HYMANS ROBERTSON

London Borough of Brent Pension Fund

Pass-through for new contractors

Discussion document

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HYMANS ROBERTSON

Section 1
Background

Introduction

Purpose and scope

This paper has been commissioned by and is addressed to Brent Council as the Administering Authority of the London Borough of Brent Pension Fund ("the Fund"). Its purpose is to set out the key factors for the Fund to consider with regards to allowing new admission bodies (specifically, contractors) to participate in the Fund on a 'pass-through' basis.

Pass-through is a way of participating in the Fund where certain risks are shared between the letting authority and the new contractor.

This paper is not a policy document. It should not be shared with any other party, including Fund Employers. This paper should not be read as providing any recommendation on a particular course of action or the preferred design of such an arrangement.

It is recommended that the Fund prepare and publish a policy document setting out the general approach they will take when admitting new contractors into the Fund.

This paper will be updated (specifically, the checklist in Appendix A) following a discussion with Fund officers around the specific design of the Fund's standard pass-through arrangement.

Current approach

Under the Fund's current admissions policy for new contractors, the following principles typically 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 is taken out by the contractor (if required by the Fund and/or letting authority); 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.)

Following cessation, the contractor makes a "clean break" from the Fund with no further obligations other than paying any cessation debt (or receiving an exit credit). The assets and liabilities left behind by the departing contractor revert to the letting authority.

What is pass-through?

The defining feature of a pass-through arrangement is to pass significantly less pension risk onto the contractor to reduce the volatility of the contractor's costs of participation. The consequence is that most of the pension risk 'passes through' the contractor to the awarding authority.

Purpose of pass-through

Letting authorities may choose to outsource services to achieve any of the following:

- Improve service delivery;
- Increase efficiency;
- Reduce service costs; and
- Aid manpower planning.

However, under the current "traditional" approach to outsourcings (set out in the previous page), all of the key pension risks transfer from the letting authority to the contractor for the duration of the contract.

For many contractors, this may be viewed as an unexpected or undesirable by-product, and this leads to additional administrative complexity for the Pension Fund during the contractor's period of participation.

Similarly, the transfer of pension risks from Academies to contractors dilutes the effect of the Academies Guarantee provided by the Department of Education (see Appendix B).

The traditional outsourcing approach can lead to a great deal of uncertainty over costs for contractors during volatile market conditions e.g. large increases to regular contributions, big cessation debts etc. Bidders for contracts are increasingly aware of these problems and may seek to price them into contracts via additional service charges which can undermine the purpose of the outsourcing.

The letting authority will want to obtain the best price for the outsourced service. Offering contractors pass-through as a means for removing some of the uncertainty of the cost for paying for the outsourced member's pension benefits may be a way of helping to achieve this.

Whether using the standard approach or pass-through, the letting authority still retains long term responsibility for the risks as all the members' accrued benefits transfer back to the letting authority at the end of the contract.

Furthermore, the letting authority remains the ultimate guarantor for all pension obligations throughout the contract in the event of the contractor becoming insolvent. This is unchanged whether adopting the standard approach or using pass-through.

Section 2
Benefits and risks

Benefits and risks of pass-through

Benefits of pass-through

For the Letting Authority

- Letting authority may be able to negotiate better contract terms.
- Easier to understand their pension responsibilities.
- Retains upside potential (i.e. retaining surpluses at end of contract).
- Clearer and more consistent tendering process.
- Avoids exit credits

For the Contractor

- The contractor bears less pension risk.
- Greater certainty of contributions
- No potential cessation debt to pay at the end of the contract.
- Reduced administrative costs as no requirement for a market risk bond.

For the Administering Authority

- Ease of administration with stakeholders.
- Reduction in time and costs of monitoring and administering bonds.
- Further protections in respect of academy outsourcings from the newly extended academy guarantee (see Appendix B)

Risks of pass-through

For the Letting Authority

- Responsibility for a potential cessation debt at the end of contract.
- Depending on design, the letting authority may be required to meet the cost of changes to LGPS benefits e.g. any strains relating to early retirements and augmentations.
- Mispricing the contract (eg if fixed rate was too low, in hindsight)
- Assets and liabilities remain on accounting balance sheet.

For the Contractor

- Loss of a potential exit credit at the end of contract.
- Potential for overpaying pension costs during the contract period

For the Administering Authority

- New documentation required, including maintenance of a clear policy on pass-through
- If implemented as a ‘default’ or ‘optional’ approach – the benefits may not be realised if letting authorities defer to traditional admission approaches.

