Gloucestershire Pension Fund

Pension Arrangements for Outsourced Services: Potential use of "pass-through"

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1 Addressee and purpose

Addressee

This paper is addressed to the Gloucestershire County Council in its capacity as the Administering Authority of the Gloucestershire Pension Fund ("the Fund"). It has been prepared by Hymans Robertson LLP in our capacity as actuaries to the Fund.

Purpose

We understand the Fund would like to understand the potential risks and impacts of setting a default approach of offering 'pass-through' to all of its related outsourcings. The purpose of this paper is to set out the principles of the admission body risk sharing route known as "pass-through" and provide a comparison of the risks between this and the traditional admission route. It also sets out the possible contribution rate approaches and next steps to consider for implementation.

2 Background and changing landscape across LGPS

Background

There are a number of approaches for awarding authorities to outsource a service to a contractor. In the past, the traditional approach has been for the awarding authority to pass the pensions risk and costs to the contractor and in return the contractor receives assets such that at commencement they are fully funded. The contractor's contribution rate will vary over time, and at the end of the contract they will either have to pay a cessation debt or potentially benefit from an exit credit at the Fund's discretion.

However, risk sharing is becoming more common in LGPS funds as contractors become more aware of pension risk and the financial consequence of adverse experience whilst participating in funds. Under these agreements, the awarding authority would agree to retain some of the pension risks that would have transferred to the contractor under the traditional approach. In essence, this means limiting (or even removing) potential variation in contribution rates, and possibly limiting (or even removing) the degree of any cessation debt / exit credit.

We are also aware that procuring a bond is becoming more difficult (or impossible) for contractors. Pass-through may eliminate the requirement for a bond to be obtained (subject to agreement from the awarding authority).

The pass-through approach

A number of different approaches can be taken in offering risk sharing agreements between the awarding authority and a contractor. However, as mentioned above, this paper focuses on the agreement known as 'pass-through'. The defining feature of a pass-through arrangement is to pass significantly less pension risk onto the contractor, in order to reduce the volatility of the contractor's costs of participation. The consequence is that more of the pension risk remains with the awarding authority. By passing less of the pension risks to the contractor, the awarding authority should expect more competitive bids as less uncertainty needs to be 'priced into' quotes.

Impact of regulation changes

Regulatory changes have changed the risk profile when outsourcing a service. Traditionally, at the end of a contract, the awarding authority who is assumed to act as guarantor;

- faced the risk that the contractor was in deficit and unable to meet the cost of any exit payment required by the Fund. In this circumstance, the responsibility for meeting this payment falls to the awarding authority; and

- had the upside potential in the case where the contractor is in surplus. Any surplus at the end of the contract would transfer back to the awarding authority.

Regulatory changes in 2018 and 2020, which introduced “exit credits”, removed the upside potential in a traditional outsourcing arrangement, as the Fund is now required to refund a surplus (if one exists) to the contractor on exit from the Fund - subject to new Fund discretions on the level of “exit credit” paid.

Under a pass-through arrangement, the awarding authority usually agrees to cover most pension fund risks. As a result, the risk of a deficit emerging usually remains with the awarding authority (so there would be no obligation for the contractor to meet any potential deficit at the end of the contract). However, it would also enable the awarding authority to keep the upside potential of an emerging surplus. This arrangement (that any deficit or surplus on cessation would pass back to the awarding authority with some exclusions – see section on what risks should not be shared) would need to be detailed in either the contract for services, a side-letter or the contractor’s admission agreement to the Fund.

3 Risk comparison of traditional and pass-through approach

There are a number of pros and cons of the traditional approach to pensions provisions when outsourcing versus those under pass-through which are set out below. We consider these separately from the perspective of the awarding authority, contractor, and Fund. A couple of case studies are also included in the Appendix comparing the traditional and pass-through approaches in the situation where there is (a) a deficit and (b) a surplus arising on cessation.

(i) Contractor’s perspective

Traditional approach	Pass-through approach
+ May **benefit from a surplus** at the end of the contract by way of an exit credit if experience is favourable. - May have to pay **a pensions debt** at the end of the contract if a deficit exists (due to unfavourable experience). - Variable ongoing contribution rates so **cost volatility may be high.** - Likely have to pay a **higher ongoing contribution rate** when assessed as a stand-alone employer of lower covenant than the awarding authority. - Required to prepare FRS102 accounting disclosures typically **adding to its balance sheet provisions**. - Likely **have to pay for actuarial reports** (opening position, FRS102, cessation). - Cost of **legal fees** and risk of exposure to pension issues such as death of an active member if an admission agreement has not been concluded by the start date of the contract.	+ **Stable, potentially lower, ongoing contributions.** + Much **reduced risk** of pension cost volatility. + **No cessation debt payable** on exit at end of contract. + **No need for annual FRS102 disclosures** / added balance sheet provision. + More easily protects transferring **members’ statutory pension rights,** as admission is more straightforward. This stops potential issues such as a death of an active member being treated as a death of a deferred member, where no finalised admission agreement is in place. - **No benefit of good experience** (not entitled to any surplus at end of contract).

