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Public Service Pensions Far Deal Consultation
Workforce, Pay and Pensions Team
Public Services and Growth Directorate
HM Treasury
1 Horse Guards Road
London
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Dear Sirs

Consultation on the Fair Deal Policy

I am writing on behalf of the Association of Consulting Actuaries (ACA) in response to the Consultation on the Fair Deal Policy issued in March 2011.

Members of the Association are all qualified actuaries and are subject to the Actuaries' Code of the Institute and Faculty of Actuaries. Advice given to clients is independent and impartial. ACA members include the scheme actuaries to schemes covering the majority of members of defined benefit pension schemes. Our members also provide advice to sponsors and trustees of thousands of arrangements, both defined benefit and defined contribution schemes of all sizes, and to organisations involved in public sector outsourcing contracts under which those organisations take on employees who are members of, or entitled to membership of, statutory public sector pension schemes.

The ACA is the representative body for consulting actuaries in the UK, whilst the Institute and Faculty of Actuaries is the professional body.

Summary

We support the Government's review of the Fair Deal policy and agree with the four key objectives identified in the consultation paper, while recognising that they in some cases they are competing objectives which cannot all be fully satisfied at the same time. The outcome will of necessity be a compromise, driven to a significant extent by political considerations, and will need to be determined according to the relative importance to the Government of each of the four objectives.

As an adviser body, we do not believe it appropriate for us to make proposals of a political nature. However, we do believe we can contribute helpfully to the debate based on the extensive experience of ACA member firms in advising service providers and local authorities regarding the costs, risks and practical aspects of satisfying the Fair Deal policy, and provide below responses to each of the questions raised in the consultation.

In particular, we strongly believe that there should be a fifth objective for the revised Fair Deal policy, which should be for the policy, and the way it is implemented, to be made as clear and simple as possible. Given the inherent complexities of pensions, this will be a real

challenge to achieve, and as such should form an integral part of the decision-making process, rather than a final stage once the key policy decisions have been made.

We would be very happy to be involved in helping the Government in the process of ensuring that the design and implementation of a revised Fair Deal policy is made as clear and efficient as practicable, based on the main policy decisions made by the Government.

Q1: The Government welcomes views on whether there are any people or organisations who may be affected by this consultation other than those listed in 1.7

The outcome of this consultation is likely to have significant implications for taxpayers, in terms of the costs and risks that they ultimately bear in respect of public sector pensions. Others who may to a lesser extent be affected by this consultation include:

- Public sector pension scheme administrators
- The Government Actuary's Department – specifically in relation to their work on staff transfers
- Existing private sector "broadly comparable" passport schemes: their trustees and advisers
- Providers of "off-the-shelf" multi-employer passport schemes such as the Prudential Platinum Scheme

Q2: The Government welcomes views from respondents on how the Fair Deal policy operates in their experience, where this is considered relevant to future policy

When considering the four objectives described in 3.2 of the consultation document, our experience is that the Fair Deal policy has generally worked well in protecting the pensions expectations of outsourced public sector employees, but much less so for the other three objectives.

As noted in the Hutton Commission report, the Fair Deal policy has deterred some potential bidders for contracts from bidding because of the high contribution rates typically required for schemes satisfying the Fair Deal's broad comparability requirements and the investment and mortality risks of running such schemes. Furthermore, many firms that have taken part in tenders have felt it necessary to add extra margins to their pricing to reflect the extra costs and risks of DB pension provision, which can be particularly problematic on short-term contracts. This is likely to have impacted adversely both on value for money for the taxpayer and plurality of public service provision, with in-house bids often having a material advantage over outsourcers simply through having substantially lower notional pensions costs and no investment or longevity risks related to pensions.

These "big picture" strategic issues are, we believe, essentially a political policy matter, in terms of where to draw the line between protecting transferring employees' pensions expectations and making the outsourcing process attractive to outsourcers. There are also, however, several more technical practical difficulties resulting from the way in which the Fair Deal has been applied and the environment in which it has operated, which have not necessarily added much extra protection to employees, but have been problematic for many bidders, through making the pensions aspects of the bidding process more complex, lengthy, costly and uncertain than it need be. These include:

- The way in which the Government Actuary's Department (GAD) has carried out its role under the Fair Deal in assessing bidders' proposed pension arrangements for transferring employees against the requirement for these to be broadly comparable to the scheme from which the employees' have transferred. Specifically, the GAD have adopted a very prescriptive approach (increasingly so in recent years) which has given bidders very little flexibility to offer pension arrangements which are easy and cost-effective to design, implement and administer. This approach, combined with regular reviews by the GAD of the actuarial assumptions they use for assessing broad comparability, and the frequent changes in recent years to the various public service schemes, have resulted in many contractors having pension schemes for outsourced public sector employees with numerous complicated benefit scales (often with only a handful of members in each section), which are enormously difficult and expensive to maintain and administer.

