SQUIRE SANDERS

PENSION ISSUES ON OUTSOURCING
NEW "FAIR DEAL" ON PENSIONS

October 2013

Much of the recent focus on public sector pensions has been on the forthcoming benefit changes (not forgetting valuations in the Local Government Pension Scheme (LGPS)). However, this week the Government has issued an updated policy protecting the pensions of public sector employees who are transferred to the private sector as part of an outsourcing. This is known as "Fair Deal". The changes will have a profound impact on public sector pension schemes and private sector contractors.

The Future of Fair Deal and Broad Comparability

As mentioned in our February 2013 briefing *Pensions Issues on Outsourcing – Withdrawal of LGPS Passports*, the Government has been consulting on the future of the Fair Deal policy and revising it. As expected, the revised Fair Deal policy guidance implements the Government's intention to phase out transfers to broadly comparable pension plans and instead allow all transferring staff to be given access to the relevant public service pension arrangement.

The Government's new Fair Deal guidance was published on 7 October 2013 after an informal consultation process which closed on 30 August 2013.

Access to Public Service Pension Schemes

The new Fair Deal policy applies, as did the old policy, when staff who are members of (or eligible to join) a public service pension scheme move from the public sector to an independent contractor by way of a compulsory transfer, to which TUPE applies. In an extension to the old policy, Fair Deal will now also apply to non-voluntary transfers to a public service mutual or other new model of public service delivery, even if TUPE does not apply to the transfer.

Transferred staff will be entitled under the new policy to the same level of protection for pensions as applied under the old policy – a right to broadly comparable pension benefits for future service plus a transfer of past service benefits to the new arrangement that will provide a day-for-day service credit. However, the method of delivering that protection will change. Whereas under the old policy staff had to be provided with a transfer to a private sector broadly comparable pension plan, under the new policy such staff will continue to be members of (or eligible to join) the public service pension scheme that applied to their employment immediately prior to the transfer.

Transferred staff will continue to be members of the public service pension scheme on the same terms as other members of that scheme. Independent contractors will be required to make sure that this membership is a contractual right under the contracts of employment of the transferred staff – this is a new requirement of the Fair Deal policy, but mirrors the obligation that has applied to "best value" authorities in the local government sphere since 2007.

Enabling Participation

The relevant independent contractor will have to supply to HM Treasury a list of employees who are covered by Fair Deal, to facilitate cross-government monitoring of the policy. In addition, the contractor will be required, through scheme regulations and/or a participation agreement, to provide the relevant public service pension scheme with information to ensure that the scheme's internal controls can be operated effectively and the scheme managed in compliance with statutory requirements.

It is recognised that, with a broader range of employers and employees participating, scheme controls will have to include provisions for risk management. Employer and employee contributions must be paid to the public service pension scheme, and employer contributions will fluctuate in accordance with any actuarial valuation. A failure to pay contributions must be notified to the Pensions Regulator.

There will be flexibility to allow contracting authorities and contractors to agree between themselves that additional funding will be provided (by the contracting authority) in the event of a change in employer contribution rates arising from a valuation. This is to reduce the danger that the contractor will include contribution fluctuation risk within its pricing structure, and should thus enable contracting authorities to secure value for money from the wider contract. The pension schemes themselves may include arrangements to apply different rates of contribution to different employers, in order to address the varying risks of default from this broader range of participating employers. This is already an issue of particular relevance to the LGPS where employer failure has a direct cost implication for the remaining participating employers, which may become more acute as the number of participating employers increases still further.

When participation terminates, there can be provisions for making an exit charge to employers where it is identified that the liabilities attributable to the exiting employer have not been met by contributions paid up to that point. The terms upon which such exit payments are levied must be disclosed and agreed in the relevant participation agreement. Exit debts have been commonplace in the LGPS for many years, but it remains to be confirmed how they will be dealt with in the unfunded public service pension schemes.

Retenders Involving Staff Transferred Under the Old Fair Deal Guidance

The new Fair Deal guidance has come into effect immediately. It will apply not only to staff transferring out of the public sector for the first time, but also to staff who have already transferred out of the public sector (under the old Fair Deal or, if the contracting authority decides, prior to 1999 when the original Fair Deal policy was made). Where an existing contract is retendered, bidders will be required to offer staff access to the appropriate public service pension scheme. The overarching principle to be applied is that previously transferred staff should not be put in a better position in pension terms than they would have been in had they not been transferred out of the public sector.

