Report Title:	**Pass-through Admission Agreements**
Contains Confidential or Exempt Information?	YES - Part I
Member reporting:	Councillor Lenton, Chairman Berkshire Pension Fund and Pension Fund Advisory Panels
Meeting and Date:	Berkshire Pension Fund and Pension Fund Advisory Panels – 12 November 2018
Responsible Officer(s):	Kevin Taylor, Deputy Pension Fund Manager
Wards affected:	None

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Royal Borough of Windsor & Maidenhead

REPORT SUMMARY

1. This report explains the financial risks involved in admitting private sector companies into the Pension Fund when they successfully bid for Local Government service contracts.
2. Members are asked to consider this paper with particular regard to the option for so-called pass-through arrangements where the perceived financial risk is considered to be acceptable.

1 DETAILS OF RECOMMENDATION(S)

RECOMMENDATION: That Panel notes the report and:

i) Approves the principle of pass-through where the risk to the Pension Fund is negated;
ii) Agrees to delegate responsibility to officers to consult with scheme employers and publish guidelines on the website.

2 REASON(S) FOR RECOMMENDATION(S) AND OPTIONS CONSIDERED

2.1 In accordance with Part 3 of Schedule 2 of the Local Government Pension Scheme Regulations 2013 ("the Regulations") an administering authority may make admission agreements with a wide-ranging number of employers defined as 'admission bodies'. For the purpose of this paper paragraph 1(d)(i) is of particular relevance; *"(1) The following bodies are admission bodies with whom an administering authority may make an admission agreement (d) a body that is providing or will provide a service or assets in connection with the exercise of a function of a Scheme employer as a result of (i) the transfer of the service or assets by means of a contract or other arrangement".* Such an arrangement would be typically described as a 'service outsourcing'.

2.2 Paragraph (13) of the same Regulation further states that *"Where an admission body of the description in paragraph (1)(d) undertakes to meet the requirement of these Regulations, the appropriate administering authority* ***must*** *admit to the Scheme the eligible employees of that body".*

2.3 When a Scheme employer (the transferor scheme employer) chooses to outsource a service and a procurement exercise is undertaken, details of the potential pension costs should be included at the earliest possible stage of the procurement process. This will normally involve the Fund actuary preparing a report at a cost of £1,580 plus VAT in which an employer contribution rate and bond/indemnity level is set and which would be required of the eventual admission body. Ideally, this report should be included in the transferor scheme employer's procurement documents. At Appendix 1 to this paper is a guide to Navigating Entry to the LGPS for Local Government Contractors as prepared by the Pensions and Lifetime Savings Association (PLSA) which provides an overview of this process.

2.4 As part of the procurement exercise the transferor scheme employer and their chosen independent service provider need to consider and discuss the financial risks associated with becoming an admission body under the LGPS Regulations. Both parties, in conjunction with the Pension Fund, need to consider the level at which the pension risks should be retained by the transferor scheme employer or transferred to the admission body. At Appendix 2 to this paper is a briefing note, prepared by Barnett Waddingham, concerning the transfer of risk and highlights the option of pass-through.

2.5 The outsourcing of a service contract will in most instances involve the transfer of employment under the TUPE regulations in force at the time for those staff involved. On many occasions, however, the numbers of staff being transferred is minimal (less than 10 and on occasion as few as 1 or 2) but the process of admitting an independent service provider to the LGPS as an admission body is currently undertaken in the same way as if a larger group of employees is transferred.

2.6 Where a limited number of employees are to be transferred, pass-through becomes an attractive option to all parties involved in the process for a number of reasons:

- The procurement process is more straightforward;
- Actuarial fees are reduced or avoided completely;
- The pension costs will be explicit from the outset therefore removing the need for the contract bidder to load their contract prices to account for the potential and unforeseen pension costs associated with becoming an admission body;
- Officer time and cost is reduced;
- There is no need for the procurement of a bond;
- Admission agreements can be executed in a timely and effective manner.

