**LONDON BOROUGH OF HAMMERSMITH & FULHAM**

**Report to:** Pension Fund Committee

**Date:** 15 November 2023

**Subject:** Passthrough Policy Update

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**Responsible Director:** Sukvinder Kalsi, Director of Finance

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## SUMMARY

Pass-through is a method whereby certain risks are shared between the letting authority and the new contractor participating in the Fund. The passthrough policy will be an appendix to the Fund's Funding Strategy Statement shown in Appendix 1. This report seeks to outline the current policy and what would change under the implementation of a passthrough policy as well as give an update on the consultation process.

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## RECOMMENDATIONS

The Committee is requested to approve the draft Appendix to the Funding Strategy Statement and, subject to any comments or amendments, delegate final approval to the Head of Pensions in consultation with the Chairman.

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**Wards Affected:** None

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| Our Values | Summary of how this report aligns to the H&F Values |
|---|---|
| Being ruthlessly financially efficient | The result of the triennial valuation shows an improved funding level, with the Council (as a single employer within the fund) now being 103% funded at the 2022 valuation, the passthrough policy implementation should continue to support employers with their funding position. |

## 1. Background

1.1 Under the Fund's current admissions policy for new contractors, 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 an additional lump sum contribution;
- a bond or other form of indemnity is taken out by the contractor and maintained throughout the term of the membership within the Fund;
- 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).

1.2 Following cessation, the contractor exits the Fund with no further obligations other than paying any cessation debt. The assets and liabilities left behind by the departing contractor revert back to the letting authority (as required under the LGPS Regulations).

## 2. Pass-through

2.1 Authorities opting to outsource services may do so to enhance service delivery, boost efficiency, lower costs, and aid in workforce planning. In the traditional outsourcing model, all pension risks are shifted from the letting authority to the contractor during the contract period. However, this transfer can complicate matters for contractors and dilute the impact of guarantees provided by entities like the Department of Education.

2.2 The traditional approach often leads to uncertainty for contractors, especially in volatile market conditions where unexpected costs may arise. Bidders may incorporate these uncertainties into their contract prices, undermining the purpose of outsourcing. To address this, letting authorities may offer pass-through options to contractors. Pass-through mechanisms help mitigate cost uncertainties for contractors, potentially ensuring better pricing for outsourced services.

2.3 Regardless of the approach (standard or pass-through), the letting authority maintains long-term responsibility for risks, including guaranteeing all pension obligations if the contractor faces insolvency.

## 3. Benefits and Risks

3.1 Letting Authority:

Benefits:

- Negotiating power: the letting authority may negotiate better contract terms, ensuring favourable financial arrangements and project conditions.

- Clarity in responsibilities: pass-through provides easier understanding of pension responsibilities for the letting authority, reducing confusion and ensuring compliance.

- Retained surpluses: the letting authority retains upside potential, allowing them to keep surpluses at the end of the contract, enhancing financial gains.

- Streamlined tendering: pass-through leads to a clearer and more consistent tendering process, making it easier for the letting authority to evaluate and select contractors.

Risks:

- Balance sheet Impact: assets and liabilities remain on the accounting balance sheet, potentially affecting financial reporting and assessments.

- Loss of cessation debt: there is a risk of losing a potential cessation debt at the end of the contract, which could impact future financial planning.

- Cost of benefit changes: depending on the design, the letting authority might be required to meet the cost of changes to LGPS benefits, such as strains related to early retirements and augmentations, leading to unforeseen financial burdens.

- Contract mispricing: there is a risk of mispricing the contract, especially if the fixed rate was set too low in hindsight, leading to financial challenges during the contract period.

**3.2 For the Contractor:**

Benefits:

- Less pension risk: the contractor bears less pension risk, providing financial stability and predictability.

- Certainty of contributions: there is a greater certainty of contributions, ensuring financial planning and budgeting are more straightforward.

- No cessation debt: there is no potential cessation debt to pay at the end of the contract, reducing financial liabilities.

- Reduced administrative costs: the absence of a market risk bond requirement reduces administrative costs for the contractor, streamlining operations.

Risks:

- Loss of exit credit: the contractor faces the risk of losing a potential exit credit at the end of the contract, impacting future financial benefits.

- Overpayment of pension costs: there is a potential for overpaying pension contributions during the contract period, leading to financial inefficiencies.

**3.3 Administering Authority:**

Benefits:

- Ease of administration: implementing the approach leads to ease of administration, simplifying processes and reducing administrative burden.

- Time and cost reduction: there is a reduction in time and costs associated with monitoring and administering bonds, leading to operational efficiency.

Risks:

- New documentation requirements: the administering authority needs to create new documentation, including maintaining a clear policy on pass-through, adding administrative workload.

- Benefits not Realised: if implemented as a 'default' or 'optional' approach, the benefits may not be realised if letting authorities defer to traditional admissions approaches, potentially undermining the intended advantages.

## 4. Consultation

4.1 Consultation has been undertaken with all employer bodies of the Fund. The consultation opened on 21 July 2023 and ran for seven weeks, closing on 8 September 2023.

4.2 The LBHF Fund has only had one response from an employer, which was very positive.

4.3 The response highlighted issues that the employer is currently facing and the hope that those issues would be solved by having a pass-through policy. The employer stated they hope that implementing a pass-through policy would encourage more companies to bid for a competitive tender which would help them with their current catering services tender and hope to see the policy approved so they could feed the information into the tender process.

**LIST OF APPENDICES**

Appendix 1: LB Hammersmith and Fulham PF FSS Appendix F Pass-through Policy Draft July 2023