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Deciding the Bond Amount

Avon Pension Fund

Contents

Introduction 3
Relevant Information 3
Risk Retained or Risk Transferred? 3
Bond Questionnaire... 4
How to Decide the Bond Amount 4
Review of Bond 6
What happens if the contractor fails with a bond in place?.................................... 7
Conventional method of determining the bond amount 7

Introduction

The Local Government Pension Scheme Regulations 2013 provide that an assessment must be carried out of the "level of risk arising on premature termination of the provision of service or assets by reason of insolvency, winding up, or liquidation of the admission body".

The Regulations further state that, "where the level of risk identified by the assessment is such as to require it, the admission body shall enter into an indemnity or bond in a form approved by the Administering Authority with" a properly regulated financial institution.

It is not clear from the Regulations who must decide whether "the level of risk is such as to require it". However, it is the view of the Avon Pension Fund that the organisation at risk of loss if the admission body should fail should make that decision. In the case of outsourcings to a contractor, it is the outsourcing Scheme Employer who is at risk because, if the contractor fails, the Scheme Employer is required under the Regulations to fund the contractor's outstanding pension liabilities.

The outsourcing Scheme Employer must therefore decide whether a bond is required. In making this decision the Scheme Employer should consider the information contained in the Fund Actuary's Summary Paper and Risk Assessment.

If the outsourcing Scheme Employer decides that a bond is required, the amount of the bond must then be determined.

Relevant Information

The information which a Scheme Employer will require to determine the amount of the bond is contained in the **Admission Summary Paper** and the **Risk Assessment Information Report**. There is a charge for these documents which are produced by the Fund Actuary. They should be obtained by the outsourcing Scheme Employer prior to commencement of the tender process. The Scheme Employer should make clear in the Invitation to Tender whether the successful tenderer will be required to provide a bond and the amount of the bond should be specified.

Risk Retained or Risk Transferred?

Before the tender process commences, the outsourcing Scheme Employer must decide whether the **pensions risk** is to be transferred to the contractor or whether it is to be retained by the outsourcing Scheme Employer (also referred to as 'passthrough'). The nature and scope of the pensions risk is set out in detail in the Risk Assessment Information Report. **In short, the pensions risk is the risk that the payment of contributions to the Fund at the initial contribution rate by the contractor is insufficient to meet the pension liabilities which arise during the contract, meaning that contribution rates have to increase or there is a**

shortfall/deficit at the end of the contract, or both. Additional liabilities can also arise if staff at age 55 or over are made redundant, resulting in Strain on the Fund costs. The outsourcing Scheme Employer should be fully familiar with these risks before deciding whether to transfer or retain the pensions risk.

If the outsourcing Scheme Employer decides to meet any excess costs itself, then a decision has been taken that the pensions risk will be retained (pass through). The Scheme Employer should, of course, make sure via the contract that if the initial contribution rate turns out to be too high and is reduced during the contract, or if there is a surplus when the contract ends, it receives the credit for this lower cost. If the pensions risk is retained, the contractor will not be liable for any increased costs which might arise during the contract and, if there is a deficit on termination, the outsourcing Scheme Employer will meet it. A bond is of no value in these circumstances. A bond provider will not meet any cost for which the contractor is not liable even if the contractor fails.

If the outsourcing Scheme Employer decides to transfer the pensions risk to the contractor, then the question of whether a bond is required comes into play. The tender and contract must specify that the contractor will be required to provide a bond, together with the value of the bond. If this is not done the contractor will not be obliged to agree to a bond. A contractor must ask a properly regulated financial institution to provide the bond and the contractor will have to pay for the bond in a similar way to an overdraft facility. A bond will take time for the contractor to organise and will require a legal agreement, which the Fund can prepare, to be signed by the contractor, bond provider, outsourcing employer, and the administering authority. The bond will provide financial recourse to the outsourcing employer in the event of the contractor failing and unmet pension liabilities becoming the responsibility of the Scheme Employer. This must be balanced against the cost to the contractor of providing the bond, which will inevitably be passed on to the outsourcing employer. A bond requirement may in some cases discourage a contractor from bidding for the contract.

Bond Questionnaire

When an outsourcing Scheme Employer has decided whether a bond is required, it should complete a **Bond Questionnaire** so that this decision is communicated to the Avon Pension Fund. This can be located on the Avon Pension Fund website, or requested by contacting APF_EmployerAdmissions@BATHNES.GOV.UK

How to Decide the Bond Amount

The Risk Assessment Information Report prepared by the Actuary explains in detail the risks for which a contractor will be responsible if the pensions risk is transferred. The actuary then quantifies these in the Admission Summary Paper (section 5). (There is a case for making these reports available to the tenderers where the pensions risk is transferred to the contractor but, if this is to be done, the permission of the Actuary is required).

Although the Actuary quantifies the risk, he does not attach any probability factors to them. This means that the outsourcing Scheme Employer must exercise its own judgement. However, the Avon Pension Fund can provide commentary on each of the risks identified by the Actuary in section 5 of their report and this is now set out below.