(ii) Awarding Authority's perspective

Traditional approach	Pass-through approach
+ Contractors take the risk of adverse market / membership experience for duration of contract (i.e. **contractor responsible for any deficit** that has emerged over the course of the contract). - **Contractors may "price high" for the contract,** or not bid at all, meaning less competitive tenders: it could be less attractive for them to bid due to potential variability of those rates following each formal actuarial valuation, and due to the potential for a cessation debt at the end of the contract. - Issues arise where the contractor cannot afford the deficit at the end of the contract (**Awarding Authority may be asked to cover the deficit** anyway as the guarantor of last resort). - **Considerable internal administration time and cost** spent on dealing with pensions issues/admission agreements (as well as actuarial/legal advice being sought). - As the Awarding Authority has **statutory responsibility to ensure pension protection** is in place when TUPE transfer takes place, if the Admission Agreement is not concluded they would be tied to resolving issues in the interim such as the death of an active member.	+ Should lead to **lower contract prices** as more certainty of pension costs for bidding contractors. + **More competitive tenders** as more bidders encouraged to respond to tender (due to more certainty over pensions costs). + Awarding Authority **retains benefit of any pension surplus** at the end of the contract. + **Less risk of bad publicity** if employer defaults. + **More straightforward** admissions process potentially with one contribution rate payable for all new contracts saving on actuarial costs. + It is the **Awarding Authority's responsibility to ensure pension protection to transferring members**. A pass-through route should **reduce risks** such as death of an active member occurring before a winning bidder is admitted to the Fund and the associated additional time and costs due to legal issues to resolve and potentially time consuming IDRPs. - Risk of increased deficit if experience is adverse as the risk of a deficit emerging **is not** transferred to the contractor, it stays with the Awarding Authority. - Potential additional work/cost to **monitor the risks that are passed to the contractor** (excessive salary awards, early retirement strains, augmentations, non-statutory transfers-in).

(iii) Fund's perspective

The Fund is protected under either approach as the awarding authority would act as guarantor of last result under the traditional route and explicitly as guarantor under the pass-through route.

However, pass-through offers several administrative benefits compared to traditional agreements:

- Simplified approach to admitting new bodies (lesser need to liaise with actuaries, template admission agreements need less manipulation);

- Reduced requirement for a bond which we are aware can be challenging for contractors in the current environment (awarding authorities may still wish the contractor to obtain a bond to cover redundancy risk);
- Simplified approach on cessation; and
- Removes the administration burden and risks associated with making a determination of the level of exit credit to be paid to a contractor if there is a surplus at the end of a contract (subject to any representations made by the contractor or awarding authority to the contrary.

What risks should not be shared?

Pass-through usually covers the majority of pension risks including market risks. However, where the contractor can materially change the liabilities (pensions) of their members, we suggest these risks should continue to lie with the contractor and should not be shared. These typically relate to strains arising due to:

- excessive salary growth (i.e. this could be anything in excess of a fixed amount, in line with Council policy or an index such as Average Weekly Earnings);
- early payment of benefit on unreduced terms, e.g. on redundancy (but excluding ill-health*); and
- augmentation of benefits.

*The awarding authority would usually retain the risk of ill-health early retirements, although this risk can be mitigated by taking out insurance from an external provider (as the Fund currently does for the majority of its employers, although notably Gloucestershire County Council do not benefit from this policy).

We strongly advise the above risks should remain with the contracting employer and should be documented in the contract for services, a side letter or the contractor's admission agreement with the Fund. This should detail which risks are being retained by the awarding authority and which risks are retained by the contractor.

4 Approach to setting contribution rates

Under the traditional approach the contractor simply pays the contribution rate arising from the triennial valuation or other reviews, which is calculated as per the approach set out in the Fund's Funding Strategy Statement (FSS).

However, under a pass-through arrangement, the contractor may pay a number of possible contribution rates. Under a pass-through arrangement, the contribution rate may be:

- set equal at all time with reference to the awarding authority's contribution rate; or
- fixed (at a single rate regardless of the valuation rate for the duration of the contract); or
- capped (the valuation rate subject to an upper, but no lower, rate); or
- collared (the valuation rate subject to a minimum and maximum level); or
- the variable cost of benefits accruing calculated based on the contractor's own membership.

If the rate the contractor is paying under a fixed or restricted arrangement is less than the amount the Fund requires to fund these liabilities under the Funding Strategy Statement (FSS), the Fund may require the Awarding Authority to make good the difference to the Fund (i.e. on a monthly basis).

