HYMANS ROBERTSON

Sixty second summary

Managing ill-Health liabilities in the Local Government Pension Scheme

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LGPS members' ill-health: it's contagious

When an LGPS member takes ill-health early retirement, their employer catches an expensive bill. We all make sure we keep ourselves and our employees as safe and well as possible, so it makes sense that we do the same for Fund employers' finances.

The symptoms

The Local Government Pension Scheme prescribes the benefits package which the Fund must pay to a member in the event of his/her ill-health. This package broadly replicates the pension the member would have lost, due to their reduced working life. This pension is no longer lost, but it comes with a cost. In effect, the member's ill-health spreads to their employer, in the form of a sometimes hefty price tag.

Clearly the best way of managing this risk is to try to prevent the ill-health in the first place: individuals and employers take various steps to promote health and well-being. But ill-health, due to sickness or accident, still happens … and when it does, there is a financial impact on the LGPS employer. Surely there are steps the employer and Fund can take, to manage that impact?

Possible treatments

All of this means that the question is not "whether" but "how" employers manage these ill-health financial risks. There are various options available, and differences in implementation within options, and it makes sense to consider the full range:

1. Each employer faces the risk on a "stand-alone" basis (but with the option to externally insure)
2. Pooling across groups of employers (by employer choice or mandated by the Fund)
3. Pooling across the whole Fund
4. External insurance across most employers (by employer choice or mandated by the Fund)
5. External insurance across the whole Fund

There are no right or wrong answers here, each option brings its own costs and benefits. The key is that the Fund engages appropriately with employers (who are ultimately on the hook for the costs), and makes an informed decision on which option to take. Your Fund Actuary will provide you with support to consider and implement any of these options.

A second opinion

You will see that options 2 and 3 are described as "pooling", whereas these are sometimes referred to elsewhere as "self-insurance". Why the distinction? Because insurance implies protection, but if there was (say) a spike in ill-health retirements across the Fund or pooled employer group then this shows the difference: options 2 and 3 simply spread the higher costs of across all employers. On the other hand, options 4 and 5 mean that an external insurer picks up the tab and therefore the cost to employers is always known in advance.

The options above are in effect allocating cost and risk differently across the employers; in the case of 4 and 5, the external insurer is brought into this too. We appreciate that some Elected Members can be wary of involving external insurers into the LGPS arrangements. Whilst this is understandable, the key is to consider the whole range of options open to the Fund and perhaps seek the views of your employers, to identify the basis for preferring one option over another.

An argument we sometimes hear is that “external insurance must cost more than pooling, because of the insurance company’s profit margin”. However, this is to mistake the principles of the two arrangements: true insurance means the policyholder pays more in order to protect themselves more. You probably don’t begrudge paying home insurance, because you know the catastrophic costs which could otherwise arise if the worst was to happen to your home. Similarly, an external insurer protects the Fund and its employers from unavoidable ill-health cost volatility: this is the primary added benefit to the Fund and employers which pooling does not provide.

Who needs treatment?

The difference between options 2 and 3, and between 4 and 5, is not simply the number of employers covered; it is usually linked to the employers’ size and nature. Does the Fund think that larger more stable employers (such as local or police authorities) should be included in the pooling/insurance arrangement to keep everyone on the same basis? Or can they be trusted to meet the costs of their own ill-health strains?

For smaller employers the issue is that a single ill-health retirement could be the ruin of the organisation unless it has some pooling or insurance. By spreading the ill-health strains among all employers or an insurance company, we avoid any one employer catching a serious dose of something nasty!

Making an appointment

None of the above is to suggest that any one option is inherently preferable to another: each gives rise to different costs and protections, and allocates these differently among the employers.

The key point is that each Fund should be clear that a policy decision is required to manage ill-health and contain the contagion in the way it thinks best. If nothing else, the status quo should be a conscious decision.

To help you consider the options, have a clear audit trail and make a decision, we can provide an ill health risk management paper which sets out the facts, options and best practice including:

- Ill health cost trends across the LGPS
- Analysis of your own Fund’s experience
- Detail on each of the possible risk management options
- Comment on the pros and cons of each option
- Independent views from a third party expert
- Next steps to make a decision

Your usual Hymans Robertson contact will be in contact shortly to discuss this further with you.