# Leicestershire County Council Pension Fund

Pass-through options for outsourcings

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# 1 Introduction

This paper considers the options available to letting authorities when commissioning services ("outsourcing") to another employer that intends to participate as an admission body in the Leicestershire County Council Pension Fund ("the Fund"). In particular, it focuses on the admission body route where risks are shared between the letting authority and the new contractor (sometimes known as 'pass through') and considers how such arrangements are set up in practice.

The Fund's policy on pass-through is generally aimed at small, shorter term outsourcings. Where a letting authority intends to outsource a significant proportion of its current active staff the implications of risk sharing should be considered in greater detail than is outlined in this paper. Further information exploring the risks and considerations of risk sharing can be provided if required.

**In all cases, it is important for the letting authority to engage with the Fund as early as possible to ascertain the best approach for the pension arrangements to any proposed outsourcing.**

# 2 Funding approach to outsourcings

## 2.1 Standard approach

Under the Fund's current policy for outsourcings, 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 with the assets notionally allocated at outset set equal to the value of the transferring accrued pension benefits based on market conditions at the transfer date;
- the starting contribution rate is the cost of providing future service pension benefits only;
- the contribution rate is reviewed at every formal valuation date during the contract period to allow for experience and changes to assumptions/market conditions, and adjusted to take account of any past service surplus or deficit that has arisen since the last valuation (or outset);
- as required by the LGPS Regulations, a bond or other form of indemnity is taken out by the contractor that is triggered in the event of its failure during the contract period; and
- when the contractor reaches the end of its contract, the LGPS Regulations require a cessation valuation to be undertaken and any deficit (or surplus) is levied on the departing employer. Recent changes to the LGPS regulations now allow any surplus to be returned to the contractor as an 'exit credit' upon cessation.

The Fund will also usually insist on early retirement strains and augmentation costs that arise during the contract being met via an additional lump sum contribution.

When the contract is terminated, the contractor is able to make a "clean break" from the Fund with no further obligations other than paying any cessation debt (should one exist). **The assets and liabilities left behind by the departing contractor revert back to the letting authority (as required under the LGPS Regulations).**

## 2.2 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 “standard” approach to outsourcings, 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.

The standard 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. Pass-through arrangements are explained in greater detail in the following section.

**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.**

# 3 Pass-through options

It is the recommendation of the Fund, as per the Fund's Funding Strategy Statement ("the FSS"), that operating a policy of pass-through for short-term outsourcings should be beneficial for all interested parties:

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.

Contractor

- The contractor bears less pension risk.
- Greater certainty of contribution costs and no potential cessation debt to pay at the end of the contract.
- Reduced administrative costs as no requirement for obtaining market risk bonds.

Administering Authority

- Ease of administration.
- Reduction in time costs monitoring and administering bonds.

## 3.1 Types of pass-through arrangements

Different approaches can be adopted in different circumstances. In the FSS the Fund advocates the following three options, with option 1 being the Fund's recommended approach.

### 3.1.1 Pooling

As per the FSS, *"Under this option the contractor is pooled with the letting employer. In this case, the contractor pays the same or similar rate as the letting employer."*

Advantages

- Same contribution rate before and after the outsourcing. This may be perceived as easier or fairer amongst the interested parties.
- Contributions rates are known well in advance of the contract commencing and can be priced appropriately. All bids should be priced on a similar basis, saving the letting authority time in comparing and analysing bids.
- Less volatile contributions from one valuation to the next as the impact of any membership experience (e.g. pensioners living longer than assumed) is spread across a wider population of employees, i.e. shared with the letting authority.
- The net effect of the above should afford contractors greater certainty and less volatility. This could translate into a reduction in the contract price for the letting authority as pension risk is not priced into the cost.
- Ease of administration in payment of contributions and monitoring of the pooled funding position.
- No requirement for the contractor to take out a bond or provide an indemnity as the letting authority will be acting as guarantor to the outsourced member's pension benefits. The cost and administration burden of

having to obtain a bond often deter contractors from bidding for a contract. The letting authority should see keener contract prices as the contractor will no longer have to add margins into the contract price to cover this cost.

