Government Actuary's Department

Government Actuary's Blog

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Outsourcing and Pension Risks

The burden of its Defined Benefit (DB) pensions responsibilities may have been a factor in the recent demise of Carillion but seemingly not the main cause of failure. The fact is that the materialisation of risks associated with pensions can be detrimental to a business and therefore to the stakeholders in that business. In the case of an outsourced service provider those stakeholders include its customers and, in the case of Carillion, one of those customers was the Government.

From an employer's perspective what could be simpler than a funded DB pension scheme where future commitments are covered by a pool of assets? Well the trouble is that rarely does that pool of assets cover those pension liabilities without requiring some additional financial support. And because the difference between the value of the assets and the pension liabilities can often fluctuate wildly according to market conditions, and the assumptions used, there can be considerable uncertainty in the amount of financial support required to remedy a deficit.

This is not new news. Defined Benefit pension scheme deficits have been making the headlines for twenty years or more, as the effects both of improvements in life expectancy and (in more recent years) of historically low rates of interest used to discount those future liabilities to present value have had their effect.

The impact of rising deficits falls mainly to the sponsoring company of the pension scheme which must agree and fund a "deficit repair plan" with the trustees of the scheme. DB pension scheme members would be at risk if the sponsor fails and there are insufficient assets in the pension fund to meet the liabilities. In this case the scheme might enter the Pension Protection Fund (PPF) which pays compensation to the members but (for those not yet above scheme retirement age) at a slightly lower level than the pensions promised by the scheme.

The recent failure of Carillion once again put the spotlight on pensions risks. Carillion group companies were sponsors of several pension schemes which had collective deficits measured in the hundreds of millions of pounds. Carillion was also a major contractor to Government and therefore the financial effects of its pension responsibilities and, indeed, the plight of its pension scheme members are of particular concern to Government as well as the more obvious and general policy issues about the operation of the pensions legislative and regulatory frameworks.

The impact of rising deficits falls mainly to the sponsoring company of the pension scheme

The "Purple Book"[1] published each year by the PPF is an excellent review of the aggregate and specific risks within the universe of private sector DB schemes, currently numbering some 5,600. It has a whole chapter on funding sensitivities including the following chart that tracks the aggregate funding ratio (value of liabilities expressed as a percentage of the value

[1] http://www.pensionprotectionfund.org.uk/Pages/ThePurpleBook.aspx

of the scheme's assets). This is the so-called Section 179 funding level which uses the value of the liabilities covered by the PPF compensation scheme measured on an approximate buy-out basis. The chart shows the sensitivity of this funding measure to market movements, notably long-dated bond yields and values of assets held such as bonds and shares.

Figure 5.1 | Historical s179 aggregate funding level (assets as a percentage of liabilities) of pension schemes in the Purple Book datasets

Source: PPF

The Purple Book notes that a 0.1 percentage point reduction in gilt yields would increase the s179 liabilities by 2 per cent and that 15-year gilt yields have ranged between just over 5 per cent and 1 per cent over the last ten years (and have generally fallen over that period). Similarly, asset values are clearly highly sensitive to market movements, which can move in very different ways to liabilities depending upon how a scheme is invested.

From a corporate balance sheet perspective, the pension fund behaves like a leveraged play on the markets. By this I mean the company is underwriting a scheme whereby the future pension obligations are a debt the company has secured against the assets of the pension scheme. It is leveraged because for a typical scheme in deficit the size of the deficit is highly sensitive to those movements in asset or liability values. Unless the pension fund is invested in low-risk assets that are suitably matched to the cash flow profile of the liabilities, the net result will fluctuate with volatility proportionate to risks in the portfolio.

“It’s all about risk and reward”

In referring to the company’s contract negotiating and pricing approaches, a witness at one of the sessions of the Work and Pensions and BEIS committees’ joint inquiry into the Carillion collapse[2] said “it’s all about risk and reward”. He might equally have been referring to its pension scheme sponsorship. This is not a feature that is particular to the Carillion schemes nor, it should be observed, was the pension scheme the principal reason that this company failed. Risk and reward are features of DB schemes in general where funding levels are such that pension trustees either choose to, or often have little choice but to, accept some investment risk as part of the strategy to close the funding gap.

In the context of outsourcing its contracts, Government is wishing to involve the private sector in the delivery of public services in order to access their expertise at delivery and also to transfer some of the risks and their risk management to the private sector supplier. These risks might also include those associated with the pension schemes and so an understanding of pensions risks is a key part of the supplier engagement and management process. In these cases the pensions risk to Government may be direct if the obligations fall directly on the State or an indirect one if it might simply affect the ability of the supplier to fulfil the terms of the contract with Government.

In 2013 the Government removed some of its direct pensions risk from outsourcing contracts with the reform of its “Fair Deal” policy[3] – which provides pensions protection for public sector staff who are compulsorily transferred to private sector providers – to enable contractors to participate in the public service pension schemes in respect of transferred staff, rather than transfer them into their own arrangements. This has lowered a barrier to plurality of public service provision by retaining this component of pension risk within Government. However, the Government still retains significant exposure in relation to liabilities in private sector contractors’ pension schemes in respect of contracts which were originally let prior to 2013.

