Ill-health early retirement risks: mitigation options

Introduction

Following a change in benefits from 1 April 2008, ill-health early retirements are a greater financial risk to employers participating in the Local Government Pension Scheme. In times of economic uncertainty and increasing upward pressure on contribution rates, risk-management is increasing in importance. The cost resulting from ill-health early retirement is one such risk. We understand that the Surrey Pension Fund ("the Fund") is considering taking steps to manage this risk. 6

Scope

This document has been commissioned by Surrey County Council in its capacity as Administering Authority to the Surrey Pension Fund ("the Fund"). It has been prepared by Hymans Robertson LLP in our capacity as actuaries to the Fund, in order to provide the Administering Authority with options to consider for protecting the Fund and its employers against the adverse effects of poor ill-health early retirement experience.

This purpose of this document is to set out the options available to the Fund to manage the ill-health early retirement risk and the advantages and disadvantages of each option. The document is not intended to provide advice of which option is most appropriate for the Fund and therefore does not offer any recommendations. It is for the Administering Authority to decide which option is most advantageous for the Fund, having taken appropriate advice if necessary.

We consider three options for managing ill-health early retirement risk:

- Purchase of an ill-health insurance policy
- Self-insurance
- Pooling of ill-health insurance risk

We have set out the options available along with the advantages, disadvantages and questions to consider for each option. **We are unable to express an opinion about the best option for the Fund.**

Background

Ill-health insurance was developed by Legal and General to help manage and mitigate a recognised risk to LGPS funds. Principally, it was aimed at small to medium sized employers to minimise the risk of a costly ill-health retirement materially impacting on the assets of the employer.

However, even at whole level, the Fund's ill-health experience is volatile. Between 2009 and 2012 the total strain payment required has increased from 0.3% of payroll to approximately 0.8% of payroll. The volatility of total ill-health retirement strains results from changes in the actual strain cost based on the type of ill-health retirement awarded, and the age and salary of the member and not the number of ill-health retirements awarded. In fact, these have remained relatively constant over the period. As evidence of how costly ill-health retirements can be, the largest strain cost for an ill-health retiree in 2011/12 was £373,000, based on the information supplied to us.

Monitoring of ill-health early retirements

The Fund does not currently monitor the level of ill-health early retirements against the budget allowed for these in the contribution rates calculated at the most recent formal valuation. Options 1 and 2 below both require ill-health retirements to be monitored and a strain cost calculated in respect of each case. As you are aware, as part of the public sector pensions reform, Lord Hutton recommended that the bar should be raised on governance for public sector pension schemes. To meet increasing governance standards, we would suggest that this is carried out in the future, irrespective of any decisions in respect of an insurance option.

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Option 1: Purchase of an ill-health insurance policy

The Fund has the option to purchase a policy from Legal and General at a cost of 0.87% of the Fund's payroll (or 0.85% with no profit share agreement). The policy would provide a payment to the Fund, equal to the strain amount which would be invoiced to the employer under the ill-health monitoring arrangements described above. Legal and General have offered a profit-share agreement allowing the Fund to benefit when claims experience is less than expected by Legal and General.

Benefits of purchasing an ill-health insurance policy

- Insurance allows proper risk management. The other approaches do not.
- Risk of higher than expected ill-health early retirements is completely removed
- All employers are protected and benefit from a lower premium cost when a policy is purchased at whole fund level
- Helps stability of contribution rate for employers
- Ancillary benefits from the policy, e.g. access to an employee assistance service from Legal and General
- Access to profit-share agreement for whole of fund policy
- Paternal approach by the Fund to protect its employers

Risks of purchasing an ill-health insurance policy

- Legal and General may not meet all ill-health claims (although this would be a reputational risk for Legal and General)
- The Fund has less ill-health early retirements than expected. Under the profit-share agreement some of this positive experience will be returned to the Fund.
- Money paid to buy the premium is not invested in the Fund until it is returned through claim payments (the total premium is approximately equivalent to receiving an extra 0.2% in investment returns on the Fund's assets, with no allowance for any claim payments or profit share refunds being received by the Fund). Assuming claims experience is close to that assumed there would be very little or no impact.

Option 2: Self insurance

The Fund could opt to charge all employers in the Fund a "premium" which would be notionally identified within the Fund's assets. On award of an ill-health early retirement, the Fund would credit the strain payment (which would otherwise have been invoiced) to an individual employer from the notional subfund.

Benefits of self-insurance

- No potential dispute over claim payment
- Fund benefits directly from positive experience
- Reduces volatility and helps stability of contribution rate

Risks of self-insurance

- No transfer of risk therefore no reduction in the risk the Fund is exposed to.
- Fund requirement to calculate premium annually (allowing for newly available experience information). Risk that this is insufficient to meet total ill-health strains. What happens if the ill-health sub fund is insufficient? How would the premium be calculated?
- Risk remains with the Fund and its employers that expected ill-health retirements are higher than expected (this is the primary risk you are trying to avoid). May need to hold a higher "notional premium" than the L&G rate to reduce the possibility of this.

- Potentially complex administration to notionally separate assets and credit strain costs to the appropriate employer.
- Potential for moral hazard by employers since Fund will meet ill-health strain costs.

Option 3: Pooling of ill-health risks

The Fund has the option of spreading the cost of all ill-health early retirements across all employers in the Fund. This would in effect work as a pooling of ill-health costs.

Benefits of pooling

- Reduced volatility possible for employers with poor experience and so more stable contribution rates
- No administration required by the Administering Authority

Risks of pooling

- No requirement to calculate a strain cost resulting in less visibility of the impact of employer experience and no attribution of strain costs to employers.
- Would this approach meet the required standards of governance? All employers would need to agree to sharing of ill-health costs as there would be an (potentially large) element of cross-subsidy
- How would the ill-health costs be shared across employers? Possible options include as a proportion of active liability or a proportion of payroll.
- If the Fund consider unitisation of assets at a later date this option would not be feasible.

Comparison of Option 2 and Option 3

There is little difference at a Fund level between Options 2 and Option 3 since there is no transfer of risk under a self-insurance option.

Option 2 would be administratively complex but allows for transparency of cost and limits cross-subsidy. An employer would be credited with assets equal to the ill-health strain cost calculated based on Axise factors although there is a risk that the amount held in the subfund to meet ill-health costs is insufficient.

Pooling of ill-health risks would result in a simple process for the Fund, but lacks transparency. Due to the method of calculating assets at a formal valuation, each employer would be allocated assets equal to the increased liability resulting from an ill-health early retirement with no specific profit or loss allocated to them depending on their own experience. This would buck the trend of trying to move away from pools and cross subsidy within the Fund.

Summary

The above sets out options for the management of ill-health early retirement risk. I understand that the Fund have considered unitisation of Fund assets which should be borne in mind when considering any decisions. Whilst we cannot advise on the best option for the Fund, we suggest that any decisions meet the governance requirements of the Fund, consider how the chosen option would fit in with any future developments and objectives the Fund has and consider the interests of all of the Fund's employers.

We would be happy to discuss the contents of this paper further.

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For and on behalf of Hymans Robertson LLP

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