

## PENSIONS & PROCUREMENT

### Potential risk and cost sharing arrangements

Any Local Government Pension Scheme (LGPS) employer that considers letting a service (commercial) contract to an independent service provider is likely to transfer its employees under a TUPE arrangement.

Whilst pensions are not covered by TUPE regulations, the transferring scheme employer will need to consider the pension arrangements that will be available to their staff following the transfer of their employment to the scheme employer's preferred independent service provider.

In most instances this will mean that the chosen independent service provider will become an admission body to the LGPS and one of the key areas to consider is whether or not there will be any risk/cost sharing arrangements between the 'new' admission body and the 'outsourcing' scheme employer and, if so, what this would entail.

**Important:** The Royal County of Berkshire Pension Fund (RCBPF) recommends that these matters are discussed and agreed upon at the time of tender and the subsequent agreement is laid out in the service (commercial) contract. RCBPF also needs to know about these arrangements as any such arrangement will affect all actuarial work that is required

Broadly speaking these arrangements fall into the categories below:

**1). Standard Arrangement (no cost or risk sharing):** RCBPF's actuary will make an assessment from the date of the transfer so that the 'new' admission body is credited with an appropriate amount of assets in relation to the pension liabilities that they have inherited in line with the agreed starting funding level. If it has been agreed that the new admission body will start 100% funded then the new admission body will be credited with an equal number of assets and liabilities. If the funding level has been agreed to be above or below 100% then the starting asset amount will be adjusted accordingly.

The actuary will also provide a starting employer contribution rate (for both an open and closed arrangement) which reflects the expected level of contributions that need to be paid to fund the future service of the transferring staff. At every triennial valuation the actuary will review the funding level of the admission body and either increase, decrease or maintain their employer contribution rate as required. Once either the service (commercial) contract comes to an end or earlier if all the LGPS members have left eligible employment, the actuary will perform a cessation valuation to determine whether a surplus or deficit exists. RCBPF will seek to recover any deficit from the admission body. Under the LGPS Regulations, RCBPF are under no obligation to return any surpluses.

As part of the admission agreement, the admission body will be responsible for pension strain costs where member benefits are released early as a result of the admission body's decision to allow a scheme member to retire through flexible retirement or as a result of redundancy or re-structuring of their business.

In this scenario, most of the pension risk lies with the new admission body. However, the scheme employer still retains some risk, as RCBPF require it to guarantee the scheme liabilities and once the admission body has ceased (and any cessation deficit has been paid) will merge the remaining assets and liabilities back with the scheme employer.

**Set-up costs:** it is policy to recharge the actuarial costs involved in this exercise to the scheme employer.

**2) Pass-Through Arrangement (cost or risk sharing arrangement in place):** 'Pass-through Arrangement' is the general name given to a wide variety of cost and risk sharing arrangements that can be put in place. By definition, this involves the scheme employer retaining some or all of the responsibility for the costs or risks related to the admission body's membership of the Pension Fund. Detailed below are some common examples of pass-through arrangements but these are by no means an exhaustive list and other arrangements are also possible.

**a). Complete pass-through:** The scheme employer remains responsibility for all of the admission body's employer pension contribution costs as well as any cessation amount. The admission body still needs to pay pension contributions directly to the RCBPF so this arrangement would normally operate in such a way that the admission body would pay contributions to Pension Fund as normal but then recharge the costs back to the scheme employer.

**Comment:** Under this arrangement, the admission body takes no risk at all and the scheme employer retains all of the pension costs and risk despite losing some control for certain relevant factors such as salary increases. However, normally the admission body would remain responsible for pension strain costs which result from an employer decision: e.g. redundancy, flexible retirement or awarding additional pension.

**b). Fixed employer contribution rate:** The scheme employer and admission body agree that the admission body will pay a fixed employer contribution rate for some or all of the contract period. The RCBPF must receive the actuarially assessed employer contribution amounts and would expect that the full employer contribution as certified by the actuary to be paid to the Pension Fund by the admission body.

Any difference in actual costs to the fixed costs would be dealt with by agreement between the scheme employer and the admission body as part of the service (commercial) contract. Normally any cessation deficit would remain the

responsibility of the scheme employer but this does not need to be the case; either way, the responsibility for any cessation amount should be clearly agreed by the two parties as part of the service (commercial) contract.

**Comment:** In terms of risk/cost sharing, this is similar in some ways to a) in that most of the risk sits with the scheme employer. However, both parties costs will be affected by salary increases while the scheme employer will still hold the risk related to changing actuarial assumptions and experience (e.g. investment returns, life-expectancy, inflation etc.).

**c). Future service rate only:** The future service rate is the estimated amount of pension contributions that is required to pay for the expected future pension entitlement of members. For example, a future service rate of 15% that applies for 3 years means that the actuary predicts that paying an employer contribution rate of 15% for all members for three years will be sufficient to fund the next 3 years worth of pension accrual. This ignores any funding that may be required for any previous deficit.

Hence, under this arrangement the admission body would only be responsible for the estimated cost of any future accrual but the scheme employer would take responsibility for any deficit or surplus. Logically it tends to follow that the scheme employer would be responsible for any cessation deficit or surplus as well. However, again, this should be explicitly agreed between the two parties in the service (commercial) contract to remove any doubt.

**Comment:** Under this arrangement, there is a more even share of risks between the two parties. Both parties are exposed to the risk of changing actuarial assumptions and predicted investment returns although only the scheme employer is responsible for actual experience.

**d). Capped employer contribution rate:** This type of arrangement will normally work in a similar way to the Standard Arrangement but here there will be a cap on how much the admission body is asked to pay (normally expressed as a percentage of pay but it is equally possible to do this on monetary payments). Whenever the employer contribution rate goes above the cap, the scheme employer will be required to pay the excess amount although such an arrangement would need to be agreed as part of the service (commercial) contract as the admission body would be required to pay the employer contributions at the rate as certified by the actuary to the Pension Fund.

**Comment:** The risk profile here is closer to the Standard Arrangement, typically with the admission body taking most of the risk. However, the risk profile will vary depending on how high the cap is.

**e). Cap and collar employer contribution rate:** This arrangement includes both the capped amount from d) but also a lower 'collar' amount. If the assessed

employer contribution rate goes above the cap, the scheme employer pays the excess. If the employer contribution rate goes below the 'collar' then the admission body pays the assessed amount and pays the difference between the assessed amount and the collar to the scheme employer. In practice the admission body pays the employer contributions at the rate certified by the actuary to the Pension Fund and any adjustments are dealt with by an agreement set out in the service (commercial) contract.

**Comment:** If the cap and collar amounts are set close to one another then this arrangement is similar to b), if they are set further apart then this becomes similar to the Standard Arrangement as it is less likely that either the cap or collar will be needed. Hence, the risk profile depends very much on the cap and collar amounts that are set.

### **Summary**

There are many ways in which an admission body may look to mitigate or limit exposure to the risks its participation in the LGPS will bring. It is for the scheme employer who outsources the service to consider the level at which it feels comfortable in either retaining those risks or passing them onto the admission body.

The financial risks to both the scheme employer and the admission body can be considerable and are somewhat unquantifiable as the funding position of the admission body, and the Pension Fund as a whole cannot be guaranteed as economic conditions change and investment returns vary over time.