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for Work &
Pensions



Social Science in Government

Pension Incentive Exercises – Code of Good Practice Case Studies

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Executive summary

Pension incentive exercises are one-off invitations or inducements provided to pension scheme members to change the form of their accrued defined benefit (DB) rights in a UK registered pension scheme.

The focus of this research was around issues involved with implementing and complying with the current voluntary Code of Good Practice around incentive exercises. The research comprised a series of nine case studies of large employers with recent experience of incentive exercises or who were actively considering instigating one.

All the case study employers that had implemented an incentive exercise reported few difficulties as a result of following the Code. Most felt that this was due to their underlying commitment within their organisation to follow best practice and an ability to fund a properly-run incentive exercise.

All recognised that complying with the Code generally carries a burden in terms of the costs incurred in doing so and time taken to implement the incentive exercise properly. However, most felt that many of these costs would have been incurred anyway. The provision of advice was regarded as the one potential exception to this view.

Several employers thought that the removal of cash incentives had resulted in lower take-up rates than had been seen in the past. Indeed, among those that had carried out an incentive exercise recently, take-up had generally fallen short of the expectations set in the feasibility study.

More positively, some felt the Code can reduce costs by providing a reference point around which the various parties involved in the incentive exercises can focus. This necessarily led to fewer and swifter resolution of disagreements between stakeholders.

On balance, the benefits of complying with the Code were felt to outweigh any challenges:

- it provides a benchmark to check performance against and a reassurance that the employer is 'doing the right thing';
- it has encouraged some employers to look at incentive exercises again, having stopped using them previously; and
- it in effect endorses the actions of those complying with it, providing 'evidence' of best practice having been followed;

At the same time, the detail of the Code appears to have become the domain of third party consultants employed to advise employers and often to implement the incentive exercise.

Pension Incentive Exercises – Code of Good Practice Case Studies

The case study employers generally felt that complying with the Code should remain voluntary and that making it compulsory might alienate employers who were already complying.

It is difficult of course to extrapolate findings from this small sample of self-selected large employers, so caution should be exercised in that respect, but the findings do at least enable us to assess the qualitative impact of the Code across this important part of the occupational pensions sector¹.

¹ Over 40 per cent of large employers (those with more than 500 employees) had some form of defined benefit occupational pension provision in 2011; this compared with less than 5 per cent of small and medium-sized employers.

Contents

1 Background to the research	6
1.1 What are incentive exercises ?	6
1.2 Incentive Exercises Code of Good Practice and the IE Monitoring Board.....	6
1.3 Why was this research carried out ?.....	7
2 Research aims	7
3 Research method and employer sample	8
4 Main research findings	10
4.1 Why do employers use incentive exercises ?.....	10
4.2 Implementing incentive exercises and the Code of Good Practice.....	10
4.3 Impact of complying with the Code.....	11
5 Conclusions	15

1 Background to the research

1.1 What are incentive exercises ?

1.1.1 Pension incentive exercises are invitations or inducements provided to pensions scheme members to change the form of their accrued defined benefit (DB) rights in a UK registered pension scheme. These exercises should meet both of the following criteria to be described as such:

- reduce risk or cost for the pension scheme or sponsor(s); and
- the invitation or inducement is not ordinarily available to members of the pension scheme i.e. they are ‘one-off’ exercises.

1.1.2 Incentive exercises may comprise transfers out of a DB scheme or modifications within an existing DB scheme. The two main types of transfer exercise are known as:

- **enhanced transfer values** (or ETVs), whereby members are offered an enhancement to the transfer value of the DB pension that would ordinarily have been available to them; and
- **total pension increase exchanges** or (TPIEs), whereby (usually older) members are offered transfer values to an immediately vesting annuity or other decumulation option.

1.1.3 The principal form of modification exercise is known simply as **pension increase exchange** (or PIE), whereby members are offered an enhancement to their pension income in return for surrendering all or part of their future pension increases.

1.2 Incentive Exercises Code of Good Practice and the IE Monitoring Board

1.2.1 A Code of Good Practice for incentive exercises was introduced in response to industry and government concerns that such exercises could be conducted in a way that disadvantaged pension scheme members. The Code was written by an Industry Working Group and published in June 2012:

www.incentiveexercises.org.uk

1.2.2 The objectives of the Code are to ensure that all incentive exercises are:

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

1.2.3 The Code is voluntary but gives employers clear principles to follow when undertaking such exercises. If it is found that the Code is not working, the Government will consider other measures, including legislation, to protect members.

1.2.4 The Department is a member of the Incentives Exercises Monitoring Board (IEMB), set up from the original working group, whose role is to own, support, monitor and evaluate use of the Code. The Board comprises members from across the pensions sector and is chaired and run by industry-based representatives, not by government.

