

Briefing

Managing the costs of risk benefits in the LGPS

RISK | PENSIONS | INVESTMENT | INSURANCE



Most LGPS benefits build up gradually during each member's employment and are funded for by regular monthly contributions. There are, however, some exceptions to this – namely ill-health retirement and death in service benefits – which can often result in additional (and sometimes immediate) payments being required from employers at inopportune times.

What are the options to consider when helping employers manage the cost and funding of risk benefits?

This note sets out some possible options that may be considered by a fund to help employers manage the cost and funding of these risk benefits. The decision of which option is used in managing these risks falls to a fund.

Most LGPS funds will make some provision for these benefits by making an assumption about the incidence of such cases and reflecting this expected cost in the normal contribution rates. However, there is no guarantee that the amount set aside equals the actual cost, and any excess would need additional funding. This means that when these events occur they are likely to lead to large additional contributions being required from employers.

Over the long term and for a large employer, the margin included in the contribution rate 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 is like putting aside £1,000 a year in case your house burns down. That is unlikely but, if it does happen, that £1,000 a year is not going to be enough to rebuild your house.

Fortunately, these events are relatively rare. However, for small or medium-sized employers, there is a risk of considerable volatility in both the funding level and employer contributions; and the additional cost can be very significant if they do occur, even when spread over a period of time. This could lead to an employer challenging any increase in contributions due or, in extreme circumstances, could lead to employer default.

Although the risks cannot be completely removed, having a policy in place can mitigate them. It is therefore important to have a policy in place to deal with these risks and we would recommend LGPS funds consider the various options ahead of the 2022 valuation.

Options for LGPS funds

There are a number of different approaches that can be used to help manage these risks. We set out three common approaches below, that more and more funds are benefitting from.

Conventional pooling

The traditional approach to minimising these risks is 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 and is excellent at reducing these risks for individual employers. However, conventional pooling means that all pension risks and costs are shared, not just the risk benefits, 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.

The fund may be comfortable with this level of cross-subsidy due to the advantage it brings to employers in managing the cost of risk benefits, but instead the fund may prefer alternative measures to manage these risk benefits, such as external or self-insurance, where this type of cross-subsidy is minimised.

External insurance

An alternative option is to insure the ill-health or death in service 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 or a death in service lump sum being paid, depending on what the fund chooses to insure.

There are a number of benefits for an employer of external insurance, namely:

- the premium paid for insurance could be deducted from the employer contribution rate under a "cost neutral option" so the total rate remains unchanged;
- removes the risk of the employer failing as a result of unaffordable strain costs;

- helps stabilise contribution rates by helping to protect against deficit increases and large contribution increases; and
- in the case of ill-health retirements, insurers may include employee assistance programs that help employees back to work, where possible.

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.

However, the main drawback of this option is that, like any insurance product, there will be a loading for expenses and profit by the insurance provider. This might make this option less cost-effective for LGPS funds that are comfortable keeping the risk within the pension fund by managing it through internal options such as conventional pooling or self-insurance, therefore avoiding having to pay a loading to insurance providers.

The fund will also need to consider any administrative changes required. This includes changes to ensure premiums are paid to the insurer and also to record any claims paid out on the ledger so they can be reflected in the relevant employer's asset allocation.

Self-insurance

Self-insurance can be used to target specific risks, particularly those that employers have no control over. It works by pooling selected risks only, rather than all experience of the employers in the pool as is the case under conventional pooling.

Death in service and ill-health retirement benefits can both be covered through this approach, or one of these could be covered in isolation, depending on the fund's preference.

The benefits of self-insurance are:

- targeting these risk benefits and using the overall size of the fund to reduce volatility will provide a more stable contribution rate on average but maintain each employer's responsibility for other risks (e.g. salary increase risk);
- the self-insurance reserve is funded by syphoning off some of the contributions already due from employers, so employer rates are no different to what they would have been if self-insurance had not been in place;
- the administration for the fund is straightforward, as this can be managed by us at each triennial valuation (or at more frequent intervals if required); and
- the review of self-insurance contributions and reallocation of any strain payments into employers' notional asset shares can be tied into the actuarial valuation process, meaning they can be done efficiently.
- The main drawback of self-insurance is that it does not mitigate against adverse experience of the whole self-insurance pool, so there may be insufficient reserve to meet the exposure.

If the strain costs required from the self-insurance reserve are higher than the contributions allocated into the reserve then future self-insurance costs could potentially be higher.

External insurance may better mitigate this risk of adverse experience, although it is not certain what an insurer's approach to setting premiums would be following such adverse experience. Like conventional pooling, there is cross-subsidy between employers, although in this case it is only with respect to ill-health and/or death in service risks.

Case study

Small employers benefitting from an ill-health arrangement

We have seen various examples where an academy (a small employer) has benefited from the Fund having put an ill-health arrangement in place. In one instance, an academy paid amounts of less than £5,000 each year towards the cost of ill-health and when an ill-health retirement case occurred the academy received hundreds of thousands of pounds to cover the strain cost. This protected the academy from potentially significant financial problems on this occasion.

Whether you look to an insurance company or to a pooled or self-insurance arrangement, it is important for funds to have an arrangement in place to manage ill-health (and perhaps death in service) risk. Although the risks of unplanned costs cannot be completely removed, having a policy in place can help mitigate them and the known costs of putting in place this kind of arrangement are often preferable to the unknown costs of managing the unexpected events.

Which option is right for my LGPS fund?

Every fund is different and has different preferences and risk appetites when it comes to the form of protection they want to provide to their employers. There is, therefore, no best option and you should consider the relative merits and drawbacks of each option in relation to your own requirements and aims. We would be happy to provide more information on the various options to help you make a decision. For example, if self-insurance is the preferred option, then we can work with the fund to agree the fund's self-insurance policy. This may require approval by the Pensions Committee, and will include decisions around which employers should be included in the proposed arrangement. Similarly, if a fund wants to take a pooling approach or external insurance, we can provide support to take this forward.

Next steps

We recommend you:

- Consider the options set out in this note and assess which option best matches your requirements.
- Discuss this with us ahead of the 2022 valuation, allowing time for any policy to be implemented and incorporated into the results. Communication to employers of policy changes will also need to be considered.

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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