Ill health early retirement costs: risk mitigation using insurance

Purpose

This paper has been requested by and is addressed to London Borough of Haringey Council as the Administering Authority to London Borough of Haringey Council Pension Fund ("the Fund"). It is intended to provide a general overview of some issues and considerations surrounding ill health retirement insurance for Funds in the Local Government Pension Scheme ("LGPS"). This paper is not intended to provide advice and should not be read as such.

Background on Ill Health Early Retirements ("IHERs")

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; and
- an increase in the benefits payable to the member through augmentation awarded on ill-health retirement (either based on full prospective service for a Tier 1 early retirement or 25% of prospective service for a Tier 2 early retirement).

Examples of sample member potential strain costs are given below. These represent an immediate increase to the liabilities (and hence deficit) of an employer.

Member age	Salary	Tier 1 strain cost
46	£32,000	£375,000
31	£26,000	£350,000
48	£67,000	£575,000
43	£110,000	£1,600,000

At present the Fund's approach is that employers effectively self-insure against IHERs via an element of their contribution rate. For example, in the London Borough of Haringey Council Pool, employers pay around 3.0% of pensionable payroll p.a. towards IHERs but this amount varies from employer to employer depending on membership profile. When a member of an employer retires due to ill health the strain cost is added to the employer's deficit at the next valuation and subsequently recovered via increased contributions. This arrangement works for larger employers (e.g. the Council) but not for 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 the increased deficit and contributions could put a Fund employer out of business.

What is ill health liability insurance (IHLI)?

In 2008 Hymans Robertson was approached by an LGPS client raising their concerns about the ill health cost risks employers face. It was clear that insurance might be a good solution but there was no insurance product covering the benefits payable in the LGPS. Hymans Robertson's Group Risk team searched the market and chose Legal and General as partner to develop what was, and remains, the only insurance solution specifically designed for LGPS ill-health early retirement benefits.

The IHLI policy provided by Legal and General pays a one-off lump sum to insured employers or Funds in the event that an employee is awarded IHER (Tier 1 or Tier 2 only). This payment is equal to the strain cost as calculated by the Fund using standard factors. It provides an immediate increase to an employer's assets to offset the increase in liability. (Note that this sum may eventually prove to be more or less than the actual additional cost: IHLI covers the immediate strain cost calculated at the time of the IHER, as opposed to insuring the ill-health pension payments for the future.)

The insurance premium can be paid from the assets of the Fund. Each employer covered by insurance will have its share of the premium deducted from its own assets (the share would be in proportion to the employer's LGPS pensionable payroll).

In the event of an IHER, a short form is provided to Legal and General to make a claim (further details below). Upon accepting a valid claim, Legal and General will then pay the strain cost to the Fund or employer. This will be attributed to the assets of the affected employer as an additional lump sum contribution.

Summary of benefits of purchasing an ill-health insurance policy

- Protects employers from large and volatile costs.
- Helps stability of employer contribution rates and balance sheets.
- Additional benefits from the policy include access to Legal & General's 24h Employee Assistance Programme as part of cover.

Ill Health Liability Insurance – policy options

The Fund officers are considering the below policy options for the Fund:

Whole Fund policy – all employers in the Fund would be covered by this policy

Partial Fund policy – all employers except London Borough of Haringey Council ("the Council") would be covered by this policy

Employer choice policies – each employer that decides to insure would have their own individual policy

Further details on the options are set out below.

1. Whole Fund policy

What is it?

This is an approach to managing the ill health risk as part of funding strategy whereby the Administering Authority maintains an ill health liability insurance policy on behalf of all of the employers.

Premium rate

The Whole Fund policy rate would be £0.88 per £100 of employer's salary roll. This quotation was issued on the 16th June 2016 by Legal and General and is valid until 16th September 2016. For full details of the terms and conditions relating to this quote, please contact the Fund Officers.

Whole Fund policy advantages

- This Fund policy is available at a lower premium rate compared to employer choice and partial fund polices. This is due to the certainty of the employers which will be insured and the likely larger number of employees (volume) being covered.
- As the insurance covers all employers in the fund, the insurer can be more confident that it is not only employers with a high likelihood of larger or multiple claims that are covered. This again allows for a lower premium.

- The employers do not have to make their own payment arrangement as with individual employer choice polices.
- Claim payments would be paid directly to the Fund, not the employer.

Whole Fund policy challenges

- Larger employers with available cashflow and low ill health retirement experience may not appreciate this as a benefit as they may be able to effectively self-insure.

