Barnett Waddingham
a true partnership approach

Briefing note

Budget flexibilities and incentive exercises

From April 2015, individuals will have much more choice in accessing their pension savings. Although these changes have the greatest impact on defined contribution (DC) arrangements, there are some matters for defined benefit (DB) schemes to consider too. This information sheet summarises the key issues trustees should be thinking about as April 2015 approaches.

In addition, the greater flexibility on offer in DC arrangements may be attractive to some members, which could lead to an increase in transfer requests from DB schemes. Employers may also propose exercises that encourage members to transfer their pension to another arrangement. This information sheet also explains the issues that trustees should consider if their employer is contemplating such an exercise.

> “” Members of DB arrangements will need to transfer their benefits to take advantage of these flexibilities.

> “” The maximum lump sum members can take on grounds of triviality from DB arrangements has been increased.

Key changes

The government consultation ‘Freedom and Choice in Pensions’ and the subsequent Taxation of Pensions Act provide much of the current policy intention for these changes. In summary:

- From April 2015, members of DC arrangements will have more flexibility in accessing their pension savings. As is currently the case, 25% of a member’s fund can be taken as a tax-free lump sum. However, in future members will also be able to draw the remaining 75% as either a single lump sum or as a series of lump sums, subject to the deduction of income tax.
- Initially, members of DB arrangements will need to transfer their benefits to take advantage of these flexibilities. DB to DC transfers will still be permitted, but members with transfer values exceeding £30,000 will be required to receive advice from a regulated financial adviser. The government intends to consult on whether to allow full or partial withdrawals directly from DB arrangements, but it is not clear when the consultation will take place or what the outcome will be.
- The maximum lump sum members can take on grounds of triviality from DB arrangements has been increased. Since March 2014, members with total pension savings worth less than £30,000 have been able to take all their pensions as a lump sum. Further, members with pension savings worth less than £10,000 in a specific arrangement can take those pensions as a lump sum regardless of their other pension savings. Previously, these limits were £18,000 and £2,000 respectively.

However, we are still awaiting a number of important details in relation to these changes. As such, there are some areas where trustees might prefer to delay decisions until the details have been confirmed.

Barnett Waddingham
a true partnership approach

> Trustees should ensure that their administrative procedures allow for the advice requirement prior to a transfer.

> Trustees need to decide whether to allow members to take higher lump sums on the grounds of triviality. If they do, rule amendments may be needed.

Budget flexibilities: issues for trustees to consider

Potential DB to DC transfers

- The rules of many pension schemes do not permit transfers within 12 months of retirement. Trustees should consider amending rules to remove this restriction, as it is unlikely that this will be covered by a statutory override.
- Trustees should also consider whether to permit partial transfers of DB benefits, to give members greater choice in accessing the new flexibilities.
- Trustees should ensure that their administrative procedures allow for the advice requirement prior to a transfer, once the duties for transferring schemes have been confirmed.
- If large numbers of transfers are expected as a result of the new flexibilities, trustees should consider reviewing their funding and investment strategy in conjunction with their advisers.

DC Additional Voluntary Contributions (AVCs)

- Trustees should consider whether to offer some of the new flexibilities to members with DC AVCs directly, or whether they should also be required to transfer to another arrangement.
- It is expected that most schemes will require members to transfer to access the new flexibilities. If so, trustees should consider whether rule amendments are needed to allow partial transfer of an individual's AVC fund, taking into account the impact of any statutory overrides.
- If trustees want to offer the flexibilities directly, they will need to review their scheme rules and administrative processes to determine what actions are needed to facilitate this.