i. **Potential Unfunded Liabilities arising from non-ill health early retirement costs:**
   These arise when Scheme members aged fifty-five or over are made redundant and therefore entitled to take an early pension. Taking a pension early (i.e. before Normal Retirement Age) generates a Strain on the Fund cost. The scenario here is that the contractor fails, and all the staff are made redundant. At the outset, the Actuary examines the cohort of staff being transferred to the contractor and identifies those who will reach the age of fifty-five during the contract. The collective Strain on the Fund costs for the members who fall in this category constitute the risk. However, Scheme Employers are invited to consider whether this cost will ever arise. If the same or a similar service is provided either in-house or by another contractor subsequently the staff will usually be TUPE transferred and the Strain on the Fund costs may therefore not arise. If TUPE does not apply because the service is discontinued or provided in a different way, this would effectively be a decision of the Scheme Employer who should check the commercial contract to establish whether, in these circumstances, the contractor would be liable to pay the Strain on the Fund costs.
ii. **Allowance for potential saving from members leaving with deferred benefits:**
   This looks at the same scenario, i.e. that the contractor fails, and all the staff are made redundant. In this case we are looking at Scheme members under the age of fifty-five who would not be entitled to take their pensions early and would become deferred members. This would generate a saving and offset the cost identified in (i). However, the same TUPE considerations apply as in (i).
iii. **See (i) and (ii).**
iv. **An unexpected increase of 5% in liabilities:**
   In his 2022 actuarial report the Actuary made an assumption that pay would increase by 4.6% over the long term. If the pay of Scheme members transferred to the contractor is not expected to increase by more than this during the period of the contract, then this risk can be ignored.
v. **Increase in liabilities due to a fall in discount rate:**
   In his 2022 actuarial report the Actuary used a discount rate of 4.6% for past service and 5.1% for future service. In his Valuation Report the Actuary quantifies the effect for the particular outsourcing of a 5% reduction in the discount rate. There could, of course, be a larger reduction than this (this is most likely to occur if interest rates fall). This is a genuine risk and consideration should be given to how much protection is required.
vi. **Short-to-medium term growth in liabilities and hence risk profile:**

This refers to the increase in liabilities as Scheme members accrue additional pension entitlements. It is a per annum percentage. However, if it is a closed admission, this may be offset by savings if any of these members leave or retire.

vii. **Initial shortfall of assets versus liabilities:**
Most admission agreements commence with the past service fully funded, in which case this risk would not be relevant.

viii. **Effect of a 10% fall in return-seeking assets:**
The Actuary quantifies the impact on the particular outsourcing of a 10% fall in the value of the assets. This is probably the contractor's main risk. The scenarios in which a fall may occur might include an increase in interest rates, recession/depression, and adverse world events, however, the precise cause of a fall is not relevant when considering risk. It is sufficient to acknowledge that a fall is possible. It should be noted that the Avon Pension Fund does have strategies in place for limiting the impact of a significant fall in asset values, so that a fall of more than 20% can probably be ignored for the purposes of determining the amount of the bond. A prudent approach would be to allow for a 10% fall. If allowance were to be made for one of the more pessimistic scenarios, then allowance could be made for a 20% fall.

ix. **Materiality Measure – Payroll of new employer versus guarantor/original employer:**
The larger the outsourcing, particularly in relation to the total activities of the outsourcing Scheme Employer, the greater will be the impact on the Scheme Employer if the contractor fails and leaves behind unfunded pension liabilities.

It is recommended that, when deciding the amount of the bond, the outsourcing Scheme Employer should consider all these factors but focus principally on risks (v) and (viii). The discount rate referred to in (v) will be subject to review at each triennial valuation but will not normally change between valuations. By contrast, the risk highlighted in (viii) is ever present and the key issue is the extent to which the value of assets changes between the commencement date of the admission agreement and the termination date. To reflect the fact that members' accrued service (i.e. the employer's liability) will increase during the course of the admission agreement, the percentage specified in (vi) would also need to be applied. If a bond is calculated on this basis, i.e. allowing for a 5% reduction in the discount rate plus a 10% fall in return-seeking assets and then applying the percentage specified in (vi), this would be a logical approach to achieving a degree of protection should the contractor go into administration before meeting the pension liabilities for which it is legally responsible. There is, however, no right or wrong answer to deciding the bond amount. Much depends on how much protection the outsourcing Scheme Employer requires, considering its potential impact on the contract price.

Review of Bond

The outsourcing Scheme Employer must decide the duration of the bond. This will depend in part on the length of time over which the bond provider is prepared to underwrite the risk.

If the bond is for the duration of the contract no review is necessary unless the contract is extended. If it is for a lesser period the Scheme Employer must decide whether, on expiry, it should be extended or not, and if the bond amount should be reviewed having regard to updated information which would need to be supplied by the actuary. If a review is to take place a new report should be commissioned from the Actuary at least two months before the bond expiry date. **It is the Scheme Employer's responsibility to keep track of the bond renewal date.**

What happens if the contractor fails with a bond in place?

If a contractor fails with a bond in place, the Avon Pension Fund will ask the Actuary to prepare a **Termination Certificate**. This will reveal the amount of money owed to the Fund at the point when the contractor failed. If there is a surplus there will be no claim against the bond provider. If there is a deficit, the Fund will take steps to recover as much of this outstanding amount as is covered by the bond – in reality, it might be that the liability is only partly covered. The bond provider will no doubt wish to inspect the commercial contract to establish that this was a genuine contractor liability prior to payment. Provided that there are no complications arising from the commercial contract, the bond provider should pay the amount due.

When payment is received from the bond provider, it will be credited to the outsourcing Scheme Employer's account with the Fund. If any of the final liability is not covered by the bond, it will be added to the Scheme Employer's existing Fund deficit or subtracted from any credit balance.

Conventional method of determining the bond amount

The historic convention for deciding the bond amount has been to take the amount identified in item 1 of Section 5 of the Admission Summary Paper. The shortcomings associated with this method have been highlighted earlier in this paper. In an extreme example there may be no amount identified in Item 1 because none of the staff engaged on the contract will reach the age of fifty-five during the contract. This means that no bond amount will be indicated even though there is a risk of a deficit occurring because of the other factors shown in Section 5. Outsourcing employers are, of course, entitled to continue with the conventional method but, if so, they should be aware of the shortcomings.

Avon Pension Fund
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