BARNETT WADDINGHAM
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Briefing

Managing ill-health risk

RISK | PENSIONS | INVESTMENT | INSURANCE

Most Local Government Pension Scheme (LGPS) benefits build up gradually during each member's employment. However there are some protection benefits, such as ill-health retirement, which will give rise to an immediate strain cost and funding deficit when they occur, unless some advance funding has been made to meet an estimate of these costs.

Most LGPS Funds will make some provision for these costs by making an assumption about the incidence of such retirements in the future and reflecting this expected cost in their contribution rates. Of course, there is no guarantee that the amount set aside equals the actual cost and any excess cost would need additional funding.

These events are relatively rare, (although there were over 4,000 ill-health retirements from the LGPS last year). However, for small or medium sized employers, any excess cost can be very expensive when compared to payroll or even an employer's Fund assets. For example, an employer had to pay over £750,000 for a claim recently. Employers may be required to pay any additional costs in full immediately when such an event occurs. Even if the additional cost is spread over a period of time this can mean a significant increase on employers' contributions.

> It is therefore very important for Funds to have a policy in place to deal with this risk and to avoid employer challenge or default. We would recommend you have a strategy in place ahead of the 2019 valuation.

There a number of ways to manage ill-health retirement risk. In this note we consider four different approaches that are all used to various extents in the LGPS.

Full risk for the employer

This is currently the most common approach. Included in each employer's contributions is a small amount towards the cost of these risk benefits based on the expected cost each year. Over the long term and for a large employer, this should broadly average against the benefits paid to the members affected by these events.

However, for smaller employers, there is little benefit from this averaging – it's like putting aside £1,000 a year in case your house burns down. That's unlikely but, if it does happen, you're not going to have enough to rebuild your house. Essentially, an employer might be funding to cover 0.01 ill-health retirements but the actual number will either be 0 or 1 (or, in fact, higher).

There is therefore a risk of considerable volatility in both the funding level and employer contributions, and unaffordable costs for small and medium employers.

The volatility for larger employers is reduced, but even for larger employers such as Borough and District Councils, this could still have a material increase on the contribution rate. Given the financial pressures that exist, this would not be good news.

There is also an important accounting point to make. If the strain cost is not paid immediately this will have an impact on the accounting balance sheet as the liabilities will have increased but the assets have remained the same, all else being equal.

Conventional pooling

The traditional approach to minimising these risks would be to pool small employers so that their experience is shared and they can benefit from the averaging that helps larger employers.

Pooling in this way is a fairly simple approach which reduces these risks for individual employers but also has some disadvantages. This form of pooling means that all pension risks and costs are shared and so there is potential for considerable cross-subsidy amongst the pooled employers. This may be appropriate for some elements of experience but not for others that are within the control of each employer; for example, salary increases which might be different for employers in different sectors.

External insurer

Another option that some Funds have taken is to insure the ill-health risk benefit with an insurance company. This mitigates the risk to the employer as they pay a premium to the insurer and in return the insurer will pay the strain cost resulting from an ill-health retirement. This is essentially pooling of just one risk – ill-health retirement – but then insuring this risk.

However, like any insurance product, there will of course be a loading for expenses and profit by the insurance provider. Although some Funds have taken out a whole of Fund policy this may not be appropriate for large councils who can more cost-effectively self-insure, which is described below. However, external insurance could be considered beneficial for groups of employers. For example:

1. where a large proportion of the payroll is attributed to a small number of large employers (e.g. a London Borough Fund), insuring all employers except the council; or
2. where there is a larger number of smaller/medium sized employers (e.g. a County Council or Metropolitan Fund).

Policies can be set-up for the whole Fund, a group of employers (e.g. academies only) or offered as an employer choice. The premium will vary depending on what type of policy is chosen, the type and number of employers and the past experience of the Fund.

The Fund will also need to consider the communication of any policy to employers and any administrative changes required to pay premiums to the insurer. It will also need to record any claims paid to employers on the ledger, as this will have a direct impact on the employer's asset allocation.

There are a number of advantages for an employer of ill-health insurance, namely:

- Cost neutral option – the premium paid for insurance could be deducted from the employer contribution rate so the rate remains unchanged. Note that in this case less money will be going into the Fund
- Removes the risk of the employer failing as a result of unaffordable strain costs arising from either one, or a string of, ill-health retirement
- Helps stabilise contribution rates and the balance sheet by helping to protect against deficit increases and large contribution increases
- Insurers may include employee assistance programs which assists employees back to work, where possible

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Self-insurance

"Self-insurance" can be used to target specific risks, particularly those that employers have no control over, so that experience is averaged across the Fund as a whole, or across a group of employers. This is actually very similar to the Fund acting as a mutual insurer for these risks.

This approach:

- uses the overall size of the Fund or group of employers to reduce the risk, particularly for small employers;
- gives the same expected contribution rates as currently but with less volatility;
- is a more targeted approach than conventional pooling; and
- does not involve external insurers or the need to put in place policy documents; it can all be achieved through the Funding Strategy Statement.

If the total cost of risk benefits for the Fund over a valuation cycle is different to the contributions paid for these, this would be rebated or charged to the appropriate employers at the next valuation; i.e. the overall experience on these benefits is shared across all, or a group of, employers.

Death in service and ill-health retirement benefits can both be covered or only one can be covered through this approach, depending on the administering authority's preference.

The benefits of external insurance noted above can be achieved using self-insurance (except the employee assistance program). So this may be the preferred option, given the Fund will not be paying part of the employer contribution outside of the Fund and will not be paying insurer expenses and profit loadings. However, it is worth noting that the self-insurance approach does not mitigate against adverse whole Fund experience, whereas external insurance does.

There are other policy and funding decisions that will be required. For example, what should the initial "premium" be and should this be the same for all employers? What happens to any premiums paid if an employer leaves the Fund? How should the money be invested?

In addition, the Funding Strategy Statement will need to be updated and the approach communicated to employers. Any cashflows will need to be recorded against employers' "premiums" and "claims" but this should be straightforward.

The advantages of self-insurance are:

- The "premiums" are just the expected cost of the risk benefits that employers are already paying; i.e. employers pay exactly the same total contribution rate as currently
- Targeting these risk benefits and using the overall size of the Fund to reduce volatility could provide a more stable contribution rate but maintain each employer's responsibility for other risks (e.g. salary increase risk)
- The administration should be more straightforward than with external insurance
- Removes the risk of the employer failing as a result of an unaffordable strain cost arising from an ill-health retirement
- Carrying out the additional calculations at actuarial valuations means that they can be done efficiently as part of the overall process

Next steps

The key recommendation is to have a policy in place to reduce the risk to the Fund of costly ill-health retirement strain costs, particularly for small and medium employers. The 2019 valuation is a good opportunity to put your policy in place. If you would like to discuss this further please get in touch with your usual Barnett Waddingham contact.

Please contact your Barnett Waddingham consultant if you would like to discuss any of the above topics in more detail. Alternatively get in touch via the following:

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