2. Partial Fund policy

What is it?

In line with option 1, this approach again manages the ill health risk as part of funding strategy whereby the Administering Authority maintains an ill health liability insurance policy on behalf of all of the employers except for the Council.

Premium rate

The Partial Fund policy rate would be £0.95 per £100 of employer's salary roll. This quotation was issued on the 16th June 2016 by Legal and General and is valid until 16th September 2016. For full details of the terms and conditions relating to this quote, please contact the Fund Officers.

Partial Fund policy advantages

- This Fund policy is available at a lower premium rate compared to employer choice but the rate is slightly higher than that for the Whole Fund. The reason for this is that the volume of employees being covered is still large but less so than the whole fund option;
- Like the Whole Fund policy, a lower premium is available (compared to employer choice) due to the certainty of the employers being covered.
- The policy will cover all employers except for the Council, ensuring they are safeguarded from the risks that ill health retirement pose.
- The employers do not have to make their own payment arrangement as with individual employer choice polices.
- Claim payments would be paid directly to the Fund, not the employer.

Partial Fund policy challenges

- If the Council has adverse IHER experience, this may result in volatile cashflows and less cashflow may be available to be used by the Council elsewhere (i.e. there is an opportunity cost).
- The premium rate is more expensive than at Whole Fund because less members are covered.

3. Employer choice policies

What is it?

Under this approach, individual employers are given the option to take out their own insurance policy with Legal and General.

This would result in multiple policies across the Fund.

How does it work?

Process to set-up multiple employer choice policies

A communication exercise would be carried out to request a decision from each employer on whether they wish to set up their own insurance policy. This would typically take the form of an email sent by the Administering Authority with all responses monitored by and queries directed to Hymans' IHLI team to ensure no additional workload for Officers.

Any employers who opt to take out the insurance would do so independently of the Fund. Insured employers will submit membership data (names, dates of birth, gender, salary) in order for Legal and General to calculate the premium due on an individual employer basis.

For the avoidance of doubt the same premium would be payable for all employers in the Fund.

Employer choice claims process

- Claims are the responsibility of the individual employers e.g. they submit their own claims. The forms required to submit a claim are the same as under the Fund policy.
- Once assessed as valid, L&G will pay the claim amount directly to the insured employer, not the Fund.

Premium rate

The Employer Choice policy rate would be £1.28 per £100 of employer's salary roll. This quotation was issued on the 16th June 2016 by Legal and General and is valid until 16th September 2016. For full details of the terms and conditions relating to this quote, please contact the Fund Officers.

Employer choice policy advantages

- Reduces the risk of small employers experiencing cashflow problems or going out of business if they have any IHERs as the strain cost will be covered by the insurance.

Employer choice policy challenges

- The insurance premium rate is higher under this approach than the Fund policy approach. This is due to the expected smaller insured group, the uncertainty surrounding which employers will opt to take up the cover, and the risk of anti-selection (where employers may be keen to take insurance if they know if their employees are more likely to go off on ill-health).
- The employer would not be obliged to pay the claim amount across to the Fund.
- A number of Funds have opted to take this approach but have found it difficult to get engagement with the smaller employer when these are often most at risk. If one of these employer was to go out of business as a result of an ill health retirement then the debt could fall back to the other fund employers.

How the Ill Health Liability Insurance premium affects the contribution rate

There are three approaches the Administering Authority may wish to take with regards to how the insurance premium is charged to employers.

A. Do not make any allowance for the IHLI premiums being deducted from the employer contribution rate (premiums would be charged on top of the employer contribution rate)

B. Partially allow for the IHLI premium in the contribution rate

C. Fully allow for the premium in the contribution rate (i.e. the full amount would be deducted from the employers contribution rate)

An illustration of the three options for an employer who normally pays contributions of £1m and whose IHLI premium would be £50,000 is shown below:

	Fund receives	IHLI Premium	Total paid by employer
Option A	£1,000,000	£50,000	£1,050,000
Option B	£975,000	£50,000	£1,025,000
Option C	£950,000	£50,000	£1,000,000

Under option A, if the premium were to be charged in addition to current employer contribution rates, then the employers may not find this an attractive option as they are having to pay extra for something they may not feel they require (especially if the claims experience is low).

Under option B, a decision could be made as to how much you wish to partially allow for the IHLI premiums in employer contribution rates. This would be more attractive than option A as the current contribution rate for employers would not increase as much.