Section 3
Design

Designing a pass-through arrangement for the Fund

Introduction

There are many ways in which a pass-through arrangement can be designed which are specific to the pension fund and to each individual employer in the Fund.

We understand it is the Fund is considering **a default arrangement to be in place for new outsourcings,** in order to realise the full benefits of pass-through and to mitigate against the new risks that may arise from this.

In the absence of a clear policy on pass-through, letting authorities and contractors have, historically, designed these arrangements without the Fund's support. These have typically been documented via a side letter to the Admission Agreement or within the commercial contract for services. Under this approach, the Fund treats the contractor as a 'standalone' scheme employer and the letting authority & contractor are then responsible for ensuring the terms of the side letter or commercial contract are adhered to. The Administering Authority is not a counterparty to this agreement and so is not responsible for ensuring the terms of the side letter are met. However, in practice the existence of a variety of pass-through arrangements in a single fund can create an administrative burden for Administering Authorities.

The remainder of this section looks at the various key design factors to assist the Fund when deciding on the parameters that could under a new pass-through policy.

Design factors

There is no single definition of a 'pass-through agreement'. The following factors distinguish between the various types of pass-through arrangements that can be implemented:

- **Application** (optional / default / mandatory?)
- **Size of contractor** (only apply to smaller admissions - fewer than X members?)
- **Types of risks shared** (between letting authority & contractor)
- **Contribution rates** (how to set and frequency of review?)
- **Bond / indemnity requirements** (redundancy only or waive requirement?)
- **Documentation** (policy documents and admissions agreement)
- **Allocation of assets** (between letting authority & contractor)
- **Legacy admission bodies** (amend old agreements?)

Application

Description

Should pass-through be the **default** approach, will it be one of many **options**, or could it be **mandatory** for all future admissions?

Key design factors

- If pass-through was set as **the default approach** for new admissions, letting authorities may be able to opt-out of this default arrangement (although not encouraged to do so by the Fund). Is it therefore unlikely that letting authorities will elect for contractors to participate on the 'traditional' (non pass-through) basis.
- If pass though was to be offered as an **option to letting authorities**, take-up may be low and specific to the department letting the contract. This may increase the administrative burden on the Fund (i.e. to track which new admissions are on the 'traditional' basis and which are on a pass-through basis).
- It may be difficult for the Fund to **mandate** pass-through for new contractors (as responsibility for the outsourcing and its pricing rests with the letting authority, rather than the Fund). Legal advice may therefore be required if the Fund wish to do this.

Size of contractor

Description

Should the new policy apply to **all contractors**, or only **smaller contractors.** Will **different forms of pass-through** apply to different sizes of employer?

Should pass-through apply to contractors from all **types of ceding employer**, or only apply to specific groups (e.g. Academies and/or Council employers)?

Key design factors

- The Fund may wish to set a cap on the number of active members where pass-through will apply e.g. under 100 active members only. This gives the Fund and the ceding employer the ability to consider applying the traditional, or a more bespoke pass-through, arrangement for larger outsourcings (where the cost and underlying pension liabilities may be significant).
- The Education & Skills Funding Agency (ESFA) has recently confirmed that the existing DfE Academy Guarantee applies to academy outsourcings in specific scenarios where the contractor participates in the Fund on a pass-through basis. See Appendix B for further information.
- We would expect the Fund to consult with affected employers prior to implementation and so, if a particular employer group (eg Council departments) are likely to object to pass-through, it may be appropriate to apply the policy to academies only.

Types of risks shared

Description

Which risks will be **retained by the letting authority** and which **risks will pass to the contractor**?

Key design factors

- The table shown on the right of the page sets out the different risks that could be shared between the letting authority and the contractor in a specific pass-through arrangement.
- The more risks retained by the letting authority, the more straight forward the arrangement, and the greater the potential governance & cost savings that will be achieved by the Administering Authority.
- The more risks passed to the contractors, the more the pass-through arrangement will feel like a 'traditional' admission, and the lower the potential governance and cost savings that will be achieved by the Administering Authority and the contractor.

Risks	Comment
Ill health retirement experience	The calculated cost of strain amounts calculated following ill health early retirements.
Non ill-health early retirements	The calculated cost of strain amounts following early retirements due to redundancy, efficiency or voluntary where actuarial reductions are waived.
Changes to LGPS benefits	Any changes to the LGPS benefits structure, which lead to a change in the costs of the scheme. Could include the effect of rectification events such as McCloud
Additional pension / augmentation	The additional liability arising from any decision taken by the contractor to award additional pension or otherwise augment benefit entitlement, as permitted under LGPS Regulations.
Pre-contract risks, including - Price inflation - Cash commutation - Withdrawal - Pay experience	The effect of member experience, relative to assumptions set at the previous actuarial valuation, leading to an increase in the past service liabilities.

