

# Technical Briefing

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## Regulation of inducements

### Introduction

Inducements are either cash payments or increases to transfer values, offered to members of defined-benefit pension schemes by the sponsoring company, and which are only paid if the member takes a transfer value of their past-service defined-benefits. Inducement offers are usually made to a whole group of members at the same time in order to reduce the amount of funding risk within the scheme. In the past, some inducement exercises have treated members very badly and so the HMRC and Pensions Regulator have issued separate guidance on this matter.

### Types of inducement offers

Inducements can be in the form of a cash-in-hand payment or an increase to the member's cash equivalent transfer value (the increase also being transferred to a money purchase pension scheme or personal pension plan).

It is usual for inducement offers to be made to a whole group of members of a pension scheme at the same, for example to members with deferred pensions. An inducement exercise might also accompany, for example, the closure of a final-salary scheme to future accrual, where active members are to receive leaving service benefits.

It is the company's decision on the size of inducement to offer each member and, in general, this should be set to optimise the member take-up rate and the capital the company will need to inject into pension provision. In the past, some inducements have been set at levels that do not reflect the value of benefits that members were being asked to give up, and the latest regulatory

announcements are designed to prevent such abuses re-occurring.

### Pros and cons

For companies, the advantages of such offers are clear. If successful, a consultation of this nature means that the open-ended cost of funding defined-benefit pension liabilities is immediately removed at known cost.

This reduces not only the liabilities of the Scheme, which currently sit in the balance sheet of the company due to the reporting requirements of FRS17, but also the amount of funding volatility moving forward, delivering contribution stability and an environment conducive to clear cashflow planning. Additionally, it will also reduce the amount of risk-based levy demanded by the Pensions Protection Fund ('PPF') (all other things being equal). Finally, administration costs are also likely to fall where transfers are made to personal pension plans.

Companies do face some important disadvantages as well.

First and foremost, they need to find the money to provide the inducements, an amount that might be considerable in order to make the offer attractive. It should be noted, however, that this money can possibly be raised externally at an interest rate lower than that being paid on the existing funding deficit.

Secondly, there is a possibility that some members may eventually receive a smaller pension than they





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were expecting, if the returns on the assets paid across are less than were needed, or life expectancy increases unexpectedly. This could result in bad publicity for the company and a deterioration in staff relations. This potential downside can be mitigated by ensuring that members are aware that:

- If they accept the offer from the Company, then they accept the risk that future economic and demographic risks might not work in their favour. As such, the eventual pension they receive may be better or worse than the pension they were promised by the existing scheme.
- The defined-pension guarantee only exists at normal retirement age, and is subject to the company still being in existence in the future. It is worth noting at this stage the existence of the PPF, which for many members will protect the majority of their accrued benefits in the event that the employer became insolvent.
- The company will pay for all affected members to receive independent financial advice.

Last, but not least, there always exists a regulatory / tax risk and a risk of legal action at some time in the future. That said, following the blueprint set out above should minimise the risk of a future adverse event.

### **The member's perspective**

For members, the pros and cons depend crucially on whether the amount offered provides them with more valuable benefits than they (or their dependants) would otherwise have received. By transferring, members accept the mortality, investment and expense risk, and these might not be covered by the combined amount offered. That said, employed scheme members might appreciate an improvement in job security through the company gaining an improvement in pension contribution stability.

If members are not provided with the information and advice they would need to assess whether the inducement represents value for money there is a very great risk of members making an irrevocable decision that adversely affects their post-retirement income.

Finally, members might have to pay Income Tax and National Insurance Contributions on a cash inducement. That said, members usually prefer a cash inducement as it is much more flexible than a one-off injection to their pension assets.

### **Pensions Regulator – guidance for trustees**

The Regulator's guidance was issued on 24 January and emphasises the need for members to be provided with the information and advice needed to properly assess whether the offer represents value for money. In considering this, the Regulator makes clear that the transfer of risk to the member and the member's own attitude to risk are important factors. In addition, the protection offered by existing wind-up legislation and from the PPF should also be considered.

