Local Government Pension Scheme
Scheme Advisory Board

SAB Guidance on Academy Conversions

Contents

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Introduction

This note has been prepared by the Section 13 working group following discussions with the Scheme Advisory Board (SAB) and fund actuaries. The note is intended to provide information and common nomenclature for common actuarial approaches adopted by LGPS funds on a local authority (LA) school's conversion to academy status. When a school is part of a local authority its members and assets aren't normally tracked separately by funds. That means it isn't possible to identify the specific deferred and pensioner liabilities that are associated with the school. The fund actuary therefore has to make an apportionment of assets and liabilities between the academy and the LA.

This wording will be incorporated into the tripartite guidance document which provides information, but not advice, to schools considering conversion to academy status when that document is next reviewed. This note provides information on the following areas:

1. Common nomenclature for conversion methodologies
2. Factors influencing what conversion decision a fund will adopt
3. Possible consequences of the choice of methodology over time

It is important to note that this document provides information only on Local Government Pension Scheme in England and Wales (LGPS) matters relating to schools considering conversion to academy status, in particular funding conversion methodologies adopted on academisation, and should not be construed to contain any advice to academies or any other bodies.

Common nomenclature

Conversion methodologies

A conversion methodology describes the approach to determining the initial assets and liabilities attributable to a new academy when it becomes an employer in that LGPS fund. Different conversion methodologies are adopted by different LGPS funds and further detail of each fund's approach can be found in their funding strategy statement (FSS) available on their website. The FSS summarises each fund's approach to ensuring contributions are sufficient to meet its pension liabilities and is reviewed at least every three years. The FSS will contain the aims and purposes of the fund and will provide information on areas including, but not limited to, funding strategy, funding assumptions, risk considerations and mitigation.

Below we set out descriptions of the common conversion methodologies. The descriptions below consider the methodologies where a deficit is relevant; there may be different considerations in the case of a surplus. For example, any potential surplus may be transferred in full or alternatively capped at a level, to act as a buffer against future adverse experience for the local authority.

Please note that there is no prescribed method to be used by LGPS funds so the conversion methodology may differ by neighbouring funds. Ultimately the methods adopted by funds are based upon consideration of a reasonable balance of risk between local authorities and academies. Based on data from a GAD 2018 report "Academies LGPS pension arrangements", approximately 60% of funds used an active cover method, 15% of funds used share of fund, 15% of funds used school/local authority matching with around 10% of funds using other methods (see definitions below). It should also be noted that any deficit or surplus on the funding basis calculated at conversion is likely to differ from any deficit or surplus reported for the purpose of academy's accounts due to the different assumptions required.

Share of fund

The share of fund approach sets the new academy's initial deficit as its share of the previous Local Authority ('LA') deficit based on the ratio of the new academy's liabilities to the LA's total liabilities i.e.

$$\text{Share of fund deficit allocated to academy} = \text{LA deficit} \times \frac{\text{New academy liability}}{\text{LA total liability}}$$

The liabilities are the actuarial value of academy's members' pension benefits. The liabilities inherited on conversion are broadly those relating to the active non-teaching staff employed by the academy and include pensionable service for those prior to academisation.

Assets are then notionally transferred from the LA to the academy as necessary to create the deficit value arrived at (this applies to all the other approaches below as well).

Active cover (also called active funding level and non-active cover)
The Active cover approach sets the new academy's initial deficit as its share of the previous LA's deficit based on the ratio of the new academy's liabilities to the LA's active member liabilities i.e.

$$\text{Active cover deficit allocated to academy} = \text{LA deficit} \times \frac{\text{New academy liability}}{\text{LA active liability}}$$

This is similar to the Share of fund approach, except that the proportion is based on the LA's active liabilities only instead of the LA's total liability. This approach allows for the LA's non-active liabilities (i.e. deferred and pensioner liabilities) to be fully funded on an ongoing basis.

The terms 'active cover', 'non-active cover' and 'prioritised share of fund' have been used to describe the same conversion methodologies historically. This may be because the deficit allocated is based on the academy active liabilities relative to LA active liabilities, hence 'active cover'. However, a corollary to this is that the non-active liabilities are treated as being fully funded (or prioritised), hence 'non-active cover' or 'prioritised share of fund'.

School/local authority matching (also called common rate approach)
Under this approach, the initial deficit attributable to the new academy is set such that the total or secondary contribution rate payable by the new academy is equal to that of the corresponding LA school. Note that the rate payable by a LA school is not necessarily the same as that paid by the LA, although in the majority of cases it is likely to be, and we have assumed this will be the case in these examples. Where matching to a total contribution rate, a further calculation is required to determine what the future service (primary contributions) for the academy will be with the balance attributed to deficit secondary contributions.