Please note that we are assuming that the Fund would propose to adopt ‘simple’ pass-through arrangements (i.e. an arrangement where the awarding authority retains responsibility for liabilities on all of the service earned by members, both transferring past service and service accrued during the contract period).

A ‘complex’ pass-through arrangement is possible where responsibility for the service is split between awarding authority and contractor, usually with the awarding authority taking on responsibility for past service liabilities at date of transfer and the contractor for liabilities that accrue on service earned during the contract period. However, this is significantly more complex to administer and would incur additional actuarial fees.

5 How does the awarding authority decide whether or not to offer risk sharing?

We understand that the Fund would like to propose “pass-through” as the standard approach for new admission agreements. However, it is possible to consider the most appropriate route to admission depending on the circumstances of the particular outsourcing. Typically a risk sharing or pass-through arrangement is suited to small contractors on short term contracts as there is less financial impact for the awarding authority in adverse markets and less time for markets to be volatile; there are also benefits in avoiding some of the administrative and actuarial processes and costs which may be disproportionate for such small cases. However, we are aware of larger contracts within the Gloucestershire Pension Fund that operate using “pass-through” arrangements.

In the event that the circumstances of each admission were considered, factors that feed into the decision making process include:

- the awarding authority’s attitude to risk e.g. if risk averse then more elements of the traditional approach may be desirable. It may wish to transfer as much risk as possible away or take the view that if the outsourcing had not happened it would have had the risk anyway and are therefore happy to retain risk (particularly in respect of pensions built up by members prior to the transfer to the new contractor);
- the extent to which the prospective contractor intends to price pension risks and costs into the contract;
- the size of the liabilities associated with the outsourcing relative to the size of the awarding authority’s liabilities (and the cumulative position should this approach apply to most of the awarding authority’s outsourcings);
- the financial strength (covenant) of the contractor;
- market conditions at the time of the outsourcing;
- the length of the contract period – the longer it is, the more room there is for risks/costs to increase; and
- preferences of bidders e.g. bidders may request fixed rate deals.

If the awarding authority decides to adopt risk sharing, it will need to think about the level at which the risks are shared and the price charged to the contractor for allowing risk sharing to happen.

For large contracts, we would recommend seeking additional advice on the risks of pass-through to ensure the awarding authority is comfortable with the level of risks being retained. Similarly, large outsourcings to a contractor where the admission agreements are closed can have cashflow and contribution rate implications. **We would strongly recommend seeking additional actuarial advice for large outsourcings.**

6 Implementing pass-through

As set out above, it is important to document all of the risk sharing arrangements. These may be included in the contractor's admission agreement to the Fund, or may also be included in either the services contract or a side agreement. Any agreement will need to be carefully drafted to ensure that it is clear from the outset:

- exactly what risks are being retained by the awarding authority;
- the specific treatment of costs arising as a result of actions by the contractor;
- who is responsible for future deficits and surpluses;
- what happens at the end of the contract;
- what happens if the contractor fails;
- who pays what to whom in terms of contributions, including the amounts and timings of contributions payable to the Fund; and
- what is the pension provision for new entrants.

Where the awarding authority has implemented pass-through arrangements, it should ensure that it keeps track of all the "retained risks" from those arrangements and that they are appropriately allowed for at valuation and accounting exercises. It should also share these with the Fund: this will be crucial at triennial valuation time (so that the contractors' contribution rates are considered appropriately) and on cessation (so that a cessation debt or exit credit is not levied on the contractor/Fund respectively).

In addition, the awarding authority may wish to draft and publish its policy on the approach to pass-through to ensure all departments, LEA schools and potential bidders are fully aware of how the pensions aspects of outsourcing will be dealt with. **Note that we have been made aware that academies should make the Department for Education aware where any pass-through arrangements are agreed due to the nature of the guarantee offered to academy schools.**

7 Recommendations and next steps

Pass-through is becoming more common in LGPS funds as contractors become more aware of pension risk and the financial consequences of adverse experience whilst participating in funds. The most competitive contract price is likely to be achieved if a contractor is offered pass-through. Recent market conditions and changes in the Regulatory environment on the ability to repay surpluses make pass-through a more attractive offering for awarding authorities. However, this brings added risks.

Our recommended approach is an arrangement where:

- the main pension risk (the liabilities and assets) effectively remain with the awarding authority;
- all new contractors pay a specified contribution rate during their participation in Fund which should be agreed between the admission body and the awarding authority. The Fund may wish to set a minimum acceptable specified contribution rate e.g. the awarding authority's primary rate.
- the contractor is held to account for any costs associated with employer driven decisions (excessive pay awards and early retirement strains);
- there is consideration and advice taken by the awarding authority on whether pass-through remains appropriate for particularly large contracts; and

- the arrangement should be clearly documented via the admission agreement, the services contract or a side agreement between the awarding authority and contractor. Either way, the Fund needs to be aware of all agreements.