Changes to trivial commutation limits

- Trustees need to decide whether to allow members to take higher lump sums on the grounds of triviality. If they do, rule amendments may be needed.
- Trustees should also consider the extent to which these options are offered as part of the normal retirement process and whether this should be reviewed.
- For schemes with a reasonable number of small pensions, it may be worthwhile carrying out an exercise to contact members over 55 who are potentially eligible for a trivial lump sum.
- In some circumstances it may be possible for a trivial lump sum to be paid automatically without consent to eligible members, and trustees should consider discussing this possibility with their legal advisers.
- Trustees should discuss with their actuary the factors that are used to convert pensions to lump sums in these circumstances and whether these need to be reviewed in light of the increased flexibilities.

Barnett Waddingham
a true partnership approach

> Trustees should consider appropriate communications to members explaining these changes.

Communications

- Trustees should consider appropriate communications to members explaining these changes. There has been a lot of press coverage of the new flexibilities and it is likely that members will be looking for help to understand how their retirement choices have (or have not) changed.
- Communications could range from a simple newsletter to a more bespoke communication detailing specific options. It may also be necessary in some circumstances to send an initial communication, with further material to follow once details have been finalised and decisions made.

Liability management and incentive exercises

Employers with DB pension liabilities have increasingly looked to reduce costs and risks through liability management or incentive exercises. The announcement of the budget flexibilities has stalled these exercises in many cases, with employers reviewing the position pending final details. However, as April 2015 approaches employers are likely to be looking at liability management exercises again.

Whilst liability management can take many forms, in this context it means an offer to the members to change the form of their benefits in a way that reduces cost or risk for the employer. These offers are commonly referred to as 'incentive exercises', although they can comprise a simple invitation without any incentive.

Incentive exercises have become popular with employers, but they have also received some negative press due to concerns that some employers have encouraged members to take an option that is not in their interests. As a result, an industry wide Code of Practice ('the Code') was established in 2012, which sets out the principles that should be followed in relation to such exercises.

One particular requirement of the Code is that advice should be provided to the member. In certain circumstances, the advice can take the form of guidance without a firm recommendation. Nevertheless, the advice (or guidance) must be provided by a regulated adviser and paid for by the party initiating the offer.

Trustees should note that in December 2014 the Incentive Exercises Monitoring Board suggested that voluntary trivial commutation exercises are generally covered by the Code. Therefore, trustees contemplating such an exercise should seek advice as to whether the Code applies, and in particular whether independent guidance should be provided for all members involved (even if it is the trustees that initiate the exercise). Trivial commutations offered in the normal course of events – i.e. as an option at retirement or on request – are normally not covered by the Code.

Barnett Waddingham
a true partnership approach

> “”
> There are lots of ways for an employer to reduce cost or risk in relation to their pension liabilities, and different types of exercise are often combined as part of a single offer.

Types of liability management exercise

There are lots of ways for an employer to reduce cost or risk in relation to their pension liabilities, and different types of exercise are often combined as part of a single offer. However, the main types of exercise and the terminology commonly in use are summarised here.

Enhanced Transfer Value (ETV)

An offer to increase the amount paid when a member elects to transfer the value of their pension to a new arrangement.

The enhancement can be expressed in different ways. For example, it might be a simple percentage, e.g. a 10% increase to normal transfer values. Alternatively, enhancements can be calculated on an individual basis to target an equivalent pension for a given level of assumed investment return.

What’s the objective?

In some cases, an employer can offer substantial enhancements and still make savings against the ongoing funding cost or the cost of securing benefits with an insurer. In addition, a transfer removes all risk associated with financing the transferring member’s benefits.

Pension Increase Exchange (PIE)

An offer to ‘reshape’ the pension benefits, normally resulting in a higher initial pension but with lower future pension increases. For example, schemes providing high levels of fixed pension increase might offer members a higher pension but with lower or no increases.

What’s the objective?

The benefits of a PIE will depend on the nature of the exercise. Typically, the intention will be a reduction in the cost of securing benefits with an insurance company, particularly for schemes with unusual pension increases that are difficult or expensive to insure.

Where the employer’s intention is not to secure benefits with an insurance company, reshaping benefits can still help reduce risk by making the liabilities easier to match with suitable investments. In some cases, the employer may be seeking to reduce the ongoing funding cost through the terms offered for the exchange.

