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 the 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 financial advice to support a recommended option 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

A summary of the overall experience across the whole of the fund is set out in Appendix A.

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 liabilities 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 mitigation 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 employee 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.

We have been working with Fund officers to investigate two possible policy options:

- Compulsory 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, and prevents the employer from effectively "paying twice" for ill health costs.

Since discussion at the June Pension Committee, indicative insurance quotes have been obtained from Legal & General. The premiums are set out below for context:

- "Partial Fund" insurance
  - *All employers excluding Councils and Fire* – 0.9% of pay
  - *All employers with less than 150 active members* - 1.4% of pay
- Employer "Choice" insurance – 1.6% of pay

Letting employers decide under the "Choice" option might be attractive. However, there is some concern that employers 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.

The "Partial Fund" approach could remove this concern by compelling or automatically opting-in employers into using the insurance to manage the risk.

However, 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.

(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, we 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.

We would be happy to 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.

Summary

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.

The following table summarises the main considerations under the three options:

<table>
<tr><th></th><th>Contribution rates adjustments
(Current approach)</th><th>Internal cost sharing</th><th>External insurance</th></tr>
<tr><td rowspan="2">Risk to Fund</td><td colspan="2">No external risk transfer or protection against poor experience.</td><td rowspan="2">Full control of risk but may cost more depending on experience</td></tr>
<tr><td>Strains could lead to failing employers with total deficits ultimately falling to other employers.</td><td>Like external insurance but no risk reduction from being able to pool experience outside the Fund.</td></tr>
<tr><td rowspan="3">Risk / Cost to employers</td><td rowspan="3">Potentially unaffordable strain costs (particularly for small to medium size employers).</td><td colspan="2">Reduces affordability & liquidity concerns</td></tr>
<tr><td>Likely lower but more volatile costs than external insurance due to pooling of experience across Fund only.</td><td>Premium depends on extent of coverage chosen (partial fund to single employer)</td></tr>
<tr><td>Additional costs for actuarial work including valuations, accounting reports and employer work</td><td>Profit share / premium refunds available for good experience.</td></tr>
<tr><td>Cross subsidies</td><td>None – employers left to meet own strain costs</td><td>Cross subsidies between employers due to sharing costs</td><td>Overall fund and wider LGPS experience could impact premium</td></tr>
<tr><td>Administration</td><td>No change to current arrangements</td><td>Additional administration requirements e.g. establishing and monitoring ill-health “reserve”, more governance</td><td>Fund needs to calculate strain costs.</td></tr>
</table>

Next steps

1. Consider preferred approach to manage ill health cost risk
2. If insurance is being considered, conduct procurement exercise for further insurance quotes
3. Conduct employer consultation exercise
4. Report final recommendation to November 2020 Pensions Committee for approval
5. Implement risk management approach
6. Regular review and monitoring of approach going forward

Reliances and limitations

This paper has been commissioned by East Sussex County Council. It intended for 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.

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For and on behalf of Hymans Robertson LLP

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

Appendix A – Whole of Fund experience

Year	No. of IHERs	Strain (£m)	Estimated Strain as % of pay[1]
2012/13[2]	34	2.9	0.76%
2013/14[2]	41	3.6	0.84%
2014/15	23	1.8	0.42%
2015/16	35	3.2	0.72%
2016/17[3]	37	2.9	0.67%
2017/18[3]	32	2.9	0.63%
2018/19[3]	32	2.4	0.52%

[1] Calculated using payroll derived from accounts and contribution data

[2] Figures have been re-based on to 2014 Scheme equivalent costs (i.e. 22% increase due to change in accrual)

[3] Estimated using the Fund's 2019 valuation data