- The Fair Deal requirements to accept a bulk transfer of past service benefits (on prescribed actuarial assumptions) at the start of a contract, and to offer a bulk transfer payment on at least equivalent terms at the end of the contract, have caused many contractors a lot of difficulty in bidding - not least because during the contract bidding process the proportion of members who will decide to transfer their benefits is unknown. Contractors taking a cautious view on the take-up rate may include extra margins in their pricing which in practice are unnecessary, and so result in extra costs to the taxpayer. In practice, on most contracts only a small proportion of employees actually choose to transfer their past service benefits, which shows that this additional complexity and uncertainty is of only limited benefit to the employees being protected by it.
- A poor level of understanding of the Fair Deal requirements at many public sector contracting authorities, which has meant that bidders are often not provided with a clear statement of the contracting authority's pensions requirements for the contract. Sometimes these emerge only late on in the bidding process, meaning uncertainty for bidders and, in some cases, potential bidders withdrawing after incurring substantial bid costs.
- Poor quality data on the pensions entitlements of the employees due to transfer on the contract - particularly (but by no means exclusively) an issue in respect of the NHS Pension Scheme. This leads to uncertainty for bidders and the potential for them to add additional margins in their bid to reflect this uncertainty and risk.
- These issues are particularly problematic on "second generation" contracts, where bidders often struggle with poor data from the incumbent contractor(s), with little understanding of the difficulties this causes, or help from, the contracting authority.

Something that has, in contrast, been helpful for many contractors (and for the employees involved) is the ability to participate as a "transferree admission body" in the LGPS on some local authority contracts. This option was introduced as the ”broadly comparable” approach that had previously applied was deemed to be problematic with the same sort of issues arising that we have covered in this response.

We therefore note with concern the recommendation in the Hutton Commission report that it is in principle undesirable for future non-public service workers to have access to public service pension schemes. The current process and guidance for contractors to become admission bodies in the LGPS is by no means perfect, and we attach the ACA submission in October 2010 in response to an informal consultation on this subject by the DCLG outlining some of the issues and difficulties experienced by contractors. Nevertheless, we believe this is a valuable option, extension of which (if the Fair Deal continues in broadly its current form) should be considered for employees transferring from other public service schemes. It does meet the aim of protecting pensions of public sector albeit it may not fully meet some of the other aims set out in the Fair Deal consultation.

Q3: The Government welcomes views on whether there are any objectives which should be taken into account other than those set out on 3.2 when developing future policy

Reflecting our comments under the previous question, we would suggest that the future policy should aim to be as clear and simple as possible, to minimise the associated “compliance” overheads, subject of course to satisfying the other objectives. Whatever policy is chosen should also be sustainable, with the aim that it should not need to be revisited in the short or medium term.

Q4: Is there a case for changing the current Fair Deal policy

We believe that any decision regarding the Fair Deal policy should ultimately be made by the Government so as to be consistent with the Government's policy objectives.

The four key objectives for future policy that have been identified as part of the Fair Deal consultation (value for money, protecting pensions of transferring public sector employees, removing barriers to plurality of public service provision, and appropriate allocation of the costs and risks of pension provision) are, as the consultation document itself identifies, somewhat contradictory. Any future policy will therefore have to be a compromise, and it is for the Government to decide how and to what extent it wishes the policy to reflect this compromise.

As noted in our responses to the previous two questions, we believe an important fifth objective should be for the policy, and the way it is implemented, to be as clear and simple as possible. Given the inherent complexities of pensions, this will be a real challenge to achieve, and as such should form an integral part of the decision-making process, rather than a final stage once the key policy decisions have been made.

We would also note that our understanding is that one of the reasons why the Fair Deal concept was first introduced was that it was recognised that, while pensions did not transfer under TUPE, any reduction in the pensions promise as a result of an outsourcing agreement, could lead to potential claims of an effective reduction in terms and conditions and possible legal challenge against the letting employer. The Government should therefore consider the extent to which this remains a material concern and potential driver for decision-making under current circumstances.