Disadvantages

- The 'true' contribution rate for the contractor will either be above or below the average being paid by the pool. Effectively this means that there are some cross-subsidies. However, with small outsourcings the cost savings should more than offset this.

**Currently pooling is the Fund's preferred approach to pass-through.** The FSS states: *"Although each matter will be dealt with on a case by case basis the Administering Authority default position is pooling with any surplus or deficit passing back to the letting employer. The Admission Agreement as well as the transfer agreement reflects this."*

### 3.1.2 Letting employer retains pre-contract risks

This is the Fund's least favoured option but remains available. Under this option the letting employer would retain responsibility for assets and liabilities in respect of service accrued prior to the contract commencement date. The contractor would be responsible for the future liabilities that accrue in respect of transferred staff. The contractor's contribution rate could vary from one valuation to the next. It would be liable for any deficit, or be paid any surplus at the end of the contract term in respect of assets and liabilities attributable to service accrued during the contract term and actions wholly attributable to the new employer for example excessive pay awards.

The approach may seem to be fairer to both the letting authority and contractor since it shares the deficit in proportion to the period over which both were employing members. However, it is more complex and costly to administer and may require additional work at valuations and for FRS102 disclosures. In addition, there will be a need for a bond, or some form of indemnity, to be provided by the contractor and there is no certainty on the contractor employer rate. This uncertainty means the overall contract price is more unpredictable. The bond, or indemnity, will need to be regularly assessed and the contractor will need to make the required changes as instructed by the Administering Authority.

### 3.1.3 Fixed contribution rate agreed

As per the FSS: *"Under this option the contractor pays a fixed contribution rate and doesn't pay any cessation deficit or receive any surplus at the end of the contract term."*

By allowing the contractor to pay a fixed rate for the duration of the contract, the letting authority is in essensce paying any difference between this fixed rate and the 'true' rate in respect of the contractor's membership.

The fixed rate charged could be adopted via the following approaches:

- equal to the cost of providing future service benefits for the transferring members at the outset (requested in advance of the outsourcing);
- equal to the letting authority Primary contribution rate at the outset; or
- either of the above, plus a risk margin to allow for the risks being retained by the letting authority.

In practice, this arrangement would operate similar to a pool. The key difference would be in the terms of any agreement between the contractor and the letting authority in respect of the contribution rate being paid by the contractor.

### 3.2 What risks should not be shared?

When establishing a pass-through arrangement, the letting authority may wish to consider if the contractor should retain responsibility for funding any risks that would be within its own control. These typically relate to strains arising due to:

- early payment of benefit on unreduced terms;
- adverse ill health experience; and
- excessive salary growth.

The Fund's current policy on early retirement requires the payment of any strains arising from early retirement to be paid immediately be the employer. As part of the contract terms, the Fund's recommendation is the letting authority should consider requesting the payment of any strains arising during the contract be paid by the contractor.

Monitoring excessive salary growth may be less practical and for smaller outsourcings the letting authority may wish to consider the significance (or lack of) if looking to establish such covenants.

### 3.3 Implementing pass-through

As per the FSS, the Fund's default approach will be to establish a pooled pass-through arrangement for new outsourcings. The admission agreement will be amended to reflect this.

In practice the Fund will treat this pool the same, before and after the transfer, as the combined membership will be unchanged. The pool will continue to pay the contribution rate already in payment by the letting authority.

# 4 Summary

Pass-through is becoming more common in LGPS Funds as contractors become more aware of pension risk and the financial consequences of adverse experience whilst participating in Funds. The Fund believes that using pass-through as the default approach for all new outsourcings will be in the best interests of all parties.

The main pass-through options discussed in this paper are:

1. Pooled contributions
2. Complex pass through (e.g. contractor responsible for risks in respect of post-transfer liabilities only)
3. Fixed contributions.

The choice of outsourcing arrangement will be very dependent on the particular outsourcing and a number of factors will shape the final form of chosen arrangement. The pass-through arrangement should be clearly documented via the admission agreement signed between the letting authority and contractor.

**On occasion there may still be circumstances where using a variation of the "pooled" approach may be better suited, e.g. large scale, longer term outsourcings. For this reason it is important for the letting authority to engage with the Fund as early as possible to ascertain the best approach for the pension arrangements to any proposed outsourcing.**