Under option C, the premium amount would be offset from the current contribution rate payable (which already includes a margin to reserve for ill health strains). This would be an attractive option for employers as they see no additional cash cost as their combined payment (Pension Fund contribution plus IHLI premium) will remain unchanged.

However, as the cash contributions being paid into the Fund are used to offset deficits, if the premium amount is being offset from the current contribution rate (either partially or fully, options B or C), then:

- there will be less money being paid towards the employer's deficit if there are no or fewer IHLI claims than expected – the money will have been paid for insurance which is not fully claimed on;
- there will be around the same, or more, money being used to pay off deficits if the employer's claims experience in the Fund is reasonable (and IHLI strains are being paid into the Fund). This is because the claim payments are likely to exceed the IHLI premium in such cases.

In practice, for options 1 and 2 (Whole Fund and Partial Fund), it is more common for Funds to pay the premium as an administration expense which is then recouped from the employers at each valuation (i.e. in effect option C) rather than explicitly allow for the premium payments in employer contribution rates (contribution allowance options A and B).

As with any insurance, for a given employer it may prove to be more or less costly depending on its IHLI experience: in turn, this may mean more or less money going to pay off its deficit, compared with the non-insured alternative. However it is worth noting that:

- The differences are likely to be small (the IHLI premium is c.1% of pay, compared to typical employer contribution rates in the Fund of c.25%)
- Whilst some employers will pay more and some pay less towards their deficits, depending on their IHLI experience, the overall Fund experience is likely to even out on average.

Effect on cashflow

Based on the draft 2016 London Borough of Haringey Pension Fund accounts, the net cashflow position (excluding transfers in and out of the Fund) is -£1m., i.e. benefit outgo exceeds contribution income by c. £1m p.a. currently.

The table below illustrates the effect on the net cashflow position of the Fund under each IHLI and contribution rate allowance options.

<table>
<tr><th colspan="2" rowspan="2"></th><th colspan="3">Ill Health Liability Insurance Policy Option</th></tr>
<tr><th>Option 1</th><th>Option 2</th><th>Option 3</th></tr>
<tr><th colspan="2">Ill health liability insurance salary roll</th><td>£140m</td><td>£40m</td><td>£10m</td></tr>
<tr><td rowspan="3">Contribution rate allowance option</td><td>Option A</td><td>nil</td><td>nil</td><td>nil</td></tr>
<tr><td>Option B</td><td>-£0.60m</td><td>-£0.20m</td><td>-£0.06m</td></tr>
<tr><td>Option C</td><td>-£1.20m</td><td>-£0.40m</td><td>-£0.13m</td></tr>
</table>

The above table illustrates the potential changes in cashflow under each IHLI option. It is important to note that this excludes the potential claim payments that would be made by Legal and General if there were any ill health retirements. Were the Fund to have an IHLI policy and any claims were made, claim payments would be paid immediately so there would be an immediate positive cashflow into the Fund. This differs from the current process where the ill health strain may be paid over a significant number of years.

These results above have been calculated to give an approximate indication of the possible net cashflow of the Fund under each IHLI policy and contribution rate allowance option. The figures have been calculated based on the following assumptions:

- Payroll has been estimated from the employee contributions in the 2016 draft accounts, assuming the average employee contribution rate is 6.6%;
- The non-Council employers make up 30% of the whole Fund;
- The take-up of the employer choice option has been assumed to be 25% of the non-Council employers.
- No allowance has been made for the claim payments they Fund may receive from Legal and General if they were to experience any ill health retirements.

Practicalities

Claims process

- A short claim form is required to submit a claim. This has a section for both the employer and employee to complete confirming that ill health retirement has taken place.
- A separate note is provided from the Administering Authority regarding the strain cost amount.
- Once assessed as valid, L&G will pay the claim amount directly to the Fund.

Additional information

- The above processes can be tailored to fit the Administering Authority's existing administration processes.
- Unless advised otherwise, all policies automatically renew annually on 1 April - although polices can be cancelled at any time (14 day notice period required).

Committee decision

The Committee is asked to consider the preferred approach to ill health liability insurance on behalf of employers.

1. Set up a Whole Fund ill health insurance policy
2. Set up a Partial Fund ill health insurance policy which covers all employers except for the Council
3. Ask employers to make their own arrangement to insure ill health retirement risk via an individual employer policy that covers their own employees.

It is also asked to consider which option to adopt for allowing for IHLI premiums in employers contributions,

A. No allowance

B. Partial allowance

C. Full allowance

Douglas Green

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For and on behalf of Hymans Robertson LLP