APPENDIX 2

HYMANS ROBERTSON

Contribution Rate Assessment for an Academy - Method, Assumptions & Limitations

To be read in conjunction with the "Schedule of Results" for:

Fund	London Borough of Tower Hamlets Pension Fund
Administering authority	London Borough of Tower Hamlets
Ceding Employer	London Borough of Tower Hamlets
Name of Academy	Old Ford/Culloden Schools Academy Trust
Date	25 January 2013

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For and on behalf of Hymans Robertson LLP

Contents

1 Introduction and background

Under the Academies Act 2010 schools can apply for academy status, allowing them to operate independently from Local Authority control, and assume responsibility for managing their own finances. Whilst academies can set pay and conditions for staff, my understanding is that non-teaching staff must have access to the LGPS.

I understand that the employer named in the accompanying Schedule of Results ("the Academy") is considering assuming or will assume academy status on the date shown in the accompanying Schedule of Results. Employees of the Academy are eligible to join the Fund under Regulation 4 (2) of The Local Government Pension Scheme (Administration) Regulations 2008 as a body listed in Schedule 2 Part 1.

I have been asked by the Administering Authority to the London Borough of Tower Hamlets Pension Fund to provide actuarial advice on the initial contribution rate payable and opening funding position of the new Academy.

To date there has been no clear guidance on the approach to allocating LGPS assets and liabilities for academies, nor to calculating their contribution rate. However, a briefing note issued by the Department for Education states that each academy should have its own contribution rate calculated and will be responsible for a share of the LGPS deficit. There are no provisions under the Regulations[1] ("the Regulations") or in any regulations or guidance relating to the establishment of academies of which we are aware, for staff previously employed in an education function, who are now deferred or pensioner members of the Fund, to be transferred to the academy (irrespective of whether or not they are identifiable as former education employees). We therefore assume that responsibility for these members will fall back to (or remain with) the relevant Local Education Authority. If we have been advised of any alternative arrangements which are in place in respect of deferred and pensioner members this will be set out in the Schedule of Results.

In addition, a joint letter of understanding has been issued by Communities and Local Government (CLG) and the Department for Education (DfE) which recommended pooling Academies with the local authority that formerly maintained the school for contribution rate purposes. There is currently no legal requirement to pool Academies with other Scheme Employers for contribution rate purposes and therefore our approach has been to calculate an individual contribution rate based on the cost of pension accrual for the Academy's own membership plus an adjustment for any deficit transferred to the new Academy.

The Local Education Authority (LEA) or grant maintained school, as the existing employer in the Fund from whom staff will transfer to the Academy, is referred to as the "ceding employer".

[1] The Local Government Pension Scheme (Administration) Regulations 2008

2 Scope, reliances and limitations

Addressee

This report is addressed to the Administering Authority to the Fund. It has been prepared in my capacity as an Actuary to the Fund and is solely for the purpose outlined below. It has not been prepared for any other purpose and should not be so used.

Purpose of report

This report is provided solely for the purposes of providing a planning exercise to assess the following:

- the contribution rate or rates payable by the Academy to the Fund until 31 March 2014 or date of earlier revision of the Rates and Adjustments Certificate; and
- the value of Fund assets notionally transferred from the ceding employer to the Academy

Where it has been specifically requested, I have also assessed the impact of the transfer of staff on the funding position and contribution rate of the ceding employer, as set out in the Schedule of Results.

The Administering Authority can share this report with the ceding employer and the Academy as users of this report. Neither I nor Hymans Robertson LLP accept any liability to any party other than the Administering Authority unless we have expressly accepted such liability in writing. The report or any part of it must not be disclosed or released in any medium to any other third party without our prior written consent. In circumstances where disclosure is permitted, the report (and accompanying Results Schedule) may only be released or otherwise disclosed in its entirety fully disclosing the basis upon which it has been produced (including any and all limitations, caveats or qualifications).

Status of results

The results shown in the Schedule will be either **estimates** or a **final assessment** as indicated in the Schedule.

Estimates: Estimates may be provided in cases where, for example, the final transfer date or date of commencement in the Fund has not yet been confirmed, finalised data is not yet available or an estimate is required in advance of the actual transfer date. If the results are estimates, they should be considered indicative only. The calculations described in this report and the results set out in the accompanying Schedule are therefore valid only for the calculation date shown. If the calculation date is prior to the transfer date, the calculations will need to be reviewed and updated to reflect market conditions and confirmed transferring membership data on the date the Academy joins the Fund.

