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 an overview of some considerations surrounding the Fund's preferred approach to managing risks of ill health early retirements and the associated additional costs of these, including requested experience analysis based on the data provided. 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

For comparison purposes, a summary of the overall experience across the whole of the fund is set out in Appendix A.

The Fund's present 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 pays 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 via 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 approach

The Fund has been considering its preferred approach to manage ill health risk. As part of this process the Committee has requested further information on employer experience in order to consider different insurance policy options.

Ill health liability insurance

In exchange for a premium, ill health liability insurance involves an external insurer paying a lump sum equal to the fund calculated strain cost in the event of an employer's member retiring on Tier 1 or Tier 2 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 covering around 1,500 employers.

The Administering Authority has considered two possible policy options:

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

The "Choice" option puts the decision on employers but we understand 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. This may apply most to those small and medium sized employers most at risk. The "Partial Fund" approach has been discussed as an option to mitigate this danger by compelling or automatically opting-in employers into using the insurance to manage the risk.

As part of initial discussions, the Fund has suggested the following tiered approach:

- Group 1 will be compelled to have the cover in place.
- Group 2 will be automatically covered unless they opt-out.
- Group 3 will only be covered if they opt-in.

The Fund's suggestion is that (i) "small" employers with less than 50 active members and (ii) employers with weaker covenant should be included in Group 1. Group 2 would include "medium" sized employers and the remaining "large" employers with strong covenants would constitute Group 3.

However, one of the key decisions for the Fund is in determining where to draw the line between medium and large, and therefore, Group 2 and Group 3 employers. There are a variety of ways of doing this such as assigning them by type of body or based upon the number of active members.

We have provided additional information below which may aid the Fund in their decision-making regarding allocation of employers to groups.

Allocating employers to Groups

The table below illustrates how the employers would be allocated if the Fund chose 50 active members as the cut-off for Group 1 and results for both 100 and 200 active members as the cut-off between Groups 2 and 3.

Employer/Pool name	No. of active members (using 2019 valuation membership data)	Group (if using 100 active members as cut-off for Group 2)	Group (if using 200 active members as cut-off for Group 2)
All individual employers and employers in pools where total active membership is less than 50 active members (including Town and Parish Councils) Other “high-risk” employers: Bexhill College Brighton, Hove & Sussex College Group Plumpton College University of Brighton Varndean Sixth Form College	Less than 50, except where employer deemed “high risk”	Group 1 - Compelled	
Cavendish Academy	59	Group 2 - opt-out	Group 2 - opt-out
Eastbourne Academy	60		
Aquinas Trust	61		
Seaford Academy	63		
Glyne Academy	66		
Langney Primary Academy	71		
Hailsham Academy	84		
Torfield and Saxon Mount Academy Trust	94		
The South Downs Learning Trust	143	Group 3 - opt-in	
The Southfield Trust	170		
SABDEN Multi Academy Trust	174		
Aurora Academies Trust Pool	177		
ARK School Hastings Pool	197		
East Sussex Fire & Rescue Service	227		Group 3 - opt-in
Rother District Council	242		
Diocese of Chichester Academy Trust	267		
Hastings Borough Council	310		
Wealden District Council	353		
University of Brighton Academies Trust	520		
Eastbourne Borough Council	738		
Brighton and Hove City Council Pool	7,035		
East Sussex County Council	7,795		

It can be seen from the table above that if you were to group employers simply by size then some academy trusts would be in Group 2 and others in Group 3. The Fund may therefore instead wish to use the above table as a guide but determine the final groupings by also considering the type of body (and their associated risk) to include within each Group. For example, choosing to include only Councils (County, Borough and Districts) and the Fire Service in Group 3, with all academy trusts and other employers with more than 50 active members covered in Group 2. This may result in a more consistent approach for employers with similar overall risk.

It is important to reiterate that the employers in Groups 2 and 3 will have the final say as to whether they wish to be covered, so any decision on groupings will not be finalised until the communication exercise is completed.