Contribution rates

Description

How will the **pass-through contribution rate** be set and how often will this be reviewed going forward?

Key design factors

- A simple approach would be to set the **rate payable by the contractor equal to that payable by the letting authority**. A variation of this would be for the contractor to pay the letting authority's Primary Rate only ie the expected cost of future service benefits. No actuarial work would be required to calculate the rate payable and this would be known in advance of any tender exercise.
- Alternatively, the contractor could be required to **pay a rate based on its own specific membership** and (possibly) market conditions as at the commencement date. This would require actuarial advice to calculate the contribution rate payable.
- Rates could be **reviewed at triennial valuations**, or, for simplicity, may be fixed for the duration of the contract. If fixed, there is a risk that the cost of LGPS benefits changes significantly over the period of the contract.
- Another simple approach would be to **set a fixed rate** (say 25% of pay) for all pass through admissions. No actuarial advice would be required, but it introduces risk due to the rate not being related to that of the underlying letting authority.
- Other pass-through options include contractor-specific rates that are set and reviewed at each triennial valuation, but are subject to a **floor and/or a cap** over the period of the contract. The management of this over time may be onerous.

Bond / indemnity requirements

Description

Will the new pass-through admission body be required to **obtain a bond or provide an indemnity** in respect of its participation in the Fund, or will this **requirement be waived**?

Key design factors

- LGPS Regulations require a bond or indemnity to be in place for admitted bodies. However the need for a market-risk bond may be waived given the existence of an effective guarantee from the letting authority as per the pass-through arrangement. A redundancy bond may still be appropriate to protect against contractor insolvency costs.
- For Academy outsourcings, the existence of the Academies Guarantee may allow the Fund letting authority to waive the need for a bond, as per the expectations of the Education & Skills Funding Agency (see Appendix B).
- For Council outsourcings, the letting authority may be comfortable waiving the need for a bond given the size of the outsourcing and the ability to recognise this in the contract terms (as removing the bond requirement is likely to make the contract more attractive to potential bidders and would be expected to remove this expense from contract pricing).

Documentation

Description

A **formal policy document** setting out the Fund's approach to pass-through is necessary. This can be included in the Fund's admission policy.

How will the **terms of the pass-through admission be documented**?

Key design factors

- Historically, pass-through arrangements were documented via a side agreement to the admission agreement.
- A cleaner approach, especially if pass-through were to be set as the default approach for new outsourcings, would be to reflect the pass-through arrangement in the admission agreement.
- Legal support would be required to prepare a new template pass-through admission agreement for use by the Fund.
- The Fund's formal pass-though policy document would form the basis of a consultation with affected employers. This document would be appended to, and referenced in, the Funding Strategy Statement.
- The Fund's internal process around pass-through, including how costs are met and the details of any monitoring framework, should be fully documented the formal policy document.

Allocation of assets

Description

How will **assets be allocated** between the letting authority / contractor during the period of participation?

This may affect the **treatment of surpluses / deficits at cessation** and/or the **accounting treatment** of the contractor's pension obligations.

Key design factors

- The transferring staff will move to the new contractor's location code on the administration system (as is the case currently). Contractor contributions will also be assigned to the new location.
- Assets and liabilities are tracked for the contractor but pooled with the letting authority for future funding (and accounting) valuations.
- The contractor may retain eligibility for an exit credit at the point of cessation, even if the agreement indemnifies the contractor against the need to pay any cessation debt.

Section 4
Next steps

Next steps

There is no single definition of 'pass-through' and the advice provided in this report is designed to assist Fund officers when designing a standard pass-through arrangement for the future admission of contractors to the Fund.

This paper should assist in both the decision to implement pass-through as a potential default admission arrangement as well as with the design of the pass-through arrangement. For completeness, the design factors to be considered are summarised in the **checklist** in Appendix A, alongside some of the comments made in our meeting with fund officers on 24 January 2024.

The Fund will be **asking the Sub-Committee** to approve the pass-through in principle in line with the key design decisions laid out in Appendix A.

Following this, the Fund will **consult with the relevant employers** (specifically, the potential letting authorities that will be affected by this) and work through **the legal documentation** to implement (including a potential formal policy document, updated Funding Strategy Statement and an updated pass-through admission agreement template).

