Briefing

Pass-through arrangements

This note outlines some of the considerations that should be taken if a new employer becomes an admission body within an LGPS Fund under a pass-through arrangement.

We summarise the key risks associated with participation in a pension scheme as well as describing different risk sharing arrangements focusing on pass-through arrangements. We also detail what a pass-through arrangement is and what a Fund should consider if this option is offered to a new employer.

Please note that this should not be seen as legal advice and this note simply summarises the issues that we believe should be considered as a minimum before taking part in a pass-through arrangement. This list is not exhaustive and there may be further Fund specific considerations that should be made.

Risks transferred

There are various pensions risks that apply to any outsourcing contract and they can be divided up between the Letting Authority and the new employer depending on the terms of the agreement. In the table to the right we consider the main pensions risks that exist and where the responsibility for these risks lie under a full risk transfer arrangement and a pass-through arrangement. Please note that the share of risk ultimately depends on the specific pass-through arrangement and so the responsibility of risks set out in the table below is only a representation of a potential pass-through arrangement. Each risk should be carefully considered so that it is clear where the responsibility lies for each risk and either set out in the admission agreement or in a side agreement. This list is not exhaustive and any Fund specific risks should be taken into consideration.

Risk	Full risk transfer	Pass-through
Investment risk	New employer	Letting Authority
Inflation risk	New employer	Letting Authority
Salary risk	New employer	Mainly the Letting Authority
Mortality risk	New employer	Letting Authority
Any change in actuarial assumptions	New employer	Letting Authority
Number of members leaving	New employer	Letting Authority
Early retirements	New employer	Usually the new employer
Ill health retirements	New employer	Varies but usually the Letting Authority
Discretions	New employer	Usually the new employer
Regulatory change	Depends on the details of the change but usually the new employer	Letting Authority

Full risk transfer

Under a full risk transfer with no pass-through arrangement, all the pensions risk is borne by the new employer and who would also be responsible for any deficit which may arise over the duration of the contract. The pensions risk would include: investment risk, salary risk and mortality risk.

Normally in these cases, the liabilities would be transferred to the new employer on a fully funded basis. In other words, any existing deficit attaching to the transferring liabilities remains the responsibility of the Letting Authority at the point of transfer, in which case the new employer is only responsible for any deficit arising after the initial transfer.

Pass-through arrangements

A pass-through arrangement is one in which the risks inherent in participating in the LGPS are shared between the new employer and Letting Authority, and typically with the majority of the pensions risk being borne by the Letting Authority rather than the new employer.

> Importantly, it also means that the new employer would not be required to fund any deficit at the end of the contract, subject to any agreed exceptions.

For example, in most cases, the new employer would still be expected to pay for the cost of any enhancements to members' benefits, including those payable via early retirement redundancies as well as meeting the contributions payable. If the new employer does not want to take responsibility for such risks it needs to be clearly stated in the admission agreement and all parties should be clear about their responsibilities from the outset.

For accounting purposes, the nature of the pass-through arrangement and the specific risk sharing arrangement needs to be considered. For example, under a full risk transfer the pensions risk would pass to the new employer and the liability would be included on the balance sheet of the new employer.

> Under a full pass-through arrangement where all the pensions risks remains with the Letting Authority, the liability would be included on the balance sheet of the Letting Authority.

Approaches to pass-through arrangements

There are three common approaches to setting the contributions payable under a pass-through arrangement which are outlined below:

1. Simple fixed rate

A simple fixed rate approach is one in which the pass-through contribution rate is fixed at outset and not re-calculated during the remainder of the contract. This can be set out in the admission agreement or may be set out as part of the commercial contract between the Letting Authority and the contractor.

It may be that the contractor pays contributions into a Fund throughout the life of the contract based on the pass-through contribution rate agreed at outset. Another approach may be that the rate the contractor pays into a Fund at varies (for example, following each triennial valuation) but the difference between the rate and the original pass-through contribution rate is reimbursed to the contractor/Letting Authority in some way, for example via adjustments to the contract pricing. Under this approach, as any differences are reimbursed, the overall effect remains that the contractor pays the pass-through contribution rate.

At the end of the contract, there would be no exit deficit for the contractor as the Letting Authority has retained all of the funding risk.

For accounting purposes, the contractor's obligation is simply to pay a fixed contribution rate so we would not expect them to have to include any liability on their balance sheet in respect of their LGPS pension participation and instead the Letting Authority would include it in their disclosures. The contractor may report its participation in the LGPS as if it were a defined contribution scheme.

2. Varies in line with the cost of benefit accrual

This approach is most likely to be found on longer contracts. An initial rate is set and then adjusted at each valuation in line with the change in the cost of benefit accrual. This means that the contractor picks up the cost of changes in the profile of their membership, the life expectancy of their members and the actuary's updated assumptions, such as future investment returns, inflation and salary increases. The Letting Authority retains much of the market risk (e.g. asset performance) and experience (e.g. if inflation has been higher or lower between the valuation periods than assumed).

> This arrangement also involves no exit deficit at the end of the contract for the contractor, and the Letting Authority has retained all of the past service deficit risk.

This approach means that if there are any updates to the future expected cost of benefits, the contractor's rate is updated. For accounting purposes, under this approach it is less clear whether the contractor needs to include a liability on their balance sheet – they are subject to some pensions risk but they never have a possibility of a past service funding deficit so it could be argued that they have no accounting balance sheet obligation. In these cases, the contractor (and Letting Authority) should check with their auditors what their requirements are.

3. Matches the Letting Authority

This is a simple approach which just means that the contractor pays the same contribution rate the Letting Authority pays. When the Letting Authority's rate is updated, the contractor's rate is also updated. This is similar to conventional pooling in an LGPS Fund where employers are grouped and pay the same contribution rate. .

> This arrangement also involves no exit deficit at the end of the contract for the contractor, however, it has taken on some of the past service deficit risk throughout the life of the contract.

Therefore, it's just another step along from the above two approaches. In these cases, the contractor shares in all pensions risks while they are on the contract but, assuming the Letting Authority is much larger than the contractor, the rate that they pay should be less volatile than it would have been if the risk had been fully transferred to the contractor.

It does introduce another risk though, which is that specific factors driving the Letting Authority's rate may inadvertently affect the contractor's rate. For example, the Letting Authority may decide to prioritise paying their pensions deficit so at the triennial valuation, they may volunteer to pay a higher rate and this would have a knock-on effect on the contractor. If the contractor leaves a Fund relatively shortly after this, they have simply paid higher contributions because of a decision by the Letting Authority. By a similar argument though, the Letting Authority's rate might be lowered for the opposite reason and therefore, the contractor would pay lower contributions because of the Letting Authority's decision.

As the contractor is now sharing in some of the pensions risk, it may be that there is a stronger argument that they should include a liability on their balance sheet. However, it may be that the absence of an exit deficit means that this is not required. Again, auditors' advice should be sought in these cases.

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

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