AVON PENSION FUND

EMPLOYER DEATH IN SERVICE CAPTIVE INSURANCE ARRANGEMENT

The Fund is proposing to implement a captive insurance arrangement with effect from 1 April 2023 in relation to the provision of death in service benefits. This note sets out further information about what the arrangement is, why it is being introduced and how this will potentially impact employers. In principle, the objectives are similar to the current ill health captive arrangement but it does have some differences with regard to which employers are included and the potential impact on cost in the long term.

BACKGROUND

If a member dies whilst in pensionable service, then the benefits paid in respect of the Scheme membership change. In replacement of the normal retirement benefits, a death grant of three times pensionable pay (if below age 75) and potentially also a survivor's and/or dependant's pension is paid based on full service to normal retirement age – typically State Pension Age. This can mean that an actuarial funding cost or saving manifests which can impact on an employer's pension costs. A cost typically manifests if the member has unfortunately died at a young age or the member has been a member for only a short period.

There is an allowance included within the contribution rate that employers pay to the Fund to cover potential costs for members who die whilst in pensionable service. This varies by employer depending on their membership profile and, based on the 2022 actuarial valuation outcomes, ranged between 0.2% to 1.6% of pensionable pay. The size of this allowance or "premium" typically increases with the average age of the membership.

In some cases, in particular for employers within the Fund with a relatively small membership, the potential cost emerging and the corresponding impact on the employer's subsequent contribution requirements can be significant. Any additional contributions due can prove unaffordable for the employer and in the extreme can impact on their viability as an organisation and ultimately their participation in the Fund. It is in all employers' interests to protect against this risk because if an employer goes insolvent and cannot afford to meet its pension obligations, the costs then fall to all employers in the Fund. For larger employers the impact is much less as across the membership the impact is inherently smoothed over time. For smaller employers the impact can be highly variable depending on experience which leads to uncertainty in costs.

The introduction of the captive arrangement will therefore provide more certainty for smaller employers and have little impact on the larger employers in the Fund, versus the current approach where the impact is allocated to each employer.

HOW WILL THE CAPTIVE FUND OPERATE?

The contribution rates that have been certified as part of the 2022 Actuarial Valuation (and became effective from 1 April 2023) included an allowance for expected death in service benefit payments based on the actuarial assumptions adopted and set out in the Funding Strategy Statement and Actuary's report. Following the move to operate a death in service captive insurance arrangement, this allowance will become an insurance premium into the "captive fund" instead, with effect from 1 April 2023 when the new valuation rates came into force. This means that all employers will have captive insurance coverage in relation to deaths in service from 1 April 2023.

The premium calculated as part of the 2022 valuation for each employer (as is already included in the employer primary contribution rate) will not change and will apply for the three years to 31 March 2026. This averages 0.5% of pay across all employers. This compares to the range of allowances in the rates for employers of 0.2% to 1.6% of pay dependent on size and age profile. For larger employers in the Fund the premium is closer to the average of 0.5% of pay.

The monies relating to any death in service impact will be directed to the captive fund rather than allocated to your own asset share. Equally the impact on your funding position (positive or negative) will be neutral in relation to any deaths in service over the intervaluation period. The Fund will monitor the level of the captive Fund over time to ensure that there is enough money to cover any net aggregate costs and the position will be reviewed as part of each valuation. Any surplus monies would be distributed back to all employers on a proportionate basis over time.

To illustrate how the captive works in practice, we have set out a simplified example below, where there is a cost associated with a death in service. This shows the impact on a small employer's funding position, if one of their members dies in service incurring a cost of £50,000.

	Position Prior to Death in Service	Position After Death in Service (not in the captive)	Position After Death in Service (part of the captive)
Assets	£64,800	£64,800	£114,800
Liabilities	£100,000	£150,000	£150,000
Deficit	£35,200	£85,200 (i.e. 242% higher)	£35,200 (i.e. no impact)
Deficit contributions (payable over 4 years)	£8,900 p.a.	£21,600 p.a. (i.e. 242% higher)	£8,900 p.a. (i.e. no impact)

As shown in the table above, in exchange for the premium (now and in the future), employers are therefore protected by the captive arrangement against a large cost and hence an increase in deficit contributions.