Assuming the Sub-Committee approves, re-approval from Sub-Committee will not be sought unless there are material changes to the key design decision.

Appendices

Appendix A - Decision checklist

Design factor	Fund comments (following meeting with Hymans Robertson on 24 January 2024)
Application – option / default / mandatory?	**Pass-through will be the default arrangement in the absence of a preferred approach from the letting authority.**
Which employers? - only apply to smaller employers? - apply to Academies / Councils or all types of letting authority?	**Default pass-through will apply to all contractors with fewer than 15 transferring members. For new contractors with 15 or more transferring members, the administering authority will agree the most suitable arrangement with the letting authority.** **Default pass-through will apply to contracts let by all types of letting authority.**
Types of risks shared – between letting authority & contractor?	**The letting authority will retain all risks, except for those brought on by the contractor (i.e. the award of excessive pay increases, additional pension / augmented benefits and the award of unreduced early retirement (non-ill-health)).** **To pass-through ill-health retirements risk to the letting authority, contractors must use the Fund's independent registered medical practitioner (IRMP)**
Contribution rates – how they are set and frequency of review?	**Contribution rate always set equal to the in-force primary rate of the letting authority, which may change at each triennial valuation.**
Bond / indemnity requirements – waive requirement (consider redundancy risk only)?	**Bond in place for "high-risk" contracts at the Fund's discretion or if required by the letting authority.**
Documentation – policy document (and associated comms and process notes) and admission agreement	**Policy principles to be agreed by Sub-Committee at the February meeting and officers to finalise and implement following consultation with employers.**
Allocation of assets – between the letting authority / contractor?	**Liabilities (with corresponding fully funded assets) are assigned to the contractor and tracked for its period of participation. However, for funding and accounting purposes, the contractor assets and liabilities are pooled with the letting authority.**

Appendix B – Academy guarantee and outsourcings

The Education & Skills Funding Agency (ESFA) recently released a policy paper regarding the operation of the DfE Academy Guarantee and its application to academy outsourcings. The statement ("the DfE Academy Trust LGPS Guarantee policy") can be found here: www.gov.uk/government/publications/academies-and-local-government-pension-scheme-liabilities/dfe-local-government-pension-scheme-guarantee-for-academy-trusts-pensions-policy-for-outsourcing-arrangements

The headlines from the new policy are:

- An **explicit statement that pension liabilities associated with academy outsourcings in the below scenarios are now guaranteed by the DfE**. This is an important development as previously outsourcings in scenarios 2 and 3 below were not being covered by the guarantee. This meant that the academy could not be a guarantor to the admission agreement. This issue is now resolved.
- The scenarios covered are set out below. This is only applicable to staff who are eligible for LGPS and if the **admission is operating under a 'pass-through' arrangement**.
    1. Staff currently working for an academy transfer to an outsourced contractor under TUPE
    2. Staff who transfer to an outsourced contractor under TUPE before the academy converted (ie when it was still a maintained school) and the outsourcing contract passes to the academy following conversion.
    3. Staff who currently work for the local authority which is providing services to the academy under a contract, but the contract is then awarded to another third-party contractor and the staff transfer to the contractor under TUPE.
- Academies **do not need to request ESFA approval** in the above scenarios. If the outsourcing is not covered under the scenarios, then academies still must contact ESFA for approval.
- ESFA's view is that this now **removes the need for a bond** for outsourcings in these scenarios. If an administering authority still insists on a bond then the contractor has to provide it as academies cannot provide bonds for LGPS liabilities.
- The policy is **retrospective** in its application.

Reliances & limitations

Reliances and limitations

We have been commissioned by Brent London Borough Council ("the Administering Authority') to provide advice on the benefits, risks and key design considerations relating to the implementation of a standard pass-through arrangement for new contractors.

This report is addressed to the Administering Authority. It has been prepared by us as actuaries to the Fund and is solely for the purpose of setting out the key factors for the Fund to consider with regards to allowing new admission bodies (specifically, contractors) to participate in the Fund on a 'pass-through' basis.

It has not been prepared for any other third party or for any other purpose. We make no representation or warranties to any third party as to the accuracy or completeness of this report, no reliance should be placed on this report by any third party and we accept no responsibility or liability to any third party in respect of it.

The following Technical Actuarial Standards apply to this advice, and have been complied with where material and to a proportionate degree. They are:

- TAS100 – Principles for technical actuarial work