	Brent Pension Fund Sub-Committee 21 February 2024
	Report from the Corporate Director, Finance and Resources

Pass-Through Policy

Wards Affected:	All
Key or Non-Key Decision:	Non-key
Open or Part/Fully Exempt: (If exempt, please highlight relevant paragraph of Part 1, Schedule 12A of 1972 Local Government Act)	Open
List of Appendices:	Two: Appendix 1 - Pass-Through for New Contractors – Discussion Document Appendix 2 - Pass-through Table
Background Papers:	None
Contact Officer(s): (Name, Title, Contact Details)	Minesh Patel, Corporate Director, Finance and Resources minesh.patel@brent.gov.uk 020 8937 4043 Ravinder Jassar, Deputy Director of Finance ravinder.jassar@brent.gov.uk 020 8937 1487 Sawan Shah, Head of Finance sawan.shah@brent.gov.uk 020 8937 1955 John Smith, Pensions Manager john.smith@brent.gov.uk 020 8937 1985

1.0 Executive Summary

1.1 This report outlines the preferred arrangements for contractors participating in the Brent Pension Fund. Brent Pension Fund's actuary, Hymans Robertson, has prepared a discussion document outlining the principles, benefits and risks of using 'pass-through' for its admission agreements and a comparison with the current 'traditional' approach. This report considers the advantages and disadvantages of the proposed course of action.

2.0 Recommendation(s)

2.1 That the Pensions Fund Sub-Committee notes the proposed pass-through approach as the default for admission agreements in line with the principles as specified in this report and that

2.2 The Pensions Fund Sub-Committee recommend that the proposed pass-through approach detailed in 2.1 is approved by the General Purposes Committee at its next meeting.

3.0 Detail

3.1 Contribution to Borough Plan Priorities & Strategic Context

3.1.1 The work of the Pension Fund is critical in ensuring that it undertakes statutory functions on behalf of the Local Government Pension Scheme and complying with legislation and best practice. Efficient and effective performance and service delivery of the Pension Fund underpins all Borough Plan priorities.

3.2 Content

Foreword

3.2.1 Hymans Robertson, in their capacity as actuary to the Fund have prepared a discussion document, attached as Appendix 1, to set out the key factors for the Fund to consider with regards to allowing new admission bodies to participate in the Fund on a 'pass-through' basis.

3.2.2 It is important to note that these proposals will affect new admission agreements and any contracts that have already been advertised will proceed on the basis set out in the prospectus. Officers may consider applying pass-though to outstanding admission agreements that have not yet been agreed on a case-by-case basis where the operational benefits can be justified and to do so would not impact on the result of the procurement process. Any existing agreed admission agreements will not be modified.

Background

3.2.3 Brent Pension Fund is required to enter into admission agreements when letting authorities outsource a service to a contractor. The Fund's current approach is the traditional approach where the following principles apply:

- all past service pension benefits in respect of outsourced members are transferred from the letting authority to the new contractor,
- the contractor is set up on a "fully funded" basis using ongoing assumptions,
- the starting contribution rate is the cost of future service benefits only,
- the contribution rate is reviewed and adjusted at every formal valuation,

- any early retirement strains and augmentation costs that arise are met by the contractor via additional lump sum contribution(s),
- a bond or other form of indemnity where considered appropriate is taken out by the contractor and
- at the point of cessation, the resulting cessation valuation may lead to the payment of a cessation debt by the employer (or an exit credit by the Fund).

3.2.4 The paper advocates changing Brent's approach to risk sharing utilising the flexibility in the Funding Strategy Statement (FSS). This involves moving away from the conventional approach to admission agreements, where the contractor bears all the pension risk, and introducing pass-through agreements where the letting authority would agree to retain some of the pension risk.

3.2.5 The main drivers for this change of policy are the practical challenges of setting up conventional admission agreements, the contractors' difficulties in sourcing bonds and the expansion of the Department of Education's pension guarantee for academy trusts on 17th May 2023.

3.2.6 Although it may appear counterintuitive for a letting authority to volunteer to bear more risk, there are sound reasons for believing that risk sharing will deliver better outcomes for everyone concerned.

Legislation, Directions and Guidance

3.2.7 When councils, maintained schools and academies let contracts, they are required to ensure that staff with entitlement to access the LGPS that are transferred pursuant to the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) have access to suitable pension arrangements.

3.2.8 Schedule 2 part 3 of the Local Government Pension Scheme Regulations 2013 (LGPS Regulations 2013) sets out the entities that can be admitted to the scheme.

3.2.9 If a council or a maintained school outsources a function, The Best Value Authorities Staff Transfers (Pensions) Direction 2007 requires the letting authority to offer the TUPE transferred staff the same, a broadly equivalent or a better pension scheme than the one they had a right to participate in before the change of employer.

3.2.10 New Fair Deal 2013 requires academies and multi academy trusts (MATs) to offer transferring staff access to the same defined benefit pension scheme (Teachers' Pensions Scheme/LGPS).

Pass-through approach

3.2.11 The philosophy behind conventional admission agreements is to pass the investment and moral hazard risks to the contractor.

