavourable, irrespective of the level of take up. However, it may take many years before this becomes clear, by which time other issues relating to the offer will have become obscure.

Individuals offered the chance to participate in member incentive exercises are faced with a difficult choice. Evaluating options based on personal circumstances is not easy, so clear communication and access to good quality individual advice is crucial; but it would be unusual for the actuary to be actively involved at this level. The actuary is more likely to be involved in advising the employer or trustees. Here we can make a difference, by:

- Reminding employers of their duty of care when providing information to members;
- Bringing the Pensions Regulator's guidance to the employer's attention, and helping the employer construct the exercise around the guidance;
- Setting success criteria that focus on more than short-term cost and/or risk reduction;
- Highlighting the importance of independent financial advice to members;
- Encouraging the involvement of trustees (and their advisers) at an early stage.

What might happen next?

The DWP has established a group to look at member incentive exercises. The intention is that a voluntary code is constructed, supported by interested parties, but legislation has not been ruled out if the voluntary code then proves to be ineffective.

The profession is actively engaged in discussions with the many stakeholders involved and is represented at the highest levels in the debate.

Regulatory drivers on the horizon may increase pressures on pension costs leading to more enthusiasm for member incentive exercises. Specifically:

- Auto enrolment could put up the cost of pension provision. Even if new members are auto enrolled into defined contribution plans, employers may look for savings elsewhere.

- Revisions to the IORP* directive could increase funding and regulatory burdens on defined benefit schemes.

These are on top of the demographic and economic drivers with which we are already familiar.

Conclusion

In the absence of further regulatory intervention, member incentive exercises will persist.

Actuaries working in this area will best continue to help their clients meet their objectives by providing advice that helps to protect those clients from regulatory and legal censure, with due regard to other parties affected by their advice.

Using the Actuaries' Code as a reference will help us address the difficult professional issues that arise. It will serve us well to remember the status and purpose of the Actuaries' Code:

"The Code consists of principles which members are expected to observe in the public interest and in order to build and promote confidence in the work of actuaries and in the Actuarial Profession."

(* Institutions for occupational retirement provisions. This is the term used by European regulators for, inter alia, employer sponsored occupational pension schemes.)

Jim Boyle on behalf of the Professionalism Awareness Committee