Q5: If so, what should the policy cover:

In framing our responses below, we have assumed that the decision is made that the Fair Deal policy should be revised. We have included suggestions based on our experience advising clients who address the current Fair Deal requirements on a regular basis. It must be recognised that service providers themselves have a wide range of experiences with Fair Deal, and their attitude to it will vary enormously.

Whatever the outcome, we believe that any revised Fair Deal policy should aim to consolidate, simplify, and clarify Government policy, and contracting authority guidance and practice, which have evolved over a number of years and for which there are several policy documents. A clearly stated and simplified policy will make it easier for both service providers and contract awarders to understand, implement, and monitor compliance with the revised policy. This will make it easier to ensure the four key objectives are addressed satisfactorily and in accordance with the Government's overall policy objectives and, all other things being equal, should reduce costs within both service providers and contract awarders, in terms of ensuring compliance with the resulting policy.

a) what (if any) stipulations should be made regarding the level and type of future pension provision following transfer;

It is not for the ACA, as an adviser body, to suggest the level and type of benefits that should be offered for transferring employees. Different contractors and other service providers will have differing views, and the responses from each of these could vary significantly.

For example, many larger contractors are experienced at addressing the costs and risks that arise through being required to provide defined benefits to transferred staff, and may be reasonably happy with the barrier to entry to competitors that the current Fair Deal policy represents. Charities and other not-for-profit organisations may be less able to manage these risks, in particular because they have no shareholders on whom they can call should pension-related costs be more significant than anticipated, while there is a material risk that funding to charities could be adversely affected should it become apparent that some of the funding is being diverted to pension provision rather than addressing the charities' primary objectives.

If there are to be any stipulations under any revised Fair Deal, it will be important to keep these as simple and straightforward as possible. This will make it easier for contractors and service providers to comply, whilst minimising associated costs (and hence contract prices). If there are any requirements regarding the type or level of benefits to be provided, we suggest this should be as far as practicable at a single level or on a single benefit structure across all the main public sector schemes, to facilitate cost-efficient provision and ease of migrating staff around. Keeping matters simple should help to ensure that transferring staff and their representatives will be better able to understand the requirements and the required benefits, encouraging greater staff engagement at a time when increased workplace saving is being encouraged. The principle should be that good quality pension benefits are provided to transferring employees, rather than an overly-precise approach that results in the need to closely copy the previous public service scheme benefits, with all the associated complexity and cost.

b) what should be the treatment of previously accrued benefits? For example, should CETV's be the norm or should bulk transfer agreements continue to be used and, if so, in what form;

The current requirement to give employees the option to transfer their benefits to the new service provider's scheme is a major concern for a large proportion of the service providers advised by ACA members.

The bulk transfer terms, and the requirement to allow employees to transfer on their benefits should an incumbent service provider not retain the business on a contract re-let, are additional sources of risk to service providers.

While the actuarial assumptions typically used for calculated bulk transfers are not generally unreasonable for long term funding of pension schemes, they do not reflect the additional risks that arise with short term contracts.

Service providers will often include additional margins in their contract prices to reflect these additional risks. The extent to which a contract price is affected will be determined by the service provider's attitude to risk, its views regarding likely future experience (in particular, the investment performance of the assets used to support the defined benefit promise) and its assumptions regarding how many and which employees will elect to transfer their benefits.

The outcome is that additional, potentially unnecessary, margins may be included in the bid price. Contracts can also be awarded to service providers whose service offering may be inferior, but whose allowance for pension risks is sufficiently lower than their competition to enable them to win the contract on price.

In practice, on most contracts few employees choose to transfer their accrued benefits, so the bulk transfer requirements in practice often have only very limited impact in protecting staff pension benefits but can act to reduce value for money - and potentially result in a non-ideal bidder winning the contract.

Overall, we do not believe that service providers should be required to offer transferring employees the option to transfer their past service benefits into the service provider's pension scheme. Removing this requirement would, we believe, remove a major problem area for contractors, without significantly affecting the employee protection provided by the Fair Deal.

One of the advantages of the admission body route in the LGPS is of course that transferring employees do not have to make a transfer decision as they remain in the same pension scheme.

c) what should the requirements be on subsequent compulsory transfer to an independent provider or return to the public sector?

The requirements should be consistent with the requirements made for the initial employee transfer.