In the case of Carillion and at the time of writing, many of the group’s pension schemes are in a PPF assessment period which is the due diligence process prior to admission and the commencement of PPF compensation payments. In terms of the risks to Government associated with pensions, the PPF is funded by a levy on other private sector DB schemes so there is no immediate direct financial cost to Government arising from the admission into PPF of Carillion schemes. There is arguably a reputational risk associated with the use of a private-sector-funded compensation scheme to support the pensions of workers engaged in the delivery of public services, albeit that the reformed Fair Deal policy has sought to address this issue. But Carillion’s wasn’t a business that was solely focused on public sector contracting.

Finally, there are also a number of employees of the Carillion companies who were former public sector workers previously compulsorily transferred to Carillion, for whom the Government’s (pre-2013) Fair Deal policy may provide some protection to their accrued benefits in the Carillion pension schemes.

In general terms, transferring pensions risks to a private sector supplier does not and should not come free. Any outsourcer taking on pensions risk from Government should incorporate the costs of those risks in the fees bid for the contract, and Government would effectively pay for those risks to be managed through the terms of the arrangement.

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[2] https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/inquiries/parliament-2017/carillion-inquiry-17-19/

[3] https://www.gov.uk/government/publications/fair-deal-guidance

Assessing a fair price to reflect those risks is not easy. And if Government remained a de facto guarantor of the pensions in some way (eg at the conclusion of the contract) there is arguably a disincentive on the part of the outsourced service provider to actively manage the pensions risk since the Government or a replacement provider would pick up the bill eventually. There is clearly a potential moral hazard where an outsourcer can gain commercial advantage or boost earnings by being less than committed to pensions deficit repair, disregard the risk or postpone its remedy. Indeed, this is one of the reasons the Government sought to reform the Fair Deal policy, by delivering better value for money to the taxpayer in respect of pension costs for outsourced arrangements.

Don't let ignorance be the enemy of good risk management

Actuaries are often asked to advise on Government's indirect exposure to pensions risk which can take many forms, eg:

- Rail franchising arrangements where contractors have specific responsibility for pension risks but only during the currency of their contract;

- Outsourcing of local government arrangements to private contractors such as the academisation of schools where the non-teaching staff of the academies are placed in the Local Government Pension Scheme, the other employers in which would cover the pension liabilities in the event of an academy default;

- Other strategically important services delivered by third party organisations with large pensions risk exposures. For example, The Universities Superannuation Scheme is one of the very largest private pensions schemes in the country, its current reform plans being a subject of intense debate.

The nature and possible impact of the pensions risk on the public sector in these examples differs according to each circumstance, but given the size and volatility of pensions liabilities, it is important to understand the nature of the risks involved when forming policy decisions. In particular:

- Identify the risks, understand their nature and particularly their quantum;

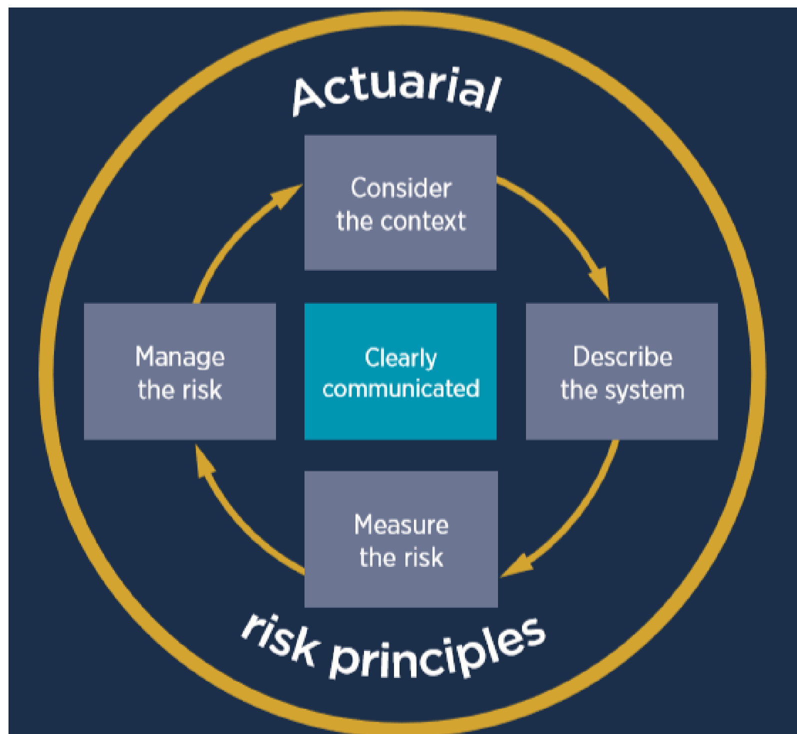
- Define responsibility clearly in contractual terms;

- Monitor closely the risk and the factors that might cause it to deteriorate; and

- Remember that risk cannot be removed – only transferred – and that in some way the Government may still have obligations if the arrangement fails.

Actuaries deal in risk of all sorts and not just pensions. The diagram reproduced opposite is from a risk management framework produced by a working party of actuaries in the UK. It is a simple conceptual guide which encourages a systematic approach to risk identification, description, quantification and management.

DB pensions risks can be both large and volatile. They are also long term. Don't let ignorance be the enemy of good risk management.



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