The final figures should be assessed at a later date and may differ, possibly materially, from the estimates given due to differences in regulations, membership data, assumptions and investment market conditions (including gilt yields and the value of the Fund's assets). In particular, the initial asset allocation would need to be updated to reflect market conditions and the funding level of the ceding Employer at the transfer date.

Final assessment: If the assessment has been based on finalised assumptions and data (including some, or all of, membership data, investment returns and cash flow information) and calculated as at the actual date of commencement in the Fund, the results shown represent the final assessment of the contribution rate and asset allocation for the new Academy (and the impact on the ceding employer's contribution rate if requested) rather than indicative estimates. It is the responsibility of the Administering Authority to request a revised calculation if subsequently any of the information used in the final assessment changes.

Post calculation events: If there have been any material changes in either the membership data or the financial conditions on which any calculations have been based since the effective date of the calculations, then the estimated effect on the Academy contribution rate payable or assets to be transferred will be illustrated in the Results Schedule.

Quality of data

As far as I can reasonably determine the membership is materially complete and accurate, and has been checked insofar as we are able based on the information available to us. However, I am not in a position to verify whether the membership data provided in respect of the transferring employees is an accurate representation of the staff who will transfer to the new Academy. In this regard I have therefore relied upon the data provided by the Administering Authority in my calculations. Hymans Robertson LLP accepts no liability for errors or omissions due to inaccurate or incomplete data.

Actuarial standards

The following Technical Actuarial Standards[2] are applicable in relation to this report:

- TAS R – Reporting;
- TAS D – Data;
- TAS M – Modelling; and
- Pensions TAS

The advice and information given in this report and accompanying Schedule of Results (which together with any covering emails, the formal valuation report dated 31 March 2011 and the LGPS 2010 Actuarial Valuations Briefing Note: Demographic Assumptions dated February 2010 comprise the aggregate report for this advice for the purpose of TAS R) comply with the above Standards.

Exclusions

Nothing in this report is intended to provide advice to the Employer named in the Schedule of Results in relation to its application for academy status or its participation in the Local Government Pension Scheme (LGPS).

This report contains comments from an actuarial perspective. It should be noted that we at Hymans Robertson LLP are not lawyers and are therefore not qualified to provide legal advice. If there is any doubt about the legal position of the Fund or other parties in relation to the transfer of pension obligations in the Fund from the ceding employer to the Academy, or in respect of any other aspect of this report, the parties concerned should seek independent legal advice.

[2] Technical Actuarial Standards (TASs) are issued by the Board for Actuarial Standards (BAS) and set standards for certain items of actuarial work, including the information and advice contained in this report.

3 Underlying principles

The calculations are based on the following key principles:

- Responsibility for the accrued pension liabilities in the Fund of all transferred employees, as summarised in the Schedule of Results, will automatically transfer from the ceding employer to the Academy.
- The Academy will be responsible for a share of the ceding employer's ongoing pensions deficit in the Fund (based on my understanding of guidance issued by the Department for Education). This means that as at the date of membership transfer, assets are notionally transferred within the Fund from the ceding employer to the new Academy on a share of deficit basis. This deficit has been calculated using the funding level as shown in the Schedule of Results. The method of calculation of the funding level is detailed below.
- The contribution rate for the new Academy is based on the assessed cost of future service benefits for its Fund membership plus an adjustment to make good the past service deficit allocated to the new Academy over an appropriate period.
- The benefits valued and the assumptions adopted are consistent with the most recent funding valuation, unless otherwise stated in the Schedule of Results.
- The investment strategy for the Academy is the same as for the Fund as a whole. This means that the Academy benefits from a lower assessed cost of the benefits than would be the case if a lower risk strategy were followed. However, it also means that the Academy's contribution rate and funding level may be volatile, due to the predominance of equity investments within the Fund's asset allocation.

Allocation of assets

Guidance issued by the Department for Education states that Academies should assume responsibility for a share of the deficit attributable to employees transferring to the new Academy. The share of the deficit, and initial funding level of the Academy, can be calculated using different methodologies. I have taken the approach to determining the initial funding level and subsequent asset allocation described below, as agreed by the Administering Authority.

The amount of assets notionally transferred is based on the ongoing funding level of active members of the London Borough of Tower Hamlets Pool on the calculation date. The funding level is calculated as the ratio of the active liabilities to the remaining assets after sufficient assets have been retained to meet the deferred and pensioner liabilities of the London Borough of Tower Hamlets Pool in full.