1.3 Why was this research carried out ?

1.3.1 The research was designed to provide information to support the IEMB in its monitoring role and its deliberations over recommendations on the instigation and running of incentive exercises in the long term.

1.3.2 The Board has three principal objectives around the collection and collation of information on incentives exercises:

- how many exercises qualifying as such under the criteria set out above (and, ideally, other types of exercise, including those referred to as 'Business as Usual' (or 'BAUs'))² have been run since the establishment of the Code in June 2012;
- how many members have been offered such exercises and have accepted offers; and
- whether and to what extent employers and providers have complied with the Code.

1.3.3 The Board is collecting information on the first two of these objectives by adding questions on incentive exercises to regular employer and scheme surveys. The focus of this research was around issues involved with implementing and complying with the Code, so supports the third of the objectives.

2 Research aims

2.1 The main aims were to draw out particular issues around compliance. These included:

- awareness of the Code;
- employer views of the Code: whether they found/find it a useful guide or, on the other hand, an actual or potential deterrent to running an incentive exercise;

² The main types of 'BAU' exercise are listed on page 27 of the Code.

- whether and to what extent employers actively sought to follow the Code (or vice-versa);
- any ‘sticking points’ around compliance – were/are these cost-related or to do with time or other constraints arising from following the Code;
- whether and to what extent the employer believed the Code affected/might affect member participation in the incentive exercise;
- estimates of any additional cost to the employer and employees of following the Code; and
- whether there were any direct and indirect benefits in following the Code.

3 Research method and employer sample

3.1 The research aimed to explore these issues amongst employers who had instigated and completed an incentive exercise(s) in the past 12 months, or were in the process of running one at the time of the research, or were thinking about running one in the next 12 months or so.

3.2 The research was qualitative in nature, comprising a series of nine case studies of employers with recent experience of incentive exercises or who were actively considering instigating one³. The case study interviews were undertaken for DWP by Optimisa Research.

3.3 The case study employers were drawn from a sample of employers who had participated in DWP’s Employer Pension Provision 2013 survey and who had indicated in that survey that:

- they had run an incentive exercise in the previous year or were actively considering running one in the near future; and
- they were happy to discuss the incentive exercise with Optimisa Research.

3.4 The National Association of Pension Funds (NAPF) also kindly provided details of a small additional number of employers implementing incentive exercises, from their 2013 survey of employers.

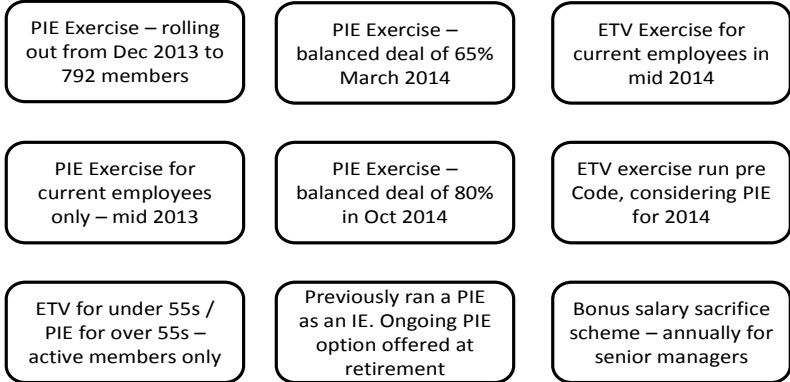
3.5 The case study interviews were carried out by Optimisa Research between December 2013 and February 2014. Figure 1 shows the details of the incentive exercises each of the nine case study employers had run or were (considering)

³ A target of 12 case studies was set at the outset of the research but in the event nine were achieved as a result of both the low numbers in the potential sample and difficulties accessing employers with recent or ongoing experience of incentive exercises.

Pension Incentive Exercises – Code of Good Practice Case Studies

running. Eight of the case studies involved ETVs and/or PIEs. The ninth was a bonus salary sacrifice scheme that fell outside the scope of the Code, and therefore the remit of the research, but was included as it was thought it could shed light on employer understanding of incentive exercises.

Figure 1- The nine case studies⁴



3.6 It should be noted at the outset that all the case study employers were classed as ‘large’ employers, with more than 500 employees. However, the actual size range varied from just over 500 to over 80,000 employees.

3.7 It is difficult of course to extrapolate findings from this small sample of self-selected large employers, so caution should be exercised in that respect, but the findings do at least enable us to assess the qualitative impact of the Code across this important part of the occupational pensions sector⁵.