3.2.12 Pass-through covers a spectrum of risk sharing between letting authorities and contractors but the key feature is to pass significantly less pension risk to the contractor and reduce the costs of participation. This means that more of the pension risk remains with the letting authority.

3.2.13 Additionally, the traditional outsourcing approach can lead to a great deal of uncertainty over costs for contractors during volatile market conditions and bidders are increasing aware about such risks therefore by passing less of the pension risks to the contractor, the letting authority should expect that more bidders are encouraged to respond and to receive more competitive bids when tendering services.

3.2.14 For the avoidance of doubt, Brent is recommending a balanced hybrid approach with the letting authority taking the investment, ill-health retirement and excess salary accrual (within reason) risks, and the contractor any costs relating to early retirement and pension enhancement. The employer's contribution would be equal to the letting authority's primary contribution (future accrual) rate and it will be reviewed in the light of experience at each triennial valuation.

3.2.15 It should be noted that in the absence of outsourcing, the letting authority would retain all of the pension risk, therefore pass-through agreements seek to obtain the correct balance of transferring risks within their control to the contractor while retaining risks which have significant uncertainty with the letting authority that would otherwise be built into the quote.

3.2.16 It is proposed that the new policy will be the default for contacts with up to fifteen transferees and an option for larger contracts at the Administering Authority's discretion with the letting authority's agreement.

Analysis of Risk

3.2.17 The discussion paper attached in Appendix 1 prepared by the Fund Actuary, Hymans Robertson, provides an overview of the benefits and risks together with the key design factors. Appendix 2 further sets out the risks in a table.

3.2.18 In summary, pass-through offers several administrative benefits compared to traditional agreements:

- Simplified approach to admitting new bodies and of cessation of contractors.

- No requirement for a market rate bond which can be difficult for contractors to obtain.

- Potentially better pricing for letting authorities because contractors have greater certainty over pension risk.

- Removes the requirement to pay an exit credit if there is a surplus at the end of the contract. This is caveated with the letting authority being responsible for a deficit, should one materialise, at the end of the contract.

3.2.19 The table below outlines the proposed pass-through policy for the Brent Pension Fund:

Application	Pass-through will be the default for admission agreements with fewer than 15 transferring members. For new contractors with 15 or more transferring members, the administering authority will agree the most suitable arrangement (pass through or traditional approach) with the letting authority.
Investment risk	If the investment risk is passed to the contractor, it is likely that the downside risk will be priced into the contract. Conversely, the letting authority is likely to be able to negotiate a better price for the contract if they retain the investment risk.
Positive investment fluctuation	In the past, the letting authority would retain any surplus and the contractor would pay an exit payment if they were in deficit. That changed when regulation 64B was inserted in the LGPS Regulations 2013 on 23rd September 2020 and the contractor may be paid an exit credit if the contract is in surplus and the requirements in the FSS are satisfied. This change has complicated pensions administration and it is not unheard of for contractors to try to terminate admission agreements early to realise a substantial surplus. Under pass-through, the contractor would pay a fixed employer's contribution rate and there would be no exit payments or exit credits when an admission agreement ends. The net effect would be that the letting authority retains any investment growth.
Ill-health retirement	Brent intends to pool ill-health experience with the letting authority. It believes it can minimise the risk of moral hazard by insisting that the contractor uses Brent's independent registered medical practitioner (IRMP) as it is entitled to do under regulation 36(3) of the LGPS Regulations 2013.
Early retirement	Brent proposes that the risks of early retirement under regulation 30(7) LGPS Regulations 2013, waiving actuarial reductions and switching on the 85-year rule should be passed to the contractor to mitigate the risk of moral hazard. The contractor would be required to pay any strain costs flowing from its decisions.
Pension enhancement	The contractor should bear any costs related to shared cost APCs, shared cost AVCs and meet any strain costs

	in relation to membership awarded under regulation 31 of the LGPS Regulations 2013.
Excessive salary increases	Brent proposes tolerating this risk and taking reasonable steps to mitigate it. The main risk is final salary membership that was accrued before 2014 and it is partly self-limiting as members with substantial membership (say 20 years) will be entering their 50s. It recommends that salary growth should be one of the factors taken into consideration when reviewing employers' contribution rates at the triennial valuation. There are also other levers for controlling salary growth as; (1) most contracts are small cleaning/catering contracts where the employer has an interest in restraining the transferred staffs' salaries and (2) contracts with large numbers of staff, of long duration or where the workforce includes high-earners can be earmarked for conventional admission agreements and (3) housing associations/ companies, large maintenance contracts and arms-length companies etc. are suitable for conventional admission agreements as there will be ample advance notice, the professional fees will be modest in comparison the size of the contract and they tend to be longer contracts.
Bonds	Brent will only ask for a bond or other security if the contract is perceived to be high risk or the letting authority insists on one. In these circumstances the contractor will have to make a cash deposit, offer an unencumbered asset or post a bond for a sum equal to six months' employer's and employees' pension contributions.
Employer contribution rate	Brent will set an employer contribution rate that is equal to the letting authority's primary contribution (future accrual) rate. Employer contribution rates can be reviewed in the light of experience at the triennial valuations, thereby minimising the risks of employer excess.
Changes in the underlying actuarial assumptions	Will be borne by the letting authority and mitigated by changes to the employers' contribution rate at each triennial valuation.
Changes in the admitted	Will be underwritten by the letting authority. It is inevitable that the average age will rise and there will be fewer