To determine the funding position of the ceding employer at the date of the transfer to the new Academy, I have rolled forward the ceding employer's funding position as determined at the latest formal valuation date. The financial assumptions for the ongoing funding basis used in this projection are derived in a manner similar to the previous formal valuation, but updated for market conditions at the date or dates shown in the Schedule of Results.

By using a rollforward approach, I have implicitly assumed that the actual experience of the ceding employer has moved in line with our assumptions at the latest formal valuation. This may not be the case and as such the accuracy of the projection decreases over time. It is not possible to fully assess the accuracy of these projections without carrying out a full funding valuation.

In particular the projection of the funding position does not allow for:

- changes in the mix of assets held since the last valuation;
- variations in liabilities arising from salary rises, deferred pension revaluation or pension increases differing from those assumed in the valuation;
- changes in the salary roll of employee members; and
- variations between actual and expected demographic experience (e.g. on withdrawals or mortality).

Initial academy contribution rate

- The Employer's contribution rate on entry to the Fund is set to cover the expected cost of accrual of pension benefits with an adjustment for any surplus or deficit based on a spreading period not exceeding that set out in the Funding Strategy Statement for this type of employer. The contribution rate is re-assessed periodically, usually at each triennial valuation.
- The financial assumptions used for setting contribution rates are normally the financial assumptions adopted for the previous formal valuation of the Fund but updated to reflect market conditions at the date shown in the Schedule of Results.

Future academy contribution rate

- In future assessments of the Academy's funding position at triennial valuations allowance will be made for the experience of its LGPS employees during the intervening period. This will include for example, the effect of how salary increases, turnover of staff, early retirements etc compared with the actuarial assumptions. Investment experience will apply across the Fund as a whole, and any surpluses or deficiencies arising from investment experience will effectively be allocated on a pro rata basis.
- The effect of any differences between actual experience and the assumptions on benefits earned both since and prior to the Academy joining the Fund (i.e. including benefits accrued up to the transfer date which are assumed to transfer to the Academy from the ceding employer in the Fund) will be evaluated and contribution rates adjusted accordingly.
- The overriding assumption is that, as for all employers in the Fund for whom an individual contribution rate is calculated, the Academy should pay for the benefits earned by its LGPS members, both those transferred from a ceding employer in the Fund and for any new entrants permitted to join the scheme.

Open contribution rate

As employees of Scheduled Bodies are automatically eligible for membership of the LGPS and hence, as I understand it, the Academy cannot close the Scheme to new entrants, I have calculated the contribution rate assuming that new employees will join the Fund. Accordingly, I have used the projected unit method to determine the future contribution rate payable. The projected unit method estimates the cost of benefits accruing to existing employee members over the year following the valuation date allowing for all expected future pay and pension increases.

This method of assessing the future contribution requirement is applied only to the membership at the calculation date. If new entrants are admitted to the Fund to the extent that the membership profile remains broadly unchanged (and if the actuarial assumptions are unchanged) then the future service contribution rate assessed at a future date should be reasonably stable.

Termination

- As far as I am aware, there is no guidance on what will happen should an Academy close down or be wound up. Under the Regulations, a Scheduled Body is unable to choose to cease participation within the Fund. However, in the event of insolvency or ceasing participation in the Fund for any other reason, the Administering Authority can require a termination valuation calculation to be carried out under Regulation 38. We understand that the Department for Education has guaranteed funding for academies for a period of seven years but that some administering authorities have expressed concern over the financial position of Academies thereafter.
- I would note the following:
    - If an Academy becomes insolvent and no other employer takes over responsibility for the Fund liabilities in respect of its current and former employees then the Administering Authority will seek to recover any existing and future funding shortfall in the Fund from the Academy.
    - The failure of the Academy *may* precipitate the immediate payment of pension benefits if there are any employees aged 55 or over, who are deemed to have been made redundant, thereby causing a further funding strain. This strain will be included in the calculation of any termination deficit.
    - If the Local Education Authority retains an obligation to provide education services (and it should be noted that it is not clear to us whether this is the case or not once an Academy has been established), then it may be possible to argue that the assets and liabilities in the Fund in respect of the Academy's current and former employees should transfer back to that LEA rather than being spread over all the employers in the Fund. The Administering Authority should consider what provisions, if any, should be put in place to cover this possibility.