2.7 In practice, pass-through works by agreeing a fixed employer contribution rate for the entire length of the service contract. The chosen independent service provider upon becoming an admission body to the Fund will be responsible for deducting the employer contributions from the pensionable pay of their 'transferred' scheme members and making payment to the Pension Fund. The employer contribution rate will be set out in the admission agreement signed between the admission body, the transferor scheme employer and the Administering Authority. The admission body will become responsible for no other pension costs. Any funding deficit, or surplus, that may arise during the term of the service contract will revert

back to the transferor scheme employer when that contract ends and the admission agreement is terminated.

2.8 The service contract between the transferor scheme employer and their chosen independent service provider (admission body) will need to reflect all other requirements relating to the funding of pension scheme benefits. The transferor scheme employer will need to consider the extent to which it is prepared to meet the pension risk even though pass-through may be agreed. For example:

2.8.1. Cap and collar - agree with its chosen service provider that where the actuary assesses that the funding level requires an increase or decrease to the employer contribution rate during the term of the contract, that the change in employer contribution rate is made within an agreed tolerance either way but that any increase or decrease to the employer rate in excess of that tolerance is adjusted for by an amendment to the contract price;

2.8.2. Pension strain costs - agree with its chosen service provider whether the service provider will be responsible for any pension strain costs arising as a result of their decision to allow the early release of unreduced pension benefits e.g. upon redundancy, business efficiency;

2.8.3. Pay increases – agree with its chosen service provider, who should meet any additional funding costs arising as a result of the admission body awarding pay increases in excess of equivalent pay increases awarded by the transferor scheme employer.

2.9 Paragraph 8(b) of Part 3 to Schedule 2 of the Regulations states that *"Where, for any reason, it is not desirable for an admission body to enter into an indemnity or bond, the admission agreement must provide that the admission body secures a guarantee in a form satisfactory to the administering authority from, in the case of an admission body falling within the description in paragraph 1(d), the Scheme employer referred to in that paragraph."* Therefore, ultimately the risk associated with pass-through is one undertaken by the transferor scheme employer and whilst pass-through may be seen as an efficient option where the risks are minimal, it may not be the preferred option for transferor scheme employers where a significant number of scheme members may be transferred to an admission body. In these cases if may be more appropriate to pursue a bond, a parent company guarantee or an equivalent indemnity to the satisfaction of the transferor scheme employer and the Pension Fund.

3 KEY IMPLICATIONS

3.1 The Administering Authority (Scheme Manager) is required by law to maintain the Royal County of Berkshire Pension Fund is accordance with the Regulations and all other associated legislation. Failure to do so could result in the Pensions Regulator issuing fines to the Authority where he deems it to have failed in areas of scheme governance, risk management and administration.

3.2 The Administering Authority has a responsibility to manage the administration of the Scheme on behalf of all Scheme employers ensuring that all aspects of administration are effective and efficient, maintaining stable employer contribution rates and reducing costs where achievable.

4 FINANCIAL DETAILS / VALUE FOR MONEY

4.1 The Pension Fund will not enter into any admission agreement without the appropriate indemnity being agreed between the parties to the agreement. Improved processes will add value for money.

5 LEGAL IMPLICATIONS

5.1 The Local Government Pension Scheme Regulations 2013 (as amended) set out the statutory requirements of the Administering Authority in admitting employers to the Fund.

6 RISK MANAGEMENT

6.1 The Administering Authority will need to ensure that appropriate measures are taken to protect the Pension Fund against any potential costs arising as a result of a Scheme employer's decision to outsource a service.

6.2 This will be achieved by ensuring that the terms of any admission agreement to which all parties are agreed clearly sets out the responsibilities for funding the pension benefits of the scheme members to which the admission agreement relates and that the Pension Fund will apply all statutory requirements set out in the Regulations.

6.3 The Pension Fund will only agree to a full pass-through arrangement where it is satisfied that any funding risks are covered by the other parties to the agreement.

7 POTENTIAL IMPACTS

7.1 Failure to maintain the Pension Fund in accordance with statutory legislation could result in a loss of confidence in the Administering Authority.