In both cases the deficit that equates to the value of the secondary contributions is determined under consistent principles to that of the LA.

Payroll based active cover
This approach adopts the same principles as Active cover described above, however the ratio of payroll is used to determine the allocation of deficit.

$$\text{Payroll active cover deficit allocated to academy} = \text{LA deficit} \times \frac{\text{payroll of academy}}{\text{LA payroll pre academisation}}$$

Identifiable assets
Where the original LA school already has an identifiable notional asset share in the fund, then the academy deficit can be allocated on this basis.

Treatment of Surpluses on Conversion

Whilst this document focuses on the position in relation to a LA deficit, we are aware that many funds and employers do have a surplus. There are a range of actuarial practices adopted on treatment of any possible surplus position in terms of ultimate impact on aggregate contribution rate to be paid by an academy. For example, any potential surplus at conversion may be transferred in full or capped at a level (possibly zero), to act as a buffer against future adverse experience on the school's deferred and pensioner liabilities that are left behind with the LA on conversion.

Pooling Arrangements / MATs

Where an academy becomes part of a multi-academy trust (MAT) there may be a subsequent calculation after the conversion to determine the contribution and deficit requirements for the MAT.

In some instances, if the academy belongs to a MAT, the MAT is treated as the relevant employer and responsible legal entity within the LGPS.

Some funds also operate pooling arrangements whereby some (or all) academies within a fund pay a single combined contribution rate. LGPS funds are, however, not obliged to offer any pooling arrangement.

Pooling can be beneficial for scheme employers as they can share risk (for example, ill-health retirement payments) across the group. Variations in the cost of future service benefits (the primary employer contribution rate) caused by changes in the age and pay profile of staff can also be reduced when part of a larger pool.

However, pooling also carries disadvantages as it involves cross-subsidy across the pool. This means that a decision made in one school within the pool, for example on salary awards or early retirements, may affect the contributions required of other schools within the pool, in order to ensure all liabilities across the pool can be met.

When pooling arrangements are implemented, individual assets and liabilities are no longer routinely tracked by the fund actuary (they can be tracked for employer accounting purposes but on the basis that the assets will then be rebalanced following each triennial valuation). Therefore, in general it is not readily possible to revert back to assessment/treatment as an individual employer.

There will be 'winners' and 'losers' between academies as a result of the operation of pooling, based upon the contribution rates they paid previously (pre-conversion as a LA school) and those that would have ordinarily applied (post-conversion) had pooling not been in place.

There are different approaches used in practice to pool academies within a fund. For example, if an academy is entering a pooled arrangement, any of the above conversion methodologies may be adopted initially to establish an asset and deficit position, before the academy is then pooled into the MAT. Other pooling processes are available and adopted in practice.

Factors influencing methodology adopted

To illustrate how conversions might occur we have considered a few numerical examples below.

Please note the worked examples included in this section are designed to illustrate the different approaches including drawing out the relevant outcomes but are not designed to be exhaustive nor should the specific outcomes be assumed to apply under all circumstances.

The worked examples consider conversions where a deficit existed, but surpluses do equally exist (and it is important to note that the approach in the case of a surplus might not mirror that of the deficit).

Please note that the assumptions used within the worked examples have been simplified for illustrative purposes only. Different assumptions will be adopted by funds which will change the figures, however we do not expect this to significantly impact the outcomes or observations.

Lastly, the recovery periods modelled are again illustrative and different approaches may validly be adopted in practice.

Active cover

Outcome: This results in the academy having the same active cover as the LA, where active cover is the funding level for the active member liabilities once available assets have first been used to fully reserve for all deferred and pensioner liabilities. In other words, the academy is allocated a portion of the LA's deficit in line with the academy's active liabilities relative to all active liabilities in the LA.

Where there is a deficit initially the funding level of the academy is likely to be lower after academisation than the LA's overall funding level both before and after academisation.

Rationale: Consistency of active cover is an objective target.

The transfer of liabilities from the original LA school to the new academy involves active members only and no former members of the LA school. Therefore, to reflect this, the LA's non-active liabilities (which would include any former members of the

original LA school) are fully reserved in calculating the initial deficit to be allocated to the new academy.

However, as with most conversions, it is dependent on market conditions at point of conversion.

Where there is a deficit at conversion a higher secondary contribution rate may be required by the academy than the LA, even where the active membership profile is the same, but this will depend on various factors such as the recovery period used after conversion (which is illustrated in the example below) and how market conditions have moved since the triennial valuation when the LA's contribution was set.