Ultimately, it is for the awarding authority to decide whether and when it wishes to utilise pass-through for future outsourcings rather than the Fund. However, a consistent policy will ensure processes at the awarding authority and the Fund will be as efficient as possible.

8 Reliances and limitations (including compliance with professional standards)

This paper has been requested by and is provided to Gloucestershire County Council, in its capacity as Administering Authority to the Fund. Its purpose is to consider options for pass-through admission agreements. It should not be used for any other purpose. It should not be released or otherwise disclosed to any third party except as required by law or with my prior written consent, in which case it should be released in its entirety. Hymans Robertson LLP accepts no liability where this is used for any other purpose or to any other party unless we have expressly accepted such liability.

The figures quoted in the appendix to this paper are intended to demonstrate, at a high level, the financial impact of adopting a simple pass-through approach.

This paper proportionately complies with Technical Actuarial Standards 100 and 300. It should be read in conjunction with the 2019 Fund valuation report and the Fund's Funding Strategy Statement.

Julie West

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5 November 2021

For and on behalf of Hymans Robertson LLP

Appendix – Case Studies

Case study 1

This contractor was set up on a fully funded basis on 1 September 2014 and ceased on 17 August 2019. In this case a deficit arose on cessation.

At end of contract:

Value of liabilities relating to past service at the cessation date = £103k

Value of assets relating to past service at the cessation date = £79k

Outcome under a traditional arrangement:

These liabilities and assets are the responsibility of the contractor and the appropriate accounting values are included on the contractor's balance sheet throughout the duration of the contract.

Contribution rates for the contractor could have varied over time as market conditions, membership experience and deficit/surpluses change over the duration of the contract (in this instance, we maintained rates at a constant level of 25.7% throughout their participation).

Cessation deficit attributable to the contractor at the end of the contract = £79k - £103k = £24k

Cessation debt payable by the contractor = £24k

The liabilities and assets (including any deficit payment recovered from the contractor) would revert to the Awarding Authority's portion of the Fund on cessation.

Outcome under a pass-through arrangement:

These liabilities and assets remain with the Awarding Authority and the appropriate accounting values are included on the Awarding Authority's balance sheet throughout the duration of the contract.

The employer would have paid a fixed contribution rate throughout the contract (they would have known this during the tendering exercise).

Cessation deficit attributable to the Awarding Authority at the end of the contract = £79k - £103k = £24k (in practice, this would be dependent on the fixed rate that would have applied during the contract period).

Cessation deficit payable by the contractor = £0k

As these liabilities have never left the Awarding Authority, no cessation payment is due from the Awarding Authority. The deficit arising at the end of the contract is funded by the Awarding Authority alongside its other liabilities. However, a check would be carried out to ensure the contractor has met the conditions of the pass-through arrangement (such as paying all its due contributions, not awarding excessive pay awards) which could precipitate a top-up from the contractor.

Case study 2

This contractor was set up on a fully funded basis on 1 June 2012 and ceased on 25 June 2020. In this case a surplus arose on cessation.

At end of contract:

Value of liabilities relating to past service at the cessation date = £13k
Value of assets relating to past service at the cessation date = £30k

Outcome under a traditional arrangement:

These liabilities and assets are the responsibility of the contractor and the appropriate accounting values are included on the contractor's balance sheet throughout the duration of the contract.

Contribution rates for the contractor varied from 26.2% to 11.9% over time as market conditions, membership experience and deficit/surpluses changed over the duration of the contract.

Cessation surplus attributable to the contractor at the end of the contract = £30k - £13k = £17k

Exit credit potentially payable to the contractor = £17k

Assuming the exit credit is then paid, the liabilities (£13k) and assets (£13k also, i.e. the £30k less the £17k exit credit payment out of the Fund) would then fall back to the Awarding Authority.

Outcome under a pass-through arrangement:

These liabilities and assets remain with the Awarding Authority and the appropriate accounting values are included on the Awarding Authority's balance sheet throughout the duration of the contract.

Contribution rates for the contractor would have been fixed throughout the contract period instead of varying.

Cessation surplus attributable to the Awarding Authority at the end of the contract = £30k - £13k = £17k (in practice, this would be dependent on the fixed rate that would have applied during the contract period).

Exit credit payable to the contractor = £0k*

*As the Awarding Authority retained the pension risks, the Fund would likely determine that no exit credit would be due to be paid to the contractor; however for LGPS regulatory reasons the Fund would strictly speaking need to formally decide this on a case-by-case basis.

The surplus arising at the end of the contract is included alongside the Awarding Authority's other assets and liabilities. However, a check would be carried out to ensure the contractor has met the conditions of the pass-through arrangement (such as paying all its due contributions, not awarding excessive pay awards) which could precipitate a top-up from the contractor.