SURREY COUNTY COUNCIL

PENSION FUND BOARD

DATE: **15 NOVEMBER 2013**

LEAD OFFICER: **SHEILA LITTLE, CHIEF FINANCE OFFICER**

SUBJECT: **ILL HEALTH RETIREMENT INSURANCE**

SUMMARY OF ISSUE:

When a scheme member is retired early due to permanent ill health, the member's accrued pension benefits are paid immediately without reduction and, in the majority of cases, with an enhancement to benefits.

The cost of providing an ill health pension can be substantial and therefore a significant financial risk to fund employers. Legal and General have developed an insurance product to insure against this risk which can be taken out by individual employers or on a whole fund basis. This report seeks approval from the Pension Fund Board to insure against the financial risk of ill health retirements on a whole fund basis.

RECOMMENDATIONS:

It is recommended that:

1. The Pension Fund Board approve the purchase of an annual insurance policy with Legal & General to insure the fund against the cost of ill health retirements, subject to the County Council's Head of Procurement confirming that it is not necessary to formally tender for an insurance provider.

REASON FOR RECOMMENDATIONS:

The costs associated with ill health retirement (IHR) can be substantial and can have serious financial implications for individual employers and potentially for the fund. Insuring against ill health retirement costs will help to manage this risk. The new LGPS coming into effect from April 2014 will increase the pension accrual from a 1/60th to a 1/49th. This will mean that the individual cost of ill health retirements will also therefore increase. Moreover, Legal & General have recently significantly reduced their premium rates from 0.85% to 0.63%. Therefore, it now appears to be an appropriate to time to consider insuring against ill health retirement costs.

Purchasing a policy on a whole fund basis rather than each employer taking out a policy on an individual basis is considered preferable as it will result in lower premiums and easier administration.
The administering authority is also best placed to understand the risks faced by its individual fund employers. Many of the smaller fund employers are likely to have a limited understanding of pension risk. Insuring on a whole fund basis demonstrates a paternal approach to employers by assisting them to reduce the risk of being liable for ill health retirement costs which they may be unable to meet and which could, ultimately, fall on other employers in the fund to meet.

DETAILS:

Background

1 To qualify for IHR benefits, the Local Government Pension Scheme Regulations require that an employer's independent registered medical practitioner (IRMP) certifies that a scheme member is permanently incapable of discharging efficiently the duties of his/her current employment and has a reduced likelihood of undertaking any gainful employment before reaching normal retirement age (NRA), which is currently age 65. If this criterion is satisfied, the member's accrued pension benefits are paid immediately. The duration of payment and level of enhancement depends on the severity of the member's medical condition as follows:

2. **Tier 1**
If the IRMP certifies that the member has no reasonable prospect of being capable of undertaking any gainful employment before his/her NRA, the pension is paid for life and enhanced by adding to the member's existing membership the period between the date of leaving employment and NRA.

Tier 2
If the IRMP certifies that, although the member is not capable of undertaking gainful employment within three years of leaving employment, it is likely that the member will be capable of undertaking any gainful employment before normal retirement age, the pension is paid for life and enhanced by adding to the member's existing membership 25% of the period between the date of leaving employment and NRA.

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Tier 3
If the IRMP certifies that it is likely that the member will be capable of undertaking gainful employment within three years of leaving employment, the pension is not enhanced and only paid for up to three years or, if earlier, until the member obtains gainful employment or reaches NRA.

3. The experience of the fund over the past five years, as indicated in the following table, is that there are far more Tier 1 ill health retirements than tier 2 or tier 3.

	13/14*	**12/13**	**11/12**	**10/11**	**09/10**	**08/09**
Tier 1	16	24	35	25	31	23
Tier 2	2	1	4	7	8	11
Tier 3	5	6	4	3	3	5

* Half year results to 30 September

4. Analysis of pension fund data reveals that in individual cases of Tier 1 ill health retirements, costs could be as high as £600,000 amongst some of the fund's admitted bodies, £800,000 amongst academies and up to a £1,000,000 in the case of the county council. These cases are exceptions rather than the rule, but it does highlight the potential risks that one single ill health retirement could bring to an employer. Although the average cost of an ill health retirement across the fund is £89,000, it still represents a substantial increase to any employer's pension liabilities, particularly so for the smaller employers.

The Insurance Policy

5. The insurance policy offered by Legal & General is renewable annually. It has been developed in partnership with Hymans Robertson, the fund's actuary. Hymans will deal with some of the administration associated with managing the policy and will also receive a commission from Legal & General of 5% of the premiums paid. The standard intermediary commission is 10%.

6. The policy is renewable annually and can be used to insure the whole fund or alternatively for individual employers to take out a policy directly with Legal & General. The premium rates are lower if a policy is taken out for the whole fund rather than by individual employers.

7. Hymans conducted a procurement exercise and were satisfied that Legal & General was the only provider of this type of insurance product. Hymans have provided a due diligence report detailing the reasons that they chose Legal & General, which is attached as Annex 1. The rules governing procurement are complex for local authorities and, whilst we are satisfied that Hymans and Legal & General are best placed to provide this arrangement, before contractually committing the county council, advice will be obtained from the Head of Procurement.