Worked example (figures are subject to rounding):

	Initial position (pre conversion)	**Active cover (post conversion)**		
	LA (£m)	LA (£m)	*Scenario 1* Academy (£m)	*Scenario 2* Academy (£m)
Payroll	20.0	18.0	2.0	2.0
Actives	40.0	37.2	2.8	2.8
Non-actives	60.0	60.0	0.0	0.0
Total liabilities	100.0	97.2	2.8	2.8
Assets	98.0	95.3	2.7	2.7
Surplus/(deficit)	(2.0)	(1.9)	(0.1)	(0.1)
Funding level	98.0%	98.1%	95.0%	95.0%
Primary cont rate	16.0%	16.0%	16.0%	16.0%
Secondary cont rate	0.6%	0.6%	0.4%	0.7%
Total cont rate	16.6%	16.6%	16.4%	16.7%
Recovery period (years)	16	16	*16*	*10*

Observations from worked example:

- The first £60m of assets is held for non-active liabilities, hence the assets allocated are then £38m x £2.8m / £40m = £2.7m, resulting in a deficit of £0.1m for the academy (£2.8m - £2.7m).
- The academy funding level is subsequently lower than the LA funding level, both pre and post conversion.
- Two different recovery periods are modelled for the academy post conversion.

- Where the recovery period is maintained, the academy's secondary contribution rate reduces slightly as its payroll relative to its deficit is proportionally greater than it is for the LA.
- The secondary contribution rate is higher for the academy in the second example where the recovery period has reduced by six years (but a smaller reduction to the recovery period might not have given rise to such an increase).

Share of fund

Outcome: By nature of the conversion the funding level of the academy and the LA remain unchanged post conversion.

Rationale: Consistency of funding level is an objective target

However: It is dependent on market conditions at conversion.
Where there is a deficit at conversion, a lower deficit contribution rate may be required by the academy than the LA even where active membership profile is the same.

Worked example (figures are subject to rounding):

	Initial position (pre conversion)	**Share of fund (post conversion)**		
			Scenario 1	*Scenario 2*
	LA (£m)	LA (£m)	Academy (£m)	Academy (£m)
Payroll	14.0	10.0	4.0	4.0
Actives	35.0	20.0	15.0	15.0
Non-actives	61.0	61.0	0.0	0.0
Total liabilities	96.0	81.0	15.0	15.0
Assets	80.0	67.5	12.5	12.5
Surplus/(deficit)	(16.0)	(13.5)	(2.5)	(2.5)
Funding level	83.3%	83.3%	83.3%	83.3%
Primary cont rate	18.0%	18.0%	18.0%	18.0%
Secondary cont rate	6.7%	7.9%	3.7%	5.2%
Total cont rate	24.7%	25.9%	21.7%	23.2%
Recovery period (years)	17	17	*17*	*12*

Observations from worked example:

- Academy must be given the same funding level (of 83.3%) meaning the assets allocated are 83.3% x £15m = £12.5m.
- Two different recovery periods are modelled for the academy post conversion.
- Where the recovery period is maintained, the academy's secondary contribution rate reduces materially as its payroll relative to its deficit is proportionally greater than it is for the LA.
- Even where the recovery period is reduced by five years as in this example the secondary contribution rate for the academy remains lower as the deficit allocated is split across the academy membership which are all active members at outset. However, a larger reduction to the recovery period could have led to a different conclusion.

School/local authority matching

Outcome: Either the total or the secondary contributions required by the academy will remain the same as the LA school (in most cases this is the same as the LA).
There is the potential for 'winners' and 'losers' to the extent that contribution rates may have been higher or lower than the LA, had an alternative conversion approach been taken.

Rationale: Consistency of total or secondary contribution rates is an objective target

However: Where a deficit exists, the academy is likely to start with relatively low assets and a lower funding level
This will be dependent on market conditions at the point of conversion

Worked example where the target is matching total contribution rates (figures are subject to rounding):

	Initial position (pre conversion)	**Contribution matching (post conversion)**	
	LA	LA	Academy
	(£m)	(£m)	(£m)
Payroll	10.0	7.5	2.5
Actives	20.0	15.0	5.0
Non-actives	40.0	40.0	0.0
Total liabilities	60.0	55.0	5.0
Primary cont rate	18.0%	18.0%	18.0%
Secondary cont rate	2.7%	2.7%	2.7%
Total cont rate	20.7%	20.7%	20.7%
Assets	56.0	52.0	4.0
Surplus/(deficit)	(4.0)	(3.0)	(1.0)
Funding level	93.3%	94.5%	80.0%
Recovery period (years)	15	15	15

Observations from worked example:

- The academy must be given a total contribution rate of 20.7% (matching the LA school). Hence the equivalent deficit to equate to this is £1.0m, meaning assets allocated are £4.0m.
- This results in a low transfer of assets and lower funding level relative to the LA, but with a consistent overall contribution rate.
- If the future service rate calculated for the academy active membership was different, the deficit allocated would be higher/lower accordingly.

