Pension Board
19 January 2022

Proposals for Pension Arrangements for Outsourced Services

Report of the Head of Pensions

Summary

This report, presented to Committee on 3 December 2021, looked to set the Funds preferred solution regarding the pension arrangements for outsourced services. The previous options were documented within the Funding Strategy Statement, but with no guidance on the Fund’s preferred approach. Hymans Robertson in their capacity as actuary to the Fund, prepared a comprehensive paper, attached as appendix 1, to assist the Fund in understanding the principles of the admission body risk sharing route known as “pass-through” and provide a comparison of the risks between this and the traditional (current) admission route. It also sets out the possible contribution rate approaches and next steps to consider for implementation.

Background

There are a number of approaches for awarding authorities to outsource a service to a contractor. The traditional (current) approach has been for the awarding authority to pass the pensions risk and costs to the contractor and in return the contractor receives assets such that at commencement they are fully (100%) 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 potentially benefit from an exit credit at the Fund’s discretion.

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 awarding authority would agree to retain 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.

The pass-through approach

A number of different approaches can be taken in offering risk sharing agreements between the awarding authority and a contractor. The attached paper focuses on the agreement known as ‘pass-through’. 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 awarding authority but by passing less of the pension risks to the contractor, the awarding authority should expect more competitive bids.

Impact of regulation changes

Regulatory changes have changed the risk profile when outsourcing a service. Traditionally, at the end of a contract, the awarding authority who is assumed to act as guarantor;

- faced the risk that the contractor was in deficit and unable to meet the cost of any exit payment required by the Fund. In this circumstance, the responsibility for meeting this payment falls to the awarding authority; and
- had the upside potential in the case where the contractor is in surplus. Any surplus at the end of the contract would transfer back to the awarding authority.

Regulatory changes in 2018 and 2020, which introduced “exit credits”, removed the upside potential in a traditional outsourcing arrangement, as the Fund is now required to refund a surplus (if one exists) to the contractor on exit from the Fund - subject to the Funds discretions on the level of “exit credit” paid.

Under a pass-through arrangement, the awarding authority usually agrees to cover most pension fund risks. As a result, the risk of a deficit emerging usually remains with the awarding authority (so there would be no obligation for the contractor to meet any potential deficit at the end of the contract). However, it would also enable the awarding authority to keep the upside potential of an emerging surplus.

The attached paper provided a risk comparison of the traditional and pass through approach from the perspectives of the awarding authority, contractor and Fund.

In the case of the Fund, it is protected under either approach as the awarding authority would act as guarantor of last result under the traditional (current) route and explicitly as guarantor under the pass-through route.

However, pass-through offers several administrative benefits compared to traditional agreements:

- Simplified approach to admitting new bodies (lesser need to liaise with actuaries, template admission agreements need less manipulation);
- Reduced requirement for a bond which we are aware can be challenging for contractors in the current environment (awarding authorities may still wish the contractor to obtain a bond to cover redundancy risk);
- Simplified approach on cessation; and
- Removes the administration burden and risks associated with making a determination of the level of exit credit to be paid to a contractor if there is a surplus at the end of a contract.

The attached paper also discussed the approach to setting contribution rates, what risks should not be shared, the options that would remain open to the awarding authority on determining whether to utilize the proposed new standard approach or other options, depending on the size and circumstances of a particular outsourcing.

Proposals and next steps
Pass-through is becoming more common in LGPS funds and we have already had multiple requests from new contractors to be admitted on this basis. Recent market conditions and changes in the Regulatory environment on the ability to repay surpluses make pass-through a more attractive offering for awarding authorities.

Our approach approved by Committee on 3 December 2021 is a preferred arrangement where:

- the main pension risk (the liabilities and assets) effectively remain with the awarding authority;
- all new contractors pay a specified contribution rate during their participation in the Fund, which should be agreed between the admission body and the awarding authority. The minimum level allowable will be no lower than the awarding authority's primary rate applicable at the time of the awarding of the contract.
- the contractor is held to account for any costs associated with employer driven decisions (excessive pay awards and early retirement strains);
- there is consideration and advice taken by the awarding authority on whether pass-through remains appropriate for particularly large contracts; and
- the arrangement should be clearly documented via the admission agreement, the services contract or a side agreement between the awarding authority and contractor. Either way, the Fund needs to be aware of all agreements.

Ultimately, it is for the awarding authority to decide whether and when it wishes to utilise pass-through for future outsourcings rather than the Fund. However, a consistent policy will ensure processes at the awarding authority and the Fund will be as efficient as possible.

Employer communication
A communication exercise targeted at the relevant employers, will be undertaken by officers and the Actuary in Q1 2022 now that the proposal to adopt pass-through as the Funds preferred option for future outsourcings has been agreed. This communication exercise will include a full explanation of the pass-through approach, the risk and benefits of the approach, as well as things that should be considered as part of an outsourcing as well as a revised process guide for awarding authority to follow.

As part of the formal valuation process, the Funding Strategy Statement will be reviewed and will state that pass-through is the preferred approach to employer outsourcings. The Funds actuary has confirmed that the adoption of the pass-through approach is permitted within the current FSS, therefore, there is no requirement at this time for this document to be revised.

Agenda Item 9

Recommendation
That the Board note the formal adoption of the pass-through approach, as specified in this paper, as the preferred pension arrangement for future outsourced services.

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