⁴ The term ‘balanced deal’ refers specifically to modification exercises (PIEs). Employers considering PIEs should provide to employees offered the PIE a ‘balanced deal percentage’ calculation. This compares the value of the initial pension uplift with the value of the pension increases given up using assumptions consistent with those used to calculate cash equivalent transfer values. The Code recommends that if the balanced deal percentage is 100 per cent or more (that is, it meets the Code’s ‘value requirement’) then the pensioner should receive independent guidance from a suitably qualified and experienced individual. If the percentage is less than 100 per cent then the pensioner should receive full financial advice including a recommendation on whether to accept the offer. In effect what this means for employers is that they must weigh up whether they should give a lower uplift and full financial advice or a bigger uplift (which meets the Code’s value requirement) and less expensive guidance.

⁵ Over 40 per cent of large employers (those with more than 500 employees) had some form of defined benefit occupational pension provision in 2011; this compared with less than 5 per cent of small and medium-sized employers.

4 Main Research Findings

4.1 Why do employers use incentive exercises ?

4.1.1 It became clear that in most instances, incentive exercises were, typically, part of the employer's wider strategy and plan of action around reducing its long-term pension scheme risk and liabilities.

4.1.2 The main drivers of action were to reduce the employer's current and prospective liabilities and address scheme deficits, whilst trying to protect members' interests. Employers had, typically, already restricted (or were considering restricting) membership to existing DB schemes, or had taken other sorts of risk-reducing measures such as bulk 'buy-in' annuity purchases to try to reduce their liabilities.

4.1.3 The general tone of employers' feelings around incentive exercises was one of 'reluctant acceptance' that they should be undertaken, rather than outright enthusiasm. This was in part due to a perceived view that incentive exercises had previously, pre- Code of Good Practice, been regarded by employees with suspicion. Most employers were well aware that incentive exercises had attracted negative media coverage in the past, particularly when up-front cash incentives were offered.

4.1.4 Although it was acknowledged that without cash incentives take-up was likely to be lower, and that this has reduced the potential of incentive exercises as an option for employers, the Code was accepted from a reputational perspective as a positive development.

4.1.5 The employers interviewed were fully aware of this 'history' around incentive exercises and of the risk of reputational damage if the exercise was badly run or poorly communicated to members.

4.1.6 On the other hand, the employers interviewed were almost all aware of the Code of Good Practice. While they were not always fully familiar with the detail of the Code, they were sufficiently aware of its purpose and status. One employer had started looking at incentive exercises again after six years, as they felt the Code made it possible to run an exercise without reputational risk.

4.1.7 The Code therefore served, in some instances, as a 'kite mark' or rubber stamp for their use of incentive exercises. There was some evidence that the Code has helped "rehabilitate" incentive exercises but that nevertheless employers continue to explore alternative measures.

4.2 Implementing incentive exercises and the Code of Good Practice

4.2.1 While the case study employers interviewed were reluctant to use incentive exercises for the most part, it was clear that where used this was within a broader strategic plan and not as a short-term 'option of last resort'. One might reasonably expect larger employers to be more strategic in their approach so these findings may simply reflect the size and status of the case study sample. As there is no comparative evidence on smaller employers' views and experiences of using incentive exercises, it is not possible to say definitively whether or not this is the case.

4.2.2 Decisions around the implementation of incentive exercises were usually taken only after consultation with senior managers, trustees and, in most instances, employee representatives. These discussions incorporated assessments of the feasibility, implementation and impact of the exercise.

4.2.3 As noted above, most of the case study employers also bought in external expertise. This was in part to provide technical and legal advice but also, often to implement all or part of the incentive exercise itself. Given the perceived ‘chequered history’ of incentive exercises, using a large, reputable consultancy was felt by employers to provide assurance that good practice was maintained and was seen as tantamount to protecting and enhancing the reputation of the employer. Smaller, less well-known consultants were used in some instances. Where this was the case the employer generally had a well-established, long-term relationship with the consultant.

4.2.4 In practice, while there were no obvious attempts to maintain a separation between senior management and members in terms of communicating the incentive exercise, responsibility for this often rested with the consultants or advisers. Helpline numbers were provided in some cases, and queries from members were usually handled by the specialist third party rather than by HR or another internal department. Likewise, although employers usually had a broad, high level awareness of the Code they relied on consultants for detail.

4.2.5 Although the existence of the Code might have tipped the balance for some employers in deciding whether or not to proceed with incentive exercises, it made little substantive difference on the actual implementation of the exercise. All the employers interviewed maintained that they would have sought to follow good practice with or without the Code.