It is also worth noting that the Fund is currently undertaking employer covenant analysis to further consider the "high risk" employer group. The results of this work can be used to review which employers might be included in Group 1. In addition, we would suggest that the employers which constitute this "high risk" group is kept under regular review e.g. at least at every formal valuation.

[Note that Royal Pavilion & Museums Trust is not listed in the table above. This is because the employer was not present in the Fund at the valuation date. At their request, the employer is currently going through the quotation process for an individual policy which could be subsumed into the partial fund policy from April. If this employer was to proceed with an individual employer policy, then they should be included in Group 1. If they do not proceed, it may be more appropriate to include them in Group 3. We understand that this employer has c150 active members.]

Ill health exposure level of groups

For ease of comparison, the exposure analysis uses the following three groups:

- A – Group 1 employers;
- B – Group 1 employers plus all employers with less than 100 active members; and
- C – Group 1 employers plus all employers with less than 200 active members.

The tables below summarises individual member exposure stats within each of the groups detailed above. The figures are based upon the estimated strain costs if each of the members was to be awarded Tier 1 ill health early retirement.

Group	Exposure (£000s)		
	Average single member exposure within Group	Median single member exposure	Maximum single member exposure
A	232	175	1,518
B	221	166	1,518
C	207	156	1,518

From the above, the average (mean) exposure, at around £220k, is relatively similar across all groups. These are also comparable with the overall fund average of £218k. However, the average strain cost is impacted more by the larger strain costs for younger and/or higher paid members. The median exposure may be a more appropriate measure, at around £165k.

The maximum exposure relates to a Plumpton College member with estimated exposure of £1.5m. However, this is not an outlier. There are a further 19 members in Group A alone with exposures of over £1m, at employers ranging from WDC – Wealden Leisure to Uckfield Town Council. Further, University of Brighton has 9 members where a strain cost of over £1m could be triggered if any one of these members retired on serious ill health.

The table below illustrates the proportion of active members with ‘large’ strain costs, for different definitions of ‘large’.

Group	Proportion of members with strain costs exceeding…			
	£100k	£200k	£300k	£500k
A	67%	46%	31%	12%
B	65%	44%	28%	10%
C	63%	41%	25%	9%

This table shows that a material proportion of the membership can produce a strain cost that would significantly impact an employer’s funding costs.

Insurance premium rates

Indicative insurance quotes were obtained prior to the September Pension Committee meeting. These quotes included two partial Fund options, along with the employer “choice” option, as set out below:

- “Partial Fund” insurance
    - *All employers excluding Councils and Fire* – 0.9% of pay
    - *All employers with less than 150 active members* - 1.5% of pay
- Employer “Choice” insurance – 1.6% of pay

The rates above are not directly comparable with the approach chosen by the Fund, due to the differing insured groups. However, they can provide an indication of the likely range of the premium rate. E.g. the insured group that is subject to a rate of 0.9% is broadly similar to the group of employers with less than 200 active members (i.e. a possible classification of Groups 1 and 2).

Typically, as you would expect, the smaller the size of the insured group, the larger the variability in ill health strain costs for the group from year to year. A larger insured group tends to reduce the volatility. There is a corresponding impact on the premium rate to cover this uncertainty, with smaller insured groups tending to have higher premium rates (and vice versa), as can be evidenced from the above rates. In addition, with a larger group, the insurer can spread the risk over a larger payroll, which also tends to result in a lower rate. Note that this may not always be the case. For example, if there was a particular large employer with poor experience who opted to be included in the cover, this may result in a slightly higher rate for the insured group compared to the rate if this employer was not included.

Once the decision has been made regarding the approach and the employers' communication exercise is complete, we will request a final quote from Legal & General.

Next steps

1 Consider which employers should be allocated to which groups

2 Conduct employer opt-out/in communication exercise

3 Obtain quotation from insurer based on final employer coverage

4 Implement risk management approach from agreed date (e.g. 1 January 2021)

5 Regular review and monitoring of approach going forward

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] 100 and 300 are applicable in relation to this report and have been complied with where material.

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October 2020

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