Barnett Waddingham

a true partnership approach

> At retirement options are new benefit choices that are made ordinarily available to members on an ongoing basis, rather than as a one-off exercise.

Total Pension Increase Exchange (TPIE)

An offer to transfer the value of a pensioner's benefits to an insurance company, and for the benefits to be 'reshaped' as part of this, i.e. normally resulting in a higher pension but with lower future pension increases.

What's the objective?

Despite the title, these exercises have more in common with an ETV exercise than a PIE exercise as they result in a member transferring the entire value of their pension benefits to an alternative provider. As such, the benefits will be similar to those for an ETV exercise i.e. the employer may be able to make cost savings, depending on the terms offered, as well as removing all risk associated with financing the transferring member's benefits.

Enhanced Early Retirement (EER)

An offer for members to take early retirement, normally on enhanced terms. For example, an employer might decide to waive some or all of the early retirement reduction that would otherwise apply.

What's the objective?

It is unlikely that an employer would make material savings in ongoing funding costs via an EER exercise. However, an EER exercise can help reduce the cost of securing benefits with an insurance company as insurers will usually offer better pricing terms for retired members due to the greater certainty regarding the benefits to be provided. In addition, an EER exercise can help with data cleansing as information such as spouse details will be obtained as part of the retirement process.

'At retirement' options

These are new benefit choices that are made ordinarily available to members on an ongoing basis, rather than as a one-off exercise. For example, an employer might seek to introduce a PIE or TPIE option as part of the normal retirement process.

Note that the Code does not cover the introduction of at retirement options. However, the Code would apply if existing pensioners are made a similar offer when the option is introduced. In addition, both the employer and the trustees are likely to consider at least some elements of the Code when introducing such an option.

What's the objective?

The benefits for the employer will be the same as for a PIE or TPIE, depending on which option is being introduced.

Barnett Waddingham
a true partnership approach

“ ”

Trustees will want any project to be well run and properly implemented.

Incentive exercises: Issues for trustees to consider

- Trustees should remember that their primary duty is to act in the interests of the beneficiaries. Trustees should seek legal advice on their responsibilities at an early stage and consider potential conflicts of interest.
- Trustees should familiarise themselves with the contents of the Code and should ask the employer to confirm that they intend to comply with its requirements (although it is the employer and their advisers who are responsible for ensuring that the requirements of the Code are met).
- Trustees should discuss the potential financial implications of an incentive offer with their Scheme Actuary, in particular how the incentive is to be funded and the impact on any existing recovery plan arrangements. The trustees may also want to discuss the design of the offer.
- Trustees should also discuss the potential investment implications with their investment adviser, in particular cashflow issues and the impact that significant changes to the membership profile might have on the long-term strategy.
- The employer may ask the trustees for details of the scheme’s beneficiaries, to assess the feasibility of an incentive and ultimately to make the offer if they decide to go ahead. Trustees should discuss their data protection responsibilities with their legal advisers before agreeing to such a request.
- Trustees should review the content of any communications to be sent to members explaining the offer. Whilst any offer would be from the employer, if trustees are not happy with the way it is presented they should raise this with the employer. If the trustees are not satisfied with the employer’s communications they can write to members themselves to set out their concerns.
- Trustees will want any project to be well run and properly implemented. Liability management exercises are typically initiated by the employer and trustees would not normally be involved with designing the offer. However, trustees and their advisers may be asked to implement the proposals and are likely to be best placed to do so, given their knowledge of the scheme and its beneficiaries.
- In the unlikely event that trustees have material concerns about the running of an incentive exercise (for example reports of coercive or misleading behaviour, concerns about the structure of an offer or concerns about the conduct of the parties involved) they should report these to The Pensions Regulator.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively contact us via the following:

info@barnett-waddingham.co.uk

020 7776 2200

www.barnett-waddingham.co.uk