8 CONSULTATION

Scheme employers will be consulted with prior to any guidelines being issued by the Pension Fund.

9 TIMETABLE FOR IMPLEMENTATION

9.1 **Implementation timetable**

As soon as possible subject to completion of consultation.

10 APPENDICES

10.1 The appendices to the report are as follows:

- Appendix 1 – PLSA guide - Navigating Entry to the LGPS for Local Government Contractors
- Appendix 2 – Barnett Waddingham briefing – Pass-through Arrangements

11 BACKGROUND DOCUMENTS

11.1 Local Government Pension Scheme Regulations 2013 (as amended)

12 CONSULTATION (MANDATORY)

Name of consultee	Post held	Date issued for comment	Date returned with comments
Cllr John Lenton	Chairman – Berkshire Pension Fund Panel		
Rob Stubbs	Section 151 Officer		

PENSIONS AND
LIFETIME SAVINGS
ASSOCIATION

A GUIDE FOR EMPLOYERS PARTICIPATING IN THE LGPS

NAVIGATING ENTRY INTO THE LGPS: FOR LOCAL GOVERNMENT CONTRACTORS

CONTENTS

1. INTRODUCTION

OVER 13,000 EMPLOYERS HELP TO DELIVER LOCAL PUBLIC SERVICES. THESE EMPLOYERS ARE TYPICALLY BUSINESSES, CHARITIES, AND HOUSING ASSOCIATIONS.

If a local authority contract involves the transfer of staff to your organisation under a TUPE arrangement, you will come to participate in the Local Government Pension Scheme (LGPS) as an 'admission body', or will be required to provide a 'comparable' pension benefit.

The LGPS provides a good quality pension for its members. However, participation in the scheme comes with potentially significant financial commitments and administrative responsibilities, including:

- Making regular contributions on behalf of employees and making additional contributions if the scheme is in deficit;
- Facilitating communications with scheme members; and
- Setting up administrative processes for making payments and providing data to the scheme when requested.

This guidance will help you to obtain a full appreciation of these obligations and any associated risks before entering into a local government contract.

WHAT IS THE LGPS?

The LGPS is a defined benefit (DB) pension scheme for employees working in local government. It is made up of three schemes – the England and Wales scheme and two additional devolved schemes in Scotland and Northern Ireland.

Members of DB schemes are promised a guaranteed pension income in retirement. This means that the financial risk of the scheme's investment falls to you as an employer in the scheme.

The LGPS is governed at national and local level by a number of different bodies[1]. As an admission body, you need to be aware of the relationships between the local commissioning authority and the local administering authorities.

You will engage with the commissioning authority on the terms of the contract you are tendering for ('the commercial contract'); and the administering authority regarding the terms of entry into the LGPS. These terms are governed by an 'admission agreement', a legally binding contract between you, the commissioning authority, and the administering authority.

1 See here for more information about how the LGPS is governed.

HOW IS THE LGPS FUNDED?

The LGPS is funded through the contributions of all employers and employees participating in the scheme. The contributions you pay are valued as an estimate of what the benefits are likely to cost when they are paid. These contributions are then invested to seek a return that can meet the promises made to members.

If the value of the pension scheme assets is not sufficient to meet the promises made to scheme members then the scheme is considered to be in deficit. If you exit the scheme, the cost of meeting the pension scheme liabilities that have accrued during the time of your participation may have decreased or increased. The deficit attributed to admission bodies is calculated at the end of the contract and levied as exit costs.

The local administering authority acts as scheme manager and so is responsible for investing and managing LGPS assets, setting employer contribution rates, collecting employer and employee contributions, paying pension benefits as they fall due, and dealing with various other aspects of administration.

The LGPS' funding position has weakened considerably over the last decade. A number of factors, such as increasing longevity and low gilt yields, have contributed to this; resulting in a rising deficit[2].