body's demographic	contributing members as the admission agreement matures. This may be partially mitigated at the triennial valuations to the extent that its experience is replicated across the fund as whole.
Changes in the scheme's benefit structure	Will be covered by the letting authority. Although the consequences of McCloud and Goodwin will lead to modest improvements in the benefit structure, they will also be taken into consideration in the schemes cost control mechanism. Should there be significant changes that breach the 3% stabilisation window there would be reciprocal reductions in other benefits to restore equilibrium.
Officer's, lawyers and professional advisers	These costs impact on all the stakeholders. Even relatively straightforward conventional admission agreements are very labour intensive and generate large professional fees. One of the advantages of pass-through is that it avoids complex actuarial calculations and a variety of professional fees as we can use a standard template admission agreement. Although the contractor is the prime beneficiary of these savings, the letting authority can take them into account when negotiating the price of the contract.
Accounting for the pension liabilities	They remain the responsibility of the letting authority under pass-through.
The risk of not having simple processes	This affects everyone involved. A pass-through agreement will streamline contract negotiations and there is no reason why an admission agreement cannot be in place as soon as a contract is let. It will remove months/years of uncertainty, ensure that employees' and employer's contributions are paid over and invested promptly and remove unnecessary stress and uncertainty from ill-health retirements and deaths in service.

Summary

3.2.20 Conventional admission agreements require considerable internal administration and legal resource and incur significant actuarial fees.

3.2.21 The advantages of pass-through are that it is transparent, easy to understand and all parties are better informed from the outset. The terms are set out in a template admission agreement that will be disclosed to contractors before they bid.

Conclusion and Next steps

3.2.22 Pass-through is not new and there are many reasons why its popularity is growing; however, the catalyst seems to have been the revised guidance issued on 23rd September 2020, which confirmed that the Department of Education's guarantee covered pass-through.

3.2.23 Pass-through can present stark choices in its purist form; however, Brent has opted for a more nuanced hybrid approach based on the principle of utility. It has tried to strike a balance between offering the contractor transparent pension costs and protecting the letting authority from moral hazard.

3.2.24 The proposed policy frees the contractor from the uncertainty of investment risk and the requirement to post a bond while protecting the letting authority from pension enhancement and strain costs. It is not a panacea as it only controls final salary growth indirectly - although this legacy risk will dissipate with the passage of time.

3.2.25 It is important to note that pass-through is not suitable for all admission agreements and it will only streamline future outsourcings. Any outstanding admission agreements will have to be worked on a case-by-case basis where the operational benefits can be justified and to do so would not impact on the result of the procurement process.

3.2.26 The feedback from authorities who have implemented pass-through is very positive. Nonetheless, if Brent has any reservations about implementing pass-through it could consider trialling it for a reasonable period (say three years) and review the decision in the light of experience.

3.2.27 If this proposal is adopted, fund officers will consult with employers in the Fund to explain the pass-through approach, the risks and benefits. This is expected to take 3 weeks. Fund officers will also ensure that the necessary documentation in place to implement pass-though taking legal advice if deemed necessary. The current working assumption is to go live on 1st April 2024.

4.0 Stakeholder and ward member consultation and engagement

4.1 In view of the nature of the report, there has been no consultation or engagement with stakeholders or ward members to date.

5.0 Financial Considerations

5.1 Implementing the pass-through policy will ensure that there is more appropriate risk sharing between letting authorities and contractors, which should result in more competitive pricing for outsourced services, although employers will accept greater risk than under the traditional approach.

5.2 While is not possible to accurately quantify the savings associated with the adoption and implementation of a pass-through policy there will be less of an administrative burden in terms of financial, legal and actuarial resources in maintaining a pass-through policy than the traditional approach. Therefore it is considered that this approach delivers value for money.

6.0 Legal Considerations

6.1 The legal considerations arising from the adoption of pass through of pensions risk are addressed in the body of the report.

6.2 Adoption of pass through arrangements for contracts with up to 15 transferees will assist the procurement of such contracts given that providers, particularly smaller providers, often encounter issues in providing bonds and other security in respect of pensions risk.

7.0 Equality, Diversity & Inclusion (EDI) Considerations

7.1 There are no adverse equality considerations arising out of this report.

8.0 Climate Change and Environmental Considerations

8.1 There are no climate change or environmental considerations arising out of this report.

9.0 Human Resources/Property Considerations (if appropriate)

9.1 There are no HR or property considerations arising out this report.

10.0 Communication Considerations

10.1 There are no communication considerations arising out of this report.

<u>Report sign off:</u>

Minesh Patel
Corporate Director of Finance and Resources