



Pension Investment Committee

Council Pass Through Policy

Date: 8 June 2023

Key decision: No.

Class: Part 1.

Ward(s) affected: None specifically

Outline:

This paper outlines the rationale for the Council agreeing to introduce a Pass Through Policy for contractors admitted to the Pension Fund.

Recommendation:

The Committee are asked to:

1. Consider and approve the attached Pass Through Policy;
2. Delegate to the Executive Director of Corporate Resources the implementation and operation of the Policy as the Scheme Employer;

Timeline of engagement and decision-making

Officers and the Funds Actuary have prepared the draft Pass Through Policy in discussion with the Executive Director for Corporate Resources.

1. Summary

- 1.1. This report sets out a number of general matters to ensure the Committee are appraised on the work ongoing in respect of the Fund.

2. Recommendations

- 2.1. The Committee are asked to:

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- 2.2. Consider and approve the attached Pass Through Policy;
- 2.3. Delegate to the Executive Director of Corporate Resources the implementation and operation of the Policy as the Scheme Employer;

3. Policy Context

- 3.1. The overriding policy context for the Pension Investment Committee are the pension regulations and Members fiduciary duty to the beneficiaries of the Fund.

4. Legislative Background

- 4.1. Employees outsourced from the Council must be offered pension benefits that are the same, better than, or count as being broadly comparable to, the LGPS (Best Value Authorities Staff Transfer (Pensions) Direction 2007). This is achieved by:
 - 4.2. The employees remaining in the LGPS and the new employer becoming an admitted body to the Fund and making the requisite employer contributions; or
 - 4.3. The employer offering the employees membership of an alternative broadly comparable scheme, as approved by the Government Actuary's Department (GAD).
 - 4.4. For the avoidance of doubt, this policy includes all outsourcings from Local Education Authority funded schools which include members eligible for participation in the LGPS.

5. Pass Through Policy

- 5.1. There are a number of approaches for the Council to outsource a service to a contractor. In the past, the traditional approach has been for the Council to pass the pensions risk and costs to the contractor and in return the contractor receives assets such that at commencement they are fully funded. The contractor's contribution rate will vary over time, and at the end of the contract they will either have to pay a cessation debt or instead be entitled to an exit credit.
- 5.2. However, risk sharing is becoming more common in LGPS funds as contractors become more aware of pension risk and the financial consequence of adverse experience whilst participating in funds. Under these agreements, the Council would agree to cover some of the pension risks that would have transferred to the contractor under the traditional approach. In essence, this means limiting (or even removing) potential variation in contribution rates, and possibly limiting (or even removing) the degree of any cessation debt / exit credit.

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- 5.3. The defining feature of a pass-through arrangement is to pass significantly less pension risk onto the contractor, in order to reduce the volatility of the contractor's costs of participation. The consequence is that more of the pension risk remains with the Council. By passing less of the pension risks to the contractor, the Council should expect more competitive bids as less uncertainty needs to be 'priced into' quote.
- 5.4. Thus, pass-through is an arrangement whereby the Council retains the main risks of fluctuations in the employer contribution rate during the life of the contract and the risk that the contributions paid may be insufficient to meet the employees' pension benefits at the end of the contract. Examples of risks which could cause the employer contribution rate to fluctuate could include the interest on the surplus / deficit, investment performance, changes to the discount rate, changes to longevity assumptions, a change in the membership profile. The contractor is responsible for early retirement strain costs, disproportionate salary increases and ill health retirements [not approved by the Fund's occupational health physician].
- 5.5. Therefore, the Council has allocated risk to the party best able to manage it which allows for a smooth and structured transition from the Council to contractors, as well as smoother ongoing arrangements.
- 5.6. The attached draft pass-through policy covers the following sections:

Summary of general principles

Section 1: Legislative background

Section 2: Pass Through Arrangements for London Borough of Lewisham Council contractors admitted to the Fund.

Section 3: Outsourcings of active employees

Section 4: Bonds

Section 5: Cessation/exit valuation

Section 6: Process Map

Section 7: Pass through (Process map graphic)

Appendix 1: Pensions Information for inclusion in procurement documents

Appendix 2: Template Admission Agreement for pass through employers

- 5.7. For ease of reference the summary of general principles relating to pass-through arrangements is set out below.
 - The contractor's pension contribution rate as a percentage of pay is set at the outset of the contract.
 - The default position is that a pass-through arrangement will apply in relation to most outsourcings.
 - The contractor's employer contribution rate will be set at 25% of pay where 20 or less members of staff are eligible to be members of the LGPS.
 - The Council reserves the right, for larger outsourcings where more than 20 members of staff are eligible to be members of the LGPS, to determine a bespoke employer rate, calculated by the Fund Actuary.

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- The fixed contribution rate will be fixed for the original period of the contract (e.g. for a 3 + 1 + 1 contract, the rate would be fixed for 5 years).
 - The Council retains responsibility for fund performance and longevity under its pass-through arrangement, irrespective of the size of the outsourcing.
 - A cessation valuation will be carried out when the contractor becomes an exiting employer, as required under the LGPS Regulations. However, any deficit or surplus relating to the employer will become the responsibility of the Council.
 - For most outsourcings, the contractor will not be required to obtain a bond where 20 or less members of staff are eligible to be members of the LGPS.
 - The Council reserves the right, for larger outsourcings where more than 20 members of staff are eligible to be members of the LGPS, to require the contractor to provide a bond to cover the potential early retirement strain costs due to redundancies made in the event of the contractor's insolvency. The level of bond should be reviewed annually.
- 5.8. The Council as both Scheme Employer and Fund Administrator wish to introduce the pass-through policy for the benefits set out above, ease of administration, appropriate risk sharing and anticipated lower contract costs, and asks the Pension Investment Committee to approve this.

6. Financial implications

- 6.1. It is not possible to accurately quantify the costs or savings associated with the adoption and implementation of a pass-through policy.
- 6.2. The policy will ensure that there is more appropriate risk sharing between the Council and contractors, which should result in more competitive pricing for outsourced services, although the Council will accept greater risk than under the traditional approach.
- 6.3. However, there will be less of an administrative burden in maintaining a pass-through policy than the traditional approach which should enable less staffing resources to be expended on this activity, thus streamlining the process.
- 6.4. On balance it is considered that this approach delivers value for money.

7. Legal implications

- 7.1. The legislative background is set out in section 4 of this report.
- 7.2. In developing the pass-through policy the Council sought external legal advice from Browne Jacobson LLP and this advice has informed the refinement of the draft policy appended to this report.
- 7.3. The Pension Regulations require that the Council has regard to the proper advice of its expert independent advisors in relation to decisions affecting the Pension Fund. They must also have regard to the separate advice of the Chief Financial Officer who has statutory responsibility to ensure the proper administration of the Council's financial affairs, including the administration of the Pension Fund.

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8. Equalities implications

8.1. There are no direct equalities implications arising from this report.

9. Climate change and environmental implications

9.1. There are no direct climate or environmental implications arising from this report.

10. Crime and disorder implications

10.1. There are no direct crime and disorder implications arising from this report.

11. Health and wellbeing implications

11.1. There are no direct health and wellbeing implications arising from this report.

12. Background papers

12.1. Draft Pass-Through Policy – appendix 1

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13. Report author and contact

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