2 A full set of figures from the latest scheme valuation can be found here.

2. WHAT DO YOU NEED TO KNOW BEFORE ENTERING THE SCHEME?

BEFORE MAKING A DECISION ABOUT TAKING ON A LOCAL GOVERNMENT CONTRACT THAT RESULTS IN ENTERING THE LGPS, YOU NEED TO UNDERSTAND:

- The process of joining the scheme (see Section 3);
- Risks associated with participating in the scheme (see Section 4);
- How these risks might affect your financial prospects and how to mitigate them (see Section 5);
- Your obligations as an employer participating in the scheme and how they could change in the future; and
- Opportunities for negotiating terms of entry, participation and exit.

GOOD GOVERNANCE

You should formalise governance processes to understand and ultimately make decisions about proceeding with becoming an admission body.

Getting this right is critical as you need to be able to assess whether the contract is still viable after taking into account financial commitments to the LGPS. The following steps capture the basic principles of setting up a good governance process.

STEP 1

Check whether or not the commercial contract involves a TUPE arrangement.

STEP 2

Investigate the terms of the standard admission agreement with the administering authority and which of them are negotiable or can be amended alongside the commercial agreement with the contracting authority.

STEP 3

Analyse how the terms of the admission agreement as they stand and possible amendments to them are a risk to the cost-benefit of the commercial contract.

STEP 4

Assess whether, in light of your organisation's risk framework and financial position, the commercial contract and admission agreement is appropriate to take on in its current or an amended form.

WHO IS RESPONSIBLE?

A number of people in your organisation need to be alert to the pension obligations associated with taking on a local government contract.

In the first instance, those responsible for submitting your contract tender need to be aware that local government contracts could include LGPS admission agreements.

Next, the person responsible for identifying the terms of the admission agreement ideally should be someone who has a sufficient 'pensions vocabulary'. In larger organisations you may have the capacity to train up senior members of your contracting team to find out and interpret essential information from the administering authority. In smaller organisations this may be your finance personnel, chief executive or even an accountant, actuary or legal adviser.

The person responsible for assessing the desirability of the contract will vary. Ultimately, where it involves taking on significant risk, this decision may need to be escalated to your senior executive team or board. They may wish to seek expert advice to make a fully informed decision.

MAKING A DECISION ABOUT PARTICIPATION IN THE SCHEME

A cost-benefit analysis of the contract that factors in LGPS costs, should only form a part of the decision-making process. Other important factors such as your financial position, aims, and what contingency mechanisms you have in place to deal with outstanding liabilities should also be considered.

3. WHAT YOU NEED TO KNOW, AND WHEN, DURING THE TENDERING PROCESS

THE TERMS OF THE ADMISSION AGREEMENT NEED TO BE CONSIDERED AS PART OF THE OVERALL PROCESS OF THE TENDER ALONGSIDE THE TERMS OF THE COMMERCIAL AGREEMENT.

There will be little room to manoeuvre beyond the standard admission agreement issued by the administering authority; however, you will have the opportunity to negotiate risk-sharing arrangements in the terms of your commercial contract with the commissioning authority.

Below we provide an explanation of what you should be thinking about at each stage of the tendering process. It is important to build in time for a series of exchanges between the three main parties. In particular, those you engage with from the commissioning authority may have varying levels of knowledge about the pension implications of the contract they are assigning and so may have to seek external advice.

PRE-TENDER

- Will you be taking on employees who are currently participating in the LGPS?
  - How many?
  - What are their ages, salaries and accrued benefits?
  - On what terms will their liabilities be transferred?
- Do you wish to allow new employees, who work on the contract but are not required to participate, to participate in the LGPS? (This is called an 'open' contract.)
- Who will you engage with on pension issues at the administering and contracting authorities?

INVITATION TO TENDER

During the tender process you should request the following information:

- Guidance for admission bodies (where available);
- An example admission agreement with an indicative contribution rate;
- The latest actuarial valuation of the fund;
- The commissioning authority's policies on pensions risk-sharing;
- Whether a bond or indemnity is required; and
- Your exposure to additional costs that could arise due to redundancy, ill health and death in service of the transferred employees.