This is important for consistency, ensuring all parties (including affected employees and their representatives) understand the requirements, and for ensuring there is as much as practicable a level playing field between the incumbent and a potential replacement service provider (whether in the private sector or on a return to the public sector). This is essential in order to ensure that pension issues are not a significant distortion getting in the way of competitive neutrality.

It is accepted that there will be legacy issues around for many years as a result of the previous versions of Fair Deal and the manner in which the Government's policy of the time was interpreted, implemented, and enforced within contracts. A level playing field should be maintained between the incumbent and the new bidding contractors. Pragmatism will therefore be needed, but competitive neutrality should always be a key aim.

Q6: In setting out a proposal for future policy, respondents are asked to set out:

a) how it would deliver against the objectives set out above and any others considered relevant;

b) the impacts on those involved, including employers and employees;

c) if possible, an indication of how much the proposal would cost or save the taxpayer compared to the current Fair Deal arrangements; and

d) any past experience, whether in the public sector or otherwise, which informs these proposals.

It is clear that no single policy will fully satisfy all four key objectives identified in the consultation document, so the outcome will of necessity be a compromise, driven to a significant extent by political considerations, and will be determined according to the relative importance to the Government of each of the four objectives. As an adviser body, we do not believe it appropriate for us to make proposals of a political nature.

However, ACA member firms have enormous experience advising service providers and local authorities regarding the costs, risks and practical aspects of satisfying the Fair Deal policy for treatment of pensions in staff transfers from, to, and between public sector organisations, and with the additional issues that arise on contract termination or re-let. As such, we have an in-depth understanding of the inefficiencies and costs that can, and indeed often do, arise under the Fair Deal as currently operated.

Based on this experience, we believe that, whatever decisions are made about the strategic direction of the Fair Deal policy for the future, it will be very important that the practical implementation is thought through carefully, with the paramount aim of ensuring that it can be operated in a clearly understood and straightforward way.

One suggestion we would make is that serious consideration be given to removing the requirement for a past service bulk transfer terms to be offered to transferring employees. As noted earlier, this requirement is highly problematic for many service providers, particularly because of the uncertainty involved over how much additional pension liabilities they will need to take on, while in practice it offers only limited protection to employees.

The impact on taxpayer costs will depend considerably on both the strategic direction and the fine detail of the new requirements. While we cannot provide estimates of costs or savings, it is clear that the current operation of the Fair Deal involves substantial additional, and in many cases unnecessary, costs to service providers which must inevitably in some way ultimately get passed on to the taxpayer.

Q7: The Government welcomes views on what approach should be taken when previously transferred public services involving compulsory Fair Deal staff transfers are re-tendered. The Government also welcomes details of any past experience informing respondents' proposals.

The primary purpose of outsourcing public services into the private sector is to provide a better value service for taxpayers than can be provided within the public sector; this does not necessarily need to include the transfer of pensions obligations or risks. Whilst contracts are generally of a specified term, the pensions obligations will remain for a much longer period than the initial contract and involve employees who no longer work for the contractor. This is unattractive for contractors and often results in additional costs being borne by the public sector since well-informed contractors price this into their contract price.

One solution to this could be that, at the end of a contract, the contractor is able to pass back (either to the contracting authority or to the next contractor) the pensions obligations in respect of all the employees who transferred across at the start of the contract, including those who are no longer employed by the contractor at the end of the contract. This would be undertaken on the same actuarial terms that applied when the benefits were transferred to the contractor's scheme at contract inception. This has the advantage to the contractor of limiting their pension exposure to the period of the contract, to the employees of essentially continuing to have a Government guarantee, and to the Government of reducing the price of contract bids from contractors who include additional margins for the unknown pension risks that could occur in the future.

Q8: The Government welcomes views on what approach should be taken for employees returning to the public sector having been transferred out in the past under the Fair Deal policy. The Government also welcomes details of any past experience informing respondents' proposals.

As outlined above, one solution would be to bring those employees back into the public sector schemes on the actuarial terms that were agreed at the point of contract inception. There is an issue as to which scheme section an employee should join (i.e. the same scheme section that they left when they were transferred to the private sector or the section for new entrants). In order to be fair to the employees, we would suggest that they should be replaced in the section of the scheme that they were transferred out of originally, possibly with an option to transfer to a section that is open to new members.

Yours sincerely

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Association of Consulting Actuaries