4.2.6 Thus, although adhering to the Code was perceived as positive for employees, and proof of the employer “doing the right thing”, there was no evidence of any of the principles of the Code being explicitly promoted or explained to members in conjunction with an incentive exercise.

4.2.7 The Code was therefore regarded by the case study employers as being more ‘nice to have’ than ‘essential’ in terms of the actual implementation of the incentive exercise – these employers were clear that they would have followed best practice with or without guidelines or the Code.

4.3 Impact of complying with the Code

4.3.1 All the employers interviewed bar one (the employer that had implemented a bonus salary sacrifice scheme and therefore not an incentive exercise) were aware of the Code and claimed that they would have followed (or would be following) best practice with or without it. However, it was not clear at the outset that employers’ interpretation of ‘best practice’ would coincide with the good practice as set out in the Code.

4.3.2 The research therefore set out to look at the way the case study employers interpreted the Code and the impact of doing so. This was done by asking the

employers about the way they regarded, interpreted and implemented each of the Code's seven main principles. These are discussed in turn:

Principle 1 – *No cash incentives should be offered that are contingent on the member's decision to accept the offer*

Main findings:

- overall, this principle was well received as cash incentives were generally seen as questionable and not fair practice
- some felt this had reduced employer options, as 2-3 years ago consultants were recommending cash incentive exercises as appropriate / acceptable – the “norm”
- in today's context cash incentives are felt to be against the principle of auto-enrolment/saving for the future (i.e. they may encourage a short-term view) – and as such, anachronistic
- there was some confusion over exactly what defined a ‘cash incentive’ and how PIEs and ETVs adhere to this, as both offer increases of some sort
- the employer with the salary sacrifice scheme felt they didn't adhere to this principle
- the employers generally saw themselves as responsible employers and there was a feeling that less responsible employers might not see this principle so positively, as previous cash incentives had resulted in higher take-up rates

Summary: Principle 1 was well received and perceived as appropriate for conscientious employers. It was relatively straightforward to comply with and had little net impact on costs.

Principle 2 - *For transfer exercises, advice should be provided to members.*

For modification exercises, either advice should be provided OR a value requirement should be complied with and guidance should be provided

Main findings:

- Overall, the majority of the employers stated that they would have provided advice to members regardless of the Code, although in some cases the advice offered pre-Code was ‘lighter touch’ (an example given was of providing one free advice session then any subsequent sessions paid for by the employee)
- The cost of advice was a significant element of any incentive exercise, directly impacting on the offer that could be made to members. As such, this cost was usually factored into the incentive exercise feasibility study early on
- Financial advisers were carefully appointed, with most employers working with their consultant to run a formal tender process before selecting their chosen supplier
- Most of the employers did not fully understand the balanced deal themselves but wanted to ensure that the offer was transparent to members; they relied on their consultants to adhere to this principle and ensure that employees were

clear what the incentive exercise offer was in comparison to their original benefits

Summary : Principle 2 was adhered to by all the employers: all were offering members free advice, driven by a desire to be transparent and fair. However, it was felt there was a relatively high net impact on costs from compliance (unlike the impact of Principle 3, around communications, see below).

Principle 3 - *Communication with members should be fair, clear, unbiased and straightforward*

Main findings:

- Good communications were seen as vital to the success of any incentive exercise
- All the employers wished to adhere to this principle and strove to achieve it, but it was widely acknowledged that pensions are not simple and that some confusion is inevitable
- Communications are perceived as one of the more costly elements of running an incentive exercise but like advice, a cost that exists in any event. While there is a sense therefore that communications costs are the same pre- and post-Code, advice costs in contrast are in some cases higher post-Code (as well as being higher overall)
- Most employers relied heavily on consultants to ensure communications were as effective and transparent as possible at every stage
- In some cases the communications were outsourced rather than managed in-house

Summary: Principle 3 was perceived, almost self-evidently, as vital but difficult to ensure due to the complexity of pensions. There was little net impact on costs.

Principle 4 - *Records should be retained by the various parties involved in an exercise so that an audit trail is maintained that can be examined in future. When providing advice, the member adviser should record and report on insistent customers to the other parties*

Main findings:

- Overall, most employers stated that individual records and an audit trail would have been put in place without the introduction of the Code
- It was acknowledged by some, however, that following the Code was likely to result in increased quality and consistency of records
- For most, records were managed externally, although two employers had a full in-house team and felt that this would give better access for any queries from current employees in future years once retired / retiring

Pension Incentive Exercises – Code of Good Practice Case Studies

Summary: Principle 4 was adhered to with little difficulty but with some net impact on costs in some instances.

