Briefing

Admission bodies in the LGPS:

what are the alternatives to a bond?

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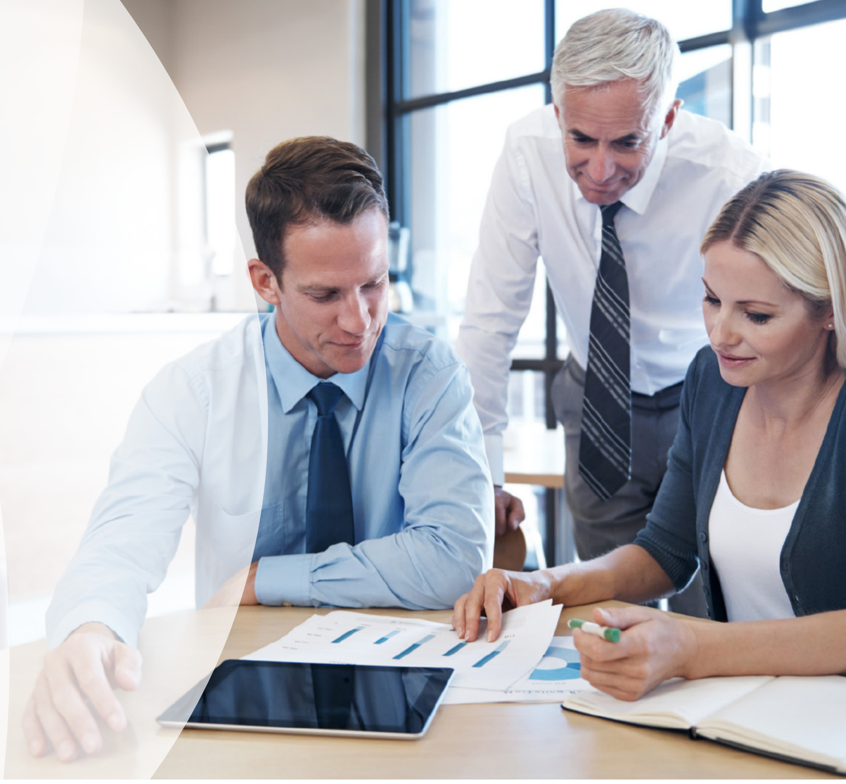

The requirement to put in place a bond is set out in Part 3 of Schedule 2 of the LGPS Regulations. The primary aim of the bond is to mitigate the risk to the administering authority that a new employer will not be able to meets its obligations in the future.

It is not unusual for prospective admission bodies to struggle to buy a traditional bond. Insurers only make bonds available to companies that meet certain financial and credit criteria, so a smaller, less well-established company with limited evidence of financial strength will find it difficult, if not impossible, to access this product.

Alternative options are available that might meet the needs of both the employer and the administering authority, which we understand are permitted under the Regulations.

This briefing note sets out some alternative options available to employers and administering authorities at a high level and it is important that any arrangement is to the satisfaction of the administering authority. Legal advice must also be obtained, where appropriate, to ensure that any arrangement is legally tested.

What are the alternative options to a bond?

Traditional bonds

The purpose of a bond is to secure a cash pay-out to the Fund from the insurer, in the event that the admission body becomes insolvent and cannot meet its obligations to the Fund. As an insurance policy it specifies the Fund as the beneficiary of any pay-out. This means that if the admission body does become insolvent then the Fund alone receives the bond payment and it is not part of the company assets that may be distributed to other creditors.

Our Bond and Contribution report written for new employers sets out the costs that are intended to be met by a bond payment, namely "strain" costs of early retirements, unpaid contributions and expenses, and some element of underfunding. However, all of these elements are an estimate only and the value of the bond is the maximum amount that the insurer will pay out. There still remains the risk to the Fund that a bond pay-out won't cover all the costs due from a ceasing admission body.

Third party guarantees

A straightforward option is for the letting authority to offer a guarantee to the Fund to take on responsibility for the liabilities when the admission agreement ends. The guarantee could involve the ceasing employer meeting as much of the deficit as they can afford, or it may be for the letting authority to make the full payment of the calculated shortfall, either immediately or over time. Any deficit simply becomes part of the letting authority's ongoing deficit and is met by the deficit contributions calculated at each actuarial valuation.

> Since 14 May 2018 a ceasing admission body may be entitled to an exit credit. So it is important that the guarantee agreement sets out each party's rights and obligations, whether there is a surplus or a deficit when the contract ends. We would suggest that legal advice is taken in putting together these agreements.

As long as the third party offering the guarantee is sufficiently strong then a guarantee can be a sensible approach, especially for shorter contracts or smaller admission bodies where the size of any shortfall is likely to be small, relative to the letting authority's own deficit in the Fund. The guarantor is typically the letting authority but a guarantee may also be acceptable from the admission body's parent company, another employer in the Fund that also contributes to the admission body, or even the Secretary of State in some cases. In any case, any guarantee must be to the satisfaction of the administering authority.