SUBMISSION TO TENDER

When submitting your bid for the contract, the price should include a prudent, risk-adjusted measure of the costs of providing the service that includes the cost of LGPS participation[3].

CONTRACT AGREED WITH THE COMMISSIONING AUTHORITY

Any risk-sharing with the commissioning authority should be agreed at this phase (see Sections 4-5).

ADMISSION AGREEMENT AGREED WITH THE ADMINISTERING AUTHORITY

The admission agreement and all of the paperwork relating to being set up as a new employer in the fund should be completed at this time. Although this and the previous stage are ordered sequentially, in practice they need to be considered alongside each other from the start of the contract.

3 NAO guidelines state that contracts should cover core costs and, for charities, that donations shouldn't be used to cover the costs of delivering a statutory service.

4. RISKS FOR ADMISSION BODIES PARTICIPATING IN THE LGPS

THE MAJOR UNFORESEEN COSTS THAT MAY COME WITH LGPS PARTICIPATION ARE:

- Increases in contributions during the term of the contract;
- Exit costs – what the fund requires at the end of the contract; and
- Unexpected increases to staff remuneration, which have a knock-on consequence for contributions during the term of the contract.

INCREASES TO CONTRIBUTIONS

There are a large number of variables that determine the cost of benefits as they accrue, including:

- Economic conditions;
- The investment profile of the fund assets;
- The current membership of the scheme; and
- Longevity projections for scheme members.

The interplay of these variables, and changes in them over time, can lead to substantial changes in employer contributions over the term of your contract. By law, the fund will undergo an actuarial valuation every three years to assess how these factors will affect contributions. However, there are circumstances where such a valuation can be brought forward outside of this cycle – most admission agreements will indicate this.

During the valuation the actuary will recalculate:

- The past service contribution rate – in relation to the deficit or surplus; and
- The future service contribution rate – in relation to the current estimated cost of providing the benefits promised in the scheme.

To make your liability for the past service liabilities of transferred employees clear to you, admission agreements will state that, on the date of your contract commencing, your participation in the scheme starts as '100% funded'. This term can be misleading, so it is important to understand what it does and doesn't mean.

When employees are transferred to you, the fund will assess whether there is a deficit relating to the funding of the scheme for those employees. If the scheme is in deficit, being 100% funded means that you are not responsible for the deficit that has arisen before you took on those employees. However, you do take on the liabilities relating to those employees, which can change over time. You will be responsible therefore for any changes to the deficit that arise from the commencement of the contract in relation to those past service liabilities.

For example if the employees' notional scheme is £5 million in deficit when you start the contract, then you won't be liable to pay extra contributions to ensure those past service liabilities are fully matched. If however, on the next valuation, that £5 million deficit has grown to £6 million, then, unless you have negotiated another arrangement, you will be liable for the extra funding gap that has arisen in relation to those employees' past service liabilities over the course of your contract – an extra £1 million.

Changes in these liabilities will, in turn, be reflected in your contribution rate and any exit costs payable at the end of the contract.

COVENANT ASSESSMENT

Your contribution rates will be affected by the administering authority's view of your 'covenant'. This is your financial ability to support your obligations to the scheme now and in the future.

You should have the capacity to feed into discussions about the covenant strength allocated to you[4]. It is important that you understand the rationale behind your allocated covenant strength, what this means for your participation in the scheme, and what factors will improve or worsen your position. Higher contributions will be required from an employer with a 'weak' covenant, because the administering authority has concerns about weaker employers' ability to pay if the deficit increases.

EXIT COSTS[5]

Exit costs are paid when you cease to participate in the scheme, and have the potential to be very high.

You are deemed to exit the scheme, known as a 'cessation event', when:

- the commercial contract has ended;
- Your last 'active' member (ie. members that are still accruing benefits) leaves the scheme; or
- You undergo an insolvency event so no longer employ any active members in the scheme.

There are also some situations where a corporate restructure (eg. a merger or an acquisition) results in an effective cessation event, because a new entity employs the members.