Principle 5 - *Exercises should allow sufficient time for members to make up their mind with no undue pressure applied*

Main findings:

- All the employers interviewed were adhering to the timescales recommended to them by their consultants (excluding the salary sacrifice scheme)
- Overall, most were aware of the Code's recommended time scales and if they weren't, they assumed their consultants' recommendations were in line with these
- There was some evidence of decision deadlines being extended; employers were generally very keen to ensure members did not feel rushed
- The cooling off period provided some challenges, where:
 - Members were looking to purchasing annuities elsewhere
 - Members were changing their minds / indecisive – requiring multiple / extended cooling off periods

Summary: There was widespread compliance with Principle 5, with guidance provided by consultants and taken as necessary and little net impact on costs.

Principle 6 - *Incentive exercises should only be offered to members who are aged over 80 on an 'opt in' basis. Advisers should adhere to a vulnerable client policy when providing advice*

Main findings:

- Generally, this principle was followed and was considered sensible
- Many had previously set their own limits prior to the Code being published
- For some this principle was not relevant as the incentive exercise was for active members only, not retirees
- For one employer who was in the planning stages, the reference to vulnerable clients was seen as very helpful in helping them define vulnerability in this context
- One employer felt the principle was slightly ageist and although they complied they did not agree that this was appropriate. Their preference would be for stronger requirements and checks beyond a certain age through the independent advice provided. Another complied but equally, felt that being over 80 was not necessarily an indicator of vulnerability.
- There was little evidence of strategies for managing other types of vulnerability such as financial capability. There was a sense that it was expected that such cases would be identified and addressed by the advisers providing the advice under Principle 2.

Summary: There was full adherence with Principle 6 amongst the employers interviewed, with little net impact on costs.

Principle 7 - *All parties involved in an incentive exercise should ensure that they are aware of their roles and responsibilities and act in good faith in areas which they have direct control.*

Main findings:

- Generally, all parties would always be expected to follow this principle
- A sense for some that this principle is largely already covered by legal obligations
- This principle was adhered to fully and in most cases specialist consultants were engaged to ensure it
- Working with one of the major consultancies (e.g. PWC, KMPG) is seen as an additional way of adhering to this principle
- Some concerns were raised that some elements of the Code are subjective and as such could have ramifications for this principle, albeit not deliberate

Summary: Principle 7 was regarded as an important principle and as a 'given' for incentive exercises.

5 Conclusions

5.1 As noted, the limited scale of the research means it is difficult to extrapolate findings from this small sample of self-selected large employers to employers using, or planning to use, incentive exercises more generally. Thus, it is difficult to draw conclusions about the extent of awareness of the Code and it was possible to draw only qualitative conclusions on the impact of the Code on the costs associated with running incentive exercises.

5.2 Nevertheless, the research offers valuable insights into employers' attitudes towards and behaviours around the Code.

5.3 None of the case study employers was able to give any examples of having encountered any difficulties as a result of following the Code. Most felt that this was due to an underlying commitment to best practice and an ability to fund a properly-run incentive exercise.

5.4 Some case study employers did however feel that smaller employers or those with more aggressive shareholders / greater financial pressure to reduce pension liabilities might find compliance more difficult, but this was a hypothetical view rather than one based on experience.

5.5 All recognised that complying with the Code generally carries a burden in terms of the costs incurred in doing so (such as the use of consultants, advisers, communications) and time taken to implement the incentive exercise properly (undertaking cost/benefit analysis, maintaining paperwork, record keeping etc.). However, most felt that many of these costs would have been incurred anyway, with

or without the Code. The provision of advice was regarded as the one potential exception to this view.

5.6 In terms of the indirect effects of complying with the Code, several employers thought that take-up of the incentive exercises offer was lower than it would otherwise have been, as a result of the removing of cash incentives set out in Principle 1. On the other hand, some felt the Code can reduce costs by providing a reference point around which the various parties involved in the incentive exercises can focus. This necessarily led to fewer and swifter resolution of disagreements between stakeholders

5.7 On balance, the benefits of complying were felt to outweigh any challenges and was widely perceived by the case study employers as a very useful template for any employer wishing to run an incentive exercise by :

- providing a benchmark to check performance against and reassurance that the employer is 'doing the right thing';
- encouraging some employers to look at incentive exercises again, having stopped using them previously; and
- in effect endorsing those complying with it, providing 'evidence' of best practice having been followed;

5.8 At the same time, the detail of the Code appears to have become the domain of third party consultants. Amongst the case studies, consultants took/were taking responsibility for ensuring that individual principles were highlighted, understood and adhered to.

5.9 The case study employers generally felt that complying with the Code should remain voluntary and that making it compulsory might alienate employers who were already complying.