Pass-through arrangement

Under a pass-through arrangement the letting authority retains the ultimate responsibility for the transferring members' liabilities and any associated deficit. The admission body takes responsibility only for meeting the contributions to the Fund and the costs of any enhancements to members' benefits (on early retirement, for example).

The admission body's contributions may be fixed at the outset or reviewed during the contract to assess and changes in the expected cost of any future accrual. The admission body's pass-through contribution rate may be set at a higher level than the expected cost of accrual. This is because the letting authority retains the bulk of the risks associated with the transferring members and may wish to be compensated for this additional risk. Alternatively, the reduced pension risk to the admission body under a pass-through arrangement may be reflected in the contract price.

In either case, when the admission body ceases there would not be expected to be any exit credit or payment to, or from, the admission body - regardless of whether there was a surplus or deficit.

Please see our other briefing note for more detailed information about pass-through arrangements here.

Payments from the admission body

Cash deposit

If the admission body has the cash available to cover the recommended value of the bond then an alternative may be to simply give the cash to the administering authority to hold in a bank account until the admission body leaves the Fund. This allows the Fund to have access to the same pay-out as they would have received from an insurer and avoids the associated cost (i.e. the premiums) to admission body of actually buying a bond.

At the end of the contract the cash is returned to the admission body, minus the value of any exit payment to the Fund if necessary. The parties would have to agree in advance how to allocate any interest earned by the cash or how to compensate the administering authority for handling the bank account and transactions. The required value of cash in the account can be relatively easily adjusted as the 'bond level' is periodically reviewed by the Fund while the admission body remains in the Fund.

> Since the account is under the control of the administering authority it is not at risk of any claims being made to the cash by any other creditors, if the admission body was to become insolvent.

However, the cash sums required may be large compared to the value of the contract. Holding cash may be an inefficient use of the admission body's capital. As with a traditional bond there remains the risk to the Fund that the value of the cash deposit still isn't enough to cover any payments due to the Fund.

Additional initial contribution to the Fund

A cash deposit held outside the Fund is secure but likely to be eroded over time in real terms, especially over a longer term contract. The admission body could instead agree to make a cash payment to the value of the recommended bond into the Fund, to be invested in the Fund's assets in the usual way. This effectively gives the admission body a better than fully funded position from the outset.

> The admission body benefits (or otherwise) from the investment performance of the Fund and at the end of the contract simply receives the balance due back to them through an exit credit. This approach concentrates the investment risk and if an exit payment is required from the admission body, then the Fund would still have to pursue the shortfall from the ceased admission body.

Any agreement would need to set out clearly the requirement to keep the additional contribution 'topped up' over the contract term, adding a complicating factor if the funding position becomes too good at any point. This would raise the possibility of an interim repayment from the Fund before the admission body leaves the Fund.

Additional ongoing contributions to the Fund

It is likely that an up-front payment of the full bond value, either to the Fund or to a separate account, would be too large an outlay for an admission body and an undesirable use of their cash reserves. An agreement to build up a reserve in the Fund over time may be an acceptable alternative.

Since the admission body would not be paying premiums to an insurer for a bond, the payments could instead be diverted to the Fund to build up a buffer against future adverse experience. This gradual payment might be an affordable strategy for the admission body but of course provides little protection to the Fund in the early stages of any agreement before a reserve has had time to accrue.

As with any approach that targets a shortfall amount, the Fund is still exposed to the risk that the amount built up was not enough to meet the full shortfall amount.

Charge over assets

The admission body may have an alternative form of security to offer, such as property or assets over which the Fund could have first charge. For a short-term contract it may not be practicable to engage in setting up such an arrangement and a longer term contract would require regular assessment of the assets which brings ongoing administration costs.

Covenant assessment

The aim of any form of security required by the administering authority is to protect the Fund and to avoid an undue burden on the other employers in the Fund. The security of admission bodies is frequently considered as part of the formal process of setting up the admission agreement, but there are a lot of benefits to assessing the covenant of other employers as well.

In addition to demonstrating good governance and risk management, a covenant analysis also helps funds to categorise employers with a view to developing more tailored funding strategies for employers. We can provide more information and advice about appropriate approaches to assessing the covenant of some or all employers in the Fund.

General comments

Any arrangement should be kept under review to make sure that it remains fit for purpose. From the outset the agreement should be well documented to make sure that all the parties understand their obligations to avoid future misunderstandings or disagreements.

In many cases legal agreements will be drafted to cover the arrangements and a copy of these agreements should be made available to Fund actuary.

Please contact your Barnett Waddingham consultant if you would like to discuss this topic in more detail.
Alternatively get in touch via the following:

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