WHEN WILL THE PREMIUMS BE REVIEWED?

The current premium has been set with the expectation that they will be sufficient to cover the aggregate net costs in the 3 years following the valuation date.

The Actuary will reassess the premium as part of each Actuarial Valuation process based on the underlying actuarial assumptions relating to the expected number and funding impact of deaths in service.

As part of this the Actuary will also consider the experience of the Captive Fund and whether there are any excess funds that can be redistributed to the employers via a reduction in contributions. This is done by considering the number of deaths that have occurred over the prior 3-year period (and the associated net costs or savings) and compare this with the captive premiums paid into the Fund:

- If there have been fewer deaths and costs than expected, the premium may reduce for the next 3 year period.
- If experience has been higher than expected, then the premium may increase.
- If any excess premiums are built up in the captive, these can be used to offset future adverse experience and/or result in lower premiums at the discretion of the Administering Authority based on the advice of the Actuary.

The premium will next be reassessed as part of the 2025 actuarial valuation and then each valuation thereafter. This will then be factored into the new employer rates from 1 April 2026.

WHO WILL BE INCLUDED IN THE CAPTIVE ARRANGEMENT?

The Fund has decided that all employers (both existing and new) will be included in the captive. This is because deaths in service, although costly when they arise, are thankfully a relatively rare event. Therefore incorporating all employers in the captive provides for better overall protection than if we were to include only the smaller employers. This, in turn, makes the arrangement more effective for employers in terms of the overall risk.

AS A LARGER EMPLOYER WHY IS IT IN MY INTERESTS?

For larger employers the funding impact of any death in service is relatively small when compared to other factors, so the impact of the captive arrangement will be minimal over time. However, the arrangement will protect larger employers against the possibility of unrecoverable debts occurring in the relation to the smaller employers if the impact is significant.

HOW DOES THIS RELATE TO THE ILL HEALTH CAPTIVE ARRANGEMENT?

Some Fund employers are included in an ill health captive insurance arrangement operated by the Fund for similar reasons i.e. to provide more certainty of cost. The ill health captive insurance arrangement will remain a separate fund from the death in service captive arrangement and operate independently.

WHAT IF THE CAPTIVE ARRANGEMENT CLOSES?

We do not expect this to happen, however in the event that the captive insurance arrangement terminates, any money left in the captive fund will be returned to the employers in an appropriate proportion. In the unlikely event that there is a shortfall in the captive fund at this point, employers may be expected to pay additional contributions.

WHAT IF AN EMPLOYER LEAVES THE SCHEME?

The employer would not receive any return of premiums from the captive fund or any share of the fund if they terminate. However, the employer would be protected against any strain costs incurred up to the point of termination.

COULD THE FUND USE AN EXTERNAL INSURER TO COVER THESE COSTS LIKE IN THE PRIVATE SECTOR?

Yes it is possible to obtain insurance for costs in relation to death in service and it is something the Fund did consider, but there was no real financial incentive to adopt this at the current time. This will be reviewed at each valuation to consider if premium savings could be obtained, taking into account the additional procurement and governance/administration costs that would be incurred. However, the only impact on employers would be the size of the premium costs net of these additional expenses.

ARE THE MEMBER’S DEPENDANTS AFFECTED BY THIS ARRANGEMENT?

No. In the unfortunate event of a death in service, the processes applied to the determination and payment of the benefits is unchanged. This arrangement is simply a change in how the costs are funded by employers over time.

WHAT IF I HAVE ANY QUESTIONS?

In the event that you have any further questions then please contact Julia Grace at the Avon Pension Fund on Julia_Grace@bathnes.gov.uk.