Managing ill-health early retirement risk

Purpose

This paper has been requested by and is addressed to East Sussex County Council as the Administering Authority to East Sussex Pension Fund ("the Fund"). It is intended to provide a general overview of some issues and considerations surrounding the risk to funds in the Local Government Pension Scheme ("LGPS") of ill health early retirements and the associated additional costs of these. We summarise the various risk mitigation options available. This paper is not intended to provide advice and should be read as such.

Ill Health Early Retirements costs

When an LGPS member is awarded early retirement on grounds of ill health there is an increase in the pension liability for the participating employer ("the strain cost"). This results from:

- early payment of the pension compared to under normal retirement; and
- an increase in the benefits payable to the member through augmentation awarded on ill-health retirement (either based on full prospective service to retirement for a Tier 1 early retirement or 25% of prospective service for a Tier 2 early retirement).

Ill health early retirements are relatively infrequent (around 1 to 2 per 1,000 employees per annum) but variable and unpredictable. The number and cost can vary significantly from year to year for an employer and at whole fund level. Examples of actual member strain costs experienced from the Fund are given below. These represented an immediate increase to the liabilities (and hence likely deficit) of the employer.

Employer	Member age	Member salary	Tier 1 strain cost	Employer payroll
Council	50	£75,000	£567,000	£133.0m
College	45	£39,000	£534,000	£2.9m
Admitted body	49	£19,000	£163,000	£1.0m
Academy	34	£20,000	£155,000	£2.2m
Town council	36	£18,000	£110,000	£0.3m

At present the Fund's approach is that employers effectively self-insure by making a contribution towards potential ill health strain costs via a small proportion of their total contribution rate. For example, East Sussex County Council pay around 0.9% of pay per annum, but this amount varies from employer to employer depending on membership profile. When a member retires due to ill health the strain cost is allowed within the liability at the next valuation and subsequently recovered within future contributions. This contribution arrangement works well for larger employers (e.g. Councils) where large numbers of members make strain costs relatively predictable, but not for medium or smaller employers (e.g. Academies). There is a risk that some employers in the Fund may be unable to meet the strain cost arising from an ill-health early retirement. In the worst-case scenario, the increased deficit and contributions could put an employer out of business.

Risk management options

Given the above disparity and risk, it has become good practice within the LGPS for funds to have an ill health cost management and mitigation approach. This typically involves either (a) insuring some or all employers via a third party insurer or (b) through internal cost sharing between employers. Each is considered below.

(a) Ill health insurance

In exchange for a premium, ill health liability insurance involves an external insurer paying a lump sum equal to the strain cost in the event of an employer's member retiring on ill health grounds. This effectively offsets the additional liabilities in the Fund. Legal & General is the established LGPS provider of the insurance with policies in place across 20 funds with around 1,500 employers covered.

There are three main options for the Fund to use ill health insurance:

- Whole Fund insurance covering all employers
- Partial Fund insurance covering a group of employers selected by the Fund (e.g. small/medium employers)
- Employer "Choice" insurance where each employer holds its own policy, should it elect to do so

The premium for the insurance is calculated as a percentage of each employer's pay and the employer's own regular contributions to the Fund are reduced by the premium. This ensures the employer's annual cash payments to the Fund are the same whether it insures or not. This ensures they are not effectively "paying twice" for ill health costs.

The Fund obtained insurance quotes from Legal & General in 2017 but did not pursue at that stage. The premiums are set out below for context (noting that these are no longer valid, and a revised quote will be required):

- Whole Fund insurance - 0.98% of pay
- Partial Fund insurance – 1.01% of pay
- Employer "Choice" insurance – 1.50% of pay

As with any insurance product, there is a risk that the Fund or employer has fewer ill health early retirements than expected, and so the insurance premium will be higher than the claims made.

Given the points raised above that the current contribution arrangement works well for larger employers, we would question if insurance across all employers (i.e. Whole Fund insurance) is required.

In addition, there is some concern that if employers were offered the choice some may not have the time or knowledge to make an informed decision on what is quite a complex issue. In particular, this may apply to those small and medium sized employers most at risk.

(b) Internal cost sharing

An alternative to external insurance is internal cost sharing or "self-insurance". This is simply an internal pooling arrangement between employers within the Fund. With cost sharing, employers with good experience subsidise those with poor experience.

The benefit to the Fund is that employers are not giving up profits to the insurer should experience be good.

Other LGPS funds have found that a major stumbling block to this approach is that employers are normally unhappy to cross-subsidise other employers in such an explicit manner. Therefore, Officers would recommend an employer consultation is carried out to explain the cost sharing approach.

In addition, there is also a danger with this approach that employers become less thorough in their decision-making process to allow an employee to ill health early retire i.e. in being aware they are only partly responsible for their own costs.

The Fund's actuary would implement the internal ill health cost sharing as part of the formal valuation process. The cost of setting up and running the arrangement would be small relative to total strain costs.

Next steps

Currently, Fund employers are (often unwittingly) exposed to ill health strain cost risk, both from their own adverse experience but also from the cost of another employer becoming insolvent as a result of unaffordable strain costs. We would suggest the Fund reviews this paper and considers putting in place an ill health risk management approach to mitigate these risks.

We would recommend a short call to discuss any questions you may have before proceeding.

Reliances and limitations

This paper has been commissioned by East Sussex County Council. It intended for the use by East Sussex County Council only for the purposes of considering its options to manage ill-health early retirement risk.

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The following Technical Actuarial Standards[1] are applicable in relation to this report and have been complied with where material:

- TAS 100; and
- TAS 300.

[1] Technical Actuarial Standards (TASs) are issued by the Financial Reporting Council (FRC) and set standards for certain items of actuarial work.

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For and on behalf of Hymans Robertson LLP