8. There are currently two other county council funds that have purchased whole fund insurance and 272 employers from ten other funds that have purchased individual policies with Legal & General. 11

9. The policy will provide for reimbursement of the total cost of all tier 1 and tier 2 ill health retirements. This will consist of the cost of paying the accrued benefits earlier than anticipated and the cost of enhancing the members' period of scheme membership as explained in paragraph 2 above. The policy will not cover tier 3 IHR as the cost for these retirements is not considered financially material as they are only paid for a maximum of three years and do not receive any enhancement of benefits.

10. If the policy is purchased on a whole fund basis, then the policy will reimburse the fund directly. If individual employers were to purchase the policy, then each employer will be reimbursed and the fund will then invoice the employer for the IHR cost.

11. The policy also incorporates an Employee Assistance Program (EAP) which is a facility currently already provided by many employers. As this facility is provided free of charge as part of the insurance policy, employers who currently pay for an EAP may be able to save money by using the Legal & General scheme. Also, some employers who were unable to provide such a facility to their employees previously, because they could not afford to do so, will now be able to if they wish.

12. Although an EAP is provided in the policy irrespective of whether the policy is taken out on a whole fund basis or by employers individually, the EAP in the whole fund policy provides more benefits.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

13. The premium payable to Legal & General if the policy was taken out on a whole fund basis would be 0.63% of the pensionable payroll of all the employers contributing to the fund. Based on the pensionable payroll of the whole fund in 2012/2013 of £489m, the resulting premium would have been £3.08m.

14. The following table provides a comparison over the last five years of what premiums would have been paid had the policy been in place compared with the pension strain costs that have actually been incurred.

Financial Year Ending	Total Payroll	Annual Premium @ 0.63%	Total Tier 1 and 2 strain	Strain & Premium Difference	Equivalent premium rate
31/03/2013	£489 m	£3.08 m	£2.30 m	-£0.78 m	0.47%
31/03/2012	£465 m	£2.93 m	£3.79 m	+£0.86 m	0.82%
31/03/2011	£460 m	£2.90 m	£2.98 m	+£0.08 m	0.65%
31/03/2010	£495 m	£3.12 m	£1.38 m	-£1.74 m	0.28%
31/03/2009	£468 m	£2.95 m	£1.72 m	-£1.23 m	0.37%
Total	£2,377 m	£14.98 m	£12.17 m	-£2.81 m	0.51%

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15. Although the premium of 0.63% takes account of the increase in pension accrual from 1/60th to 1/49th from April 2014, the actual pension strain costs quoted in the table do not take account of this increase.

16. If the policy was not taken out on a whole fund basis, but instead employers took out the policy individually, the premiums would be higher at 0.85% of pensionable payroll.

17. Purchasing a policy for the whole fund will not only result in lower premium rates but will also reduce the complexity and cost of administering the policy as Legal & General will only be dealing with one single policy holder rather than potentially up to 133 individual fund employers with separate policies.

18. Fund employers will incur no additional cost if the insurance policy is purchased. The 0.63% premium will be taken from each employer's normal employer pension contribution. This therefore means that slightly less of each employer's pension contribution will be invested. The fund actuary has advised that the resulted reduction in annual investment return would be approximately 0.15%, which will not have a material effect on funding positions.

CONSULTATION:

17 The Chairman of the Pension Fund Board has been consulted on this report.

RISK MANAGEMENT AND IMPLICATIONS:

18 The purpose of purchasing the insurance policy is to reduce the risk that employers may have to pay substantial pension costs as a result of their employees being retired on health grounds.

19 The cost of the insurance premium will be met from the employer's pension contribution which otherwise would have been used to earn an investment return. The relatively small loss of investment return is not considered material when weighed against the benefits of having the insurance cover in place.

SECTION 151 OFFICER COMMENTARY

20 The Section 151 Officer (Chief Finance Officer) is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed and that insuring against ill health retirement costs will help manage and mitigate against the risk materially affecting the assets of fund employers.

LEGAL IMPLICATIONS – MONITORING OFFICER

21 The Head of Procurement will provide advice as to whether or not the County Council can purchase the insurance policy with Legal & General without breaching procurement regulations.

EQUALITIES AND DIVERSITY

22 Taking out an insurance policy to meet the cost of ill health retirements will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONNS

23 There are no potential implications for council priorities and policy areas.

WHAT HAPPENS NEXT:

24 The following next steps are planned:

- Obtain confirmation from the Head of Procurement that the council would not breach any procurement regulations by taking out the insurance policy with Legal & General.
- Liaise with Legal & General and Hymans to agree an implementation date and confirm administrative process.
- Send a briefing note to all employers.
- Review annually in the light of ill health retirement experience and premium rates offered on renewal.

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Consulted:
Pension Fund Board Chairman

Annexes:
Annex 1: Hyman's Due Diligence Report

Sources/background papers:
None

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