The guidance also alerts trustees of affected schemes to existing laws and powers at their disposal, specifically:

- Trust law and data protection requirements should be considered when deciding on the extent of assistance they should provide to the employer during such an exercise.
- Trustees must consider their scheme's funding position in deciding on (a) the transfer value that can be paid on behalf of each member (b) any further, immediate funding that they should be demanding, and (c) whether the payment of such inducements weakens the employer's ability to finance the scheme.



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- The trustees' fiduciary responsibilities mean that they should check the employer's communications material to ensure that members are provided with independent financial advice and, where necessary, question or challenge the appropriateness of an inducement offer.
- Section 67 permits trustees to prevent certain types of changes being made. Further, the new Information and Consultation regulations will also require the company to consult with affected members where an inducement offer is combined with any one of a set number of changes to a pension scheme.

### HMRC announcement

This was issued on 24 January and confirms that cash inducements announced from that date will be subject to Income Tax and National Insurance. Cash inducement offers made before this date and those for which the HMRC has otherwise advised upon will not be subject to taxation and National Insurance.

The position regarding inducements paid directly to pension schemes is not clearly communicated, in that the announcement confirms that no tax or national insurance will be levied on inducement payments used to enhance transfer values and included in the funds transferred between schemes, but does not refer to tax treatment should a pension contribution be made outside of the existing defined benefit scheme. In view of this we contacted HMRC directly and received confirmation that inducements paid to receiving pension arrangements are also free of tax and National Insurance, as long as each member's annual pension contribution is within the Annual Allowance.

### Internet links

Copies of the HMRC announcement and the Pensions Regulator's guidance note can be found at:

<http://www.hmrc.gov.uk/pensionschemes/draft-announcement.htm>

<http://www.thepensionsregulator.gov.uk/guidance/inducementOffer/index.aspx>

### CPRM Commentary

Any conversion of pension from defined-benefit to defined-contribution has the practical impact of transferring risk from the company to scheme members, consequently, there is a probability that some members will be winners, whilst some may be losers – providing independent financial advice to members at the point the offer is made will, without doubt, alter the ratio of winners and losers.

The ability to ensure that more members do at least as well in the event the transfer of risk is, however, more than a function of individual advice, it is a function of the assumptions used by the actuaries in calculating the offer to be made to members, and other factors such as continuing employment etc.

In our opinion, the guidance from the Pensions Regulator, and the HMRC statement on tax treatment of cash incentives has ensured that the communication with members where an exercise of this nature is implemented will be significantly improved, and that where cash offers are made these will have to increase pro-rata to recognise the tax payable by the member in the event that they accept an offer from the Company.



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In many ways, however, the guidance does not go far enough, in that it does not insist that the members be provided with independent financial advice.

Employers may assume that the independent financial advice is an element of the process that is for the benefit of members only. However, this is not true because:

- The provision of independent financial advice means that members are providing consent to transfer (assuming they accept the offer from the Company) on an 'informed-consent basis'. This not only alters the ratio of winners to losers, but materially reduces the potential for claims in the longer term.
- In the event that there are losers, the first area for review is the advice provided to the member. If the advice is flawed in any way, this is the responsibility of the advisor, not the company or the trustees.
- The provision of the independent financial advice acts as a quality check on the advice provided by the actuary or the consultant, because if they have not taken into account the interests of all parties in the design of the offer, it will fail the financial tests set by the independent financial advisor in providing advice. The company will then be in a position to interrogate the advice. The provision of the independent financial advice acts as a quality check on the provided to them, and determine whether the consultant they have engaged has met the objectives set at outset.

If you wish to discuss this Technical Briefing, or the subject matter raised, please contact Simon Chrystal on 0191 233 9408, or, Philip Wheeler and Jonathan Black on 0131 220 8247.