Where there is no successor body agreeing to take on the liabilities, or no guarantor in place, cessation or exit debts are generally calculated using more cautious assumptions (known as a 'risk-free' basis) than the basis used to calculate the cost of providing pensions for your employees, resulting in higher liabilities. This basis is employed to minimise the risk that deficits attributable to members of departing employers inadvertently fall onto other employers as 'orphan liabilities'.

BONDS AND OTHER SECURITY

To mitigate the risk that employers won't be able to honour their commitments to the scheme, many administering authorities will ask for some form of indemnity against an inability to pay, such as a bond, security or a parent guarantee.

Different administering authorities apply different policies regarding what the bond is designed to cover. Some simply cover the costs of any likely redundancy payments on early termination. Others may go far wider and cover exit costs.

Bonds can be expensive to provide and may have a negative impact on your sponsor's balance sheet. Companies are not always willing to provide bonds readily; particularly if they already have a number of other bonds in place.

4 The Pensions Regulator provides helpful guidance on covenant assessment for private pension schemes – many of the same principles apply to employers participating in public service pension schemes.
5 Please see our 'managing exit' guidance for further information.

COST OF REDUNDANCIES, ILL HEALTH AND DEATH IN SERVICE

When an employee is made redundant or suffers ill health, they may be eligible for early retirement benefits from the LGPS. If an employee dies in service then their beneficiaries are due a sum that is a multiple of their salary.

When these events occur, you may need to pick up the increased value of the benefit earned over the member's total service. Some administering authorities make their own insurance provisions for these purposes so that the employer rate includes a small amount intended to cover these costs.

Most commissioning authorities will require you to pay for any increase in costs due to redundancies or greater-than-expected numbers of early retirees separately – and so where you are planning redundancies, it is important to factor in this cost.

5. MITIGATION OF RISKS

THERE ARE MANY WAYS TO LIMIT YOUR EXPOSURE TO RISKS FROM PARTICIPATING IN THE LGPS. THE MOST IMPORTANT THING TO REMEMBER IS THAT ONCE YOU ARE AN EMPLOYER IN THE LGPS, THE REGULATIONS, THE COMMERCIAL CONTRACT AND THE ADMISSION AGREEMENT WILL CONTROL YOUR RELATIONSHIP WITH THE LGPS.

To the extent that you can mitigate risks, it will be through the commercial contract. Different commissioning authorit ies have different policies on which risks they are willing to cover for admission bodies.

Some common risk mitigation measures are described below:

- Unless you have an agreement with the administering or contracting authority to the contrary, you are responsible for all past service liability which includes pensionable service accrued prior to you taking on the contract. You may want to ensure that you are isolated from this funding risk. You should discuss with the commissioning authority options to remove responsibility for any past service liability accrued before the start of the contract.
- You should seek to have liabilities dealt with on a consistent (actuarial) basis on joining and exiting the scheme in order to avoid unexpected exit costs.
- If you have agreed to assume the risk for pre-contract past service liability then care should also be taken over the actuarial basis used to calculate this. Even if there is no funding volatility over the course of the contract, pre-contract liability could be calculated on a higher basis at exit.
- Some funds will allow the costs arising from ill health retirements and deaths in service to be smoothed through your ongoing contributions or, especially for small contractors, shared among a pooled group of similar employers. The default position is for these additional costs to be levied by a single payment.
- Costs arising as a result of redundancy are generally considered an employer decision rather than a risk to be shared. However, there may be some room to discuss how costs arising very early in a contract are handled.
- It may be possible to request that the contracting authority pays any excess should contributions exceed a stated ceiling. This is known as a ‘pass-through’ arrangement.
- A more sophisticated arrangement is a ‘cap and collar’ arrangement where the contracting employer agrees to pay contributions only if they are within a certain range. If they fall outside this range, adjustments are made to the contribution rate.
- You can agree to restraints on your own behaviour or options so as to reduce risk of increasing liabilities. A commissioning authority may agree to retain certain risks if the contractor takes responsibility for matters affecting pension liabilities under its control, such as excessive pay awards.

NOTES

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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

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beyond the expected

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.

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beyond the expected

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.

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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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