- Whilst this example targets a consistent total contribution rate, another common method is to target a consistent deficit secondary rate, with the primary rate reflecting the profile of the academy.

Payroll based active cover

Outcome: The LA deficit is weighted by the academy active payroll relative to active payroll of LA.

Rationale: The academy inherits any deficit in line with the payroll that is to address such a deficit.

However: The payroll level does not necessarily correlate with the active liability level, which may lead to a different academy funding level relative to the LA.

Worked example:

	Initial position (pre conversion)	**Deficit based on payroll (post conversion)**	
	LA	LA	Academy
	(£m)	(£m)	(£m)
Payroll	16.0	12.0	4.0
Actives	52.0	36.0	16.0
Non-actives	48.0	48.0	0.0
Total liabilities	100.0	84.0	16.0
Assets	90.0	76.5	13.5
Surplus/(deficit)	(10.0)	(7.5)	(2.5)
Funding level	90.0%	91.1%	84.4%
Primary cont rate	15.0%	15.0%	15.0%
Secondary cont rate	3.1%	3.1%	3.1%
Total cont rate	18.1%	18.1%	18.1%
Recovery period (years)	20	20	20

Observations from worked example:

- The LA deficit of £10m is allocated based on the academy payroll relative to LA payroll, that is £10m x £4m / £16m = £2.5m.
- The secondary contribution rate is consistent with the LA secondary contribution rate. This relationship would not hold true if the recovery period was reduced post conversion (in this instance the secondary contribution rate would increase relative to the LA).

Identifiable assets

Outcome: The level of assets and liabilities attributed to the academy do not necessarily change because of conversion

Rationale: There is little judgement required in the application of this methodology as they are available before conversion

However, this is only available to an academy where assets were already attributed to them as a LA-maintained school, which is not the case in most, if not all, instances

Progression over time

Factors influencing academy funding positions
Most historic conversions occurred when funds were in deficit. On average funds within LGPS E&W were 85% funded at 31 March 2016 and the funding level improved to 98% on average at 31 March 2019. The average funding level of funds, and local authorities, will be above 100% at 31 March 2022.

Academisation results in defining a funding position and/or the necessary contribution rates at a point in time, however both will change over time. The principal factors that determine how funding positions and contribution rates develop are:

- Actual investment returns earned by funds
- Actuarial assumptions (such as future asset return expectations, future levels of inflation and future mortality rates)
- Active member profile (for example the average age of members)

Some specific points relating to academies may be:

- If a conversion approach results in lower assets being allocated (relative to the LA), there may be a lower opportunity to benefit from asset returns equally there is lower investment risk. If the conversion approach results in higher assets being allocated the converse argument would also be expected to hold true.
- The profile of academies will differ from that of the LA given initial 100% active liability allocation. Therefore, academies may be particularly sensitive to payroll progression and changes to the balance of their membership between active and non-active members. In addition, their cash-flow position will be different and the funding role of future contributions would be expected to be more significant role than investment performance for academies, while the reverse may be true of the LA
- Given their much smaller workforce size, academies are also likely to see greater variation in the average age and hence liability of their active members both from the LA and from other academies.

Different funding positions:
Ultimately the cost of providing benefits cannot be known until all benefits have been paid (many years in the future). Therefore, there is a not a single, unique correct answer in terms of assigning a liability value to future benefit payments. Accordingly, there are several different liability bases used to assess a liability value for different purposes.

Some examples of different liability bases are:

- Funding basis use to set employer contribution rates – assumptions used to measure the liabilities are consistent with the funding regime the fund operates within, the LGPS regulations, and will, to some extent, reflect the actual assets held by the fund. The funding basis will vary by LGPS fund.
- FRS 102 / IAS19 accounting basis – employers are required to include benefit provisions within their employer accounts and the basis to be used to measure pension liabilities and accruals are set out in the relevant accounting standards. These bases tend to be quite prescribed and don't necessarily refer to the specific, underlying assets of the fund.
- It is common for liability values under different bases to be significantly different due to the differing assumptions – for example, different bases make different assumptions in terms of future expected asset returns which impacts on the reserve required to be held today (the liability value).