It is recognised, however, that incumbent contractors might face significant costs if required to transfer staff from their existing broadly comparable plan (put in place under the old Fair Deal) to a public service pension scheme (for example, if the transfer triggered a section 75 debt in their plan). Notwithstanding the suggestion in the Fair Deal policy that the contracting authority should pick up any shortfall in the bulk transfer payment, this may result in the absence of a level playing field between all bidders and so, to the extent the contracting authority would be unable to comply with its legal obligation under procurement law to treat bidders equally, the new Fair Deal gives incumbent contractors two options. They can either provide access to a public service pension scheme or, alternatively, offer a broadly comparable pension plan.

The alternative of offering a broadly comparable pension plan will, however, have to take into account changes during the life of the original contract in the relevant public service pension scheme to which comparison is made. This is a new requirement under Fair Deal, but matches the obligation that has applied to best value authorities since 2007. Consequently, if the relevant public service pension scheme operates with a Career Average Revalued Earnings (CARE) benefit structure (rather than final salary – this will be the case for the LGPS from April 2014 and all other public service pension schemes from April 2015), the broadly comparable pension plan must be changed to offer that CARE structure. As has been the case in recent years (as a matter of GAD policy when certifying private sector pension plans as broadly comparable), known future changes in benefits in the applicable public service pension scheme will be taken into account in the assessment – so the forthcoming switch to CARE in public service pension schemes will already need to be reflected in any new broad comparability certificates.

For public service pension schemes other than the LGPS and NHS Pension Scheme (which already allow admitted bodies), this new Fair Deal policy represents a significant change. Some schemes will not be able to admit participating bodies without changes to their governing regulations (although we understand the Principal Civil Service Pension Scheme in particular already has changes in hand). The new Fair Deal guidance will not yet apply to best value authorities, who are subject to statutory Directions issued in 2007 under the Local Government Act 2003. Whilst the Directions are broadly similar to the new Fair Deal policy, we hope that the Department for Communities and Local Government (which is currently reviewing the Directions) will take an opportunity to ensure that the two regimes are fully aligned.

The new Fair Deal policy may provide transferred staff with the same level of protection, but it marks a significant departure in terms of delivery. All public service pension schemes will have to develop processes to deal with an influx of new participating employers – even the LGPS, with its large number of existing admitted bodies, will need to consider how to better analyse the funding challenges posed by an increased number of non-public sector employers. Contractors will need to manage their relationships with public service schemes, particularly where they have a large number of contracts spread across different schemes or LGPS funds. The challenges for private sector broadly comparable pension plans posed by a transfer of members back to a public sector pension scheme at the end of a contract may also be considerable.

Action Points

- The new policy is effective immediately, so should be taken into account in any current or future bids for outsourcing contracts (unless they are at an advanced stage).
- Contractors will need to make sure they understand the cost implications of participating in a public service pension scheme and price their bid accordingly. The wider outsourcing contract should reflect the agreed cost position both during and at the end of the contract.
- Public service pension scheme administrators will need to adopt processes to deal with an influx of private sector participating employers, both to ensure effective scheme administration and to manage the risk of employer failure in a proportionate manner.
- Trustees of private sector broadly comparable pension plans should monitor their active member population and make contingency plans with their sponsoring employers for members transferring back into a public service pension scheme at the end of the contract term.

Further information

For further information please contact any of the partners listed or your usual contact in the Squire Sanders Pensions team.

Catherine McKenna
Partner, Leeds
T +44 113 284 7045
E catherine.mckenna@squiresanders.com

Wendy Hunter
Partner, London
T +44 20 7655 1119
E wendy.hunter@squiresanders.com

Charmian Johnson
Partner, Manchester
T +44 161 830 5047
E charmian.johnson@squiresanders.com

Anthea Whitton
Partner, Leeds
T +44 113 284 7364
E anthea.whitton@squiresanders.com

Matthew Giles
Partner, Birmingham
T +44 121 222 3296
E matthew.giles@squiresanders.com

10990/10/13