Other considerations

- The Administering Authority's principal role is to look after the interests of the Fund. We usually interpret this to mean the interests of all the employers in the Fund (since the members' benefits are set out in Regulations and are generally assumed to have a statutory guarantee). With this in mind the Administering Authority should consider what protections are required for the Fund and ensure that it does not confuse these with the protections which might be helpful for the ceding employer, where these might conflict with the best interests of the Fund as a whole.
- In setting the contribution rates for the academies, the Administering Authority may wish to consider its approach to other scheduled bodies, such as further and higher education colleges. The approach taken need not be identical, but the Administering Authority may wish to consider how it would justify any differences in approach.

4 Data and assumptions

Data

A summary of the membership data for the new Academy used in my calculations is set out in the Schedule of Results. I have included the transferring employees' total membership in the Fund in my calculations, including that prior to the transfer date.

To determine the funding position of the ceding employer at the date of transfer to the new Academy, I have also used data provided for the ceding employer for the purposes of the most recent formal valuation. This is summarised in the Schedule of Results. Any actual or estimated cashflows, and investment returns used to determine the funding position of the new Academy are also shown in the Schedule of Results.

In practice, the final membership that is transferred to the Academy and new members who join the Fund may be different to that on which my calculations are based. If the actual final membership is different from that assumed for the purpose of this report, I may have to revisit my calculations.

Assumptions

For the purpose of my calculations I have assumed that the Academy joined the Fund on the date shown in the Schedule of Results.

The financial assumptions used are shown in the Schedule of Results.

Demographic assumptions i.e. assumed incidence of ill health early retirement, members leaving early with a deferred pension, proportions exchanging pension for tax-free cash at retirement and longevity assumptions etc, are normally those used at the most recent formal valuation, unless stated otherwise in the Schedule of Results. Assumptions regarding scheme benefits, retirement age, any uptake of additional tax-free cash permitted by Regulations, mortality and other key assumptions are shown in the Schedule of Results. Any departure from the previous formal valuation assumptions will be shown in the Schedule of Results.

Full information on the derivation of the financial and demographic assumptions for the 2010 formal valuation is set out in the formal valuation report dated 31 March 2011 and the LGPS 2010 Actuarial Valuations Briefing Note: Demographic Assumptions dated February 2010.

5 Risk assessment

The results of the calculations set out in Section 3 (new Academy contribution rate and initial allocation of assets) depend on the actuarial assumptions made for those calculations. The Schedule of Results illustrates the sensitivity of the results to those assumptions made, and illustrates the effect of a change to those assumptions. However, over time the funding position of the new Academy and ceding employer (if any) will depend on the extent to which future experience matches the assumptions made. The main risks in respect of the participation of the new Academy are set out under 'Termination' and 'Other Considerations' within Section 3. This section considers the potential implications of the actuarial assumptions used in the calculations not being met in the future.

Risk of a general shortfall arising due to differences between experience and assumptions used

The risk that the liabilities and assets do not move in line, resulting in a shortfall arising in the future, depends separately on the financial and demographic assumptions made:

- ***Financial risks*** include the risk that the Fund assets fail to deliver investment returns in line with the anticipated returns underpinning the valuation of liabilities; or returns on Government bonds fall, leading to a rise in the value placed on liabilities; or actual pay and price inflation are significantly more than assumed. These financial risks have a direct impact on the funding level and hence on the risk of the Academy's share of the Fund being underfunded on ceasing to participate in the Fund.

  The salary increase assumption adopted for the 2010 formal valuation of the Fund was set allowing for the Chancellor's Budget Statement announcement of public sector pay freezes with some protection for the low paid. It has been assumed that pensionable pay will increase at 1% p.a. in the 3 years following the 2010 formal valuation date and then revert to the long term assumption at 1.5 percentage points above the rate of increase in RPI. Since such increases are under the control of the Academy, it would seem appropriate to make an allowance for this risk at the outset if the Academy expects that pay rises will be higher. I therefore recommend that the Academy undertakes to advise the Administering Authority if pay increases are to be granted above the valuation assumption described above.

- ***Demographic risks*** include the risk of pensioners living longer than expected; or the emergence of further evidence that they are likely to live longer; or that there are significantly more early retirements on ill-health or redundancy/efficiency grounds than expected. Again, these risks would have an impact on the amount of any shortfall in the Academy's share of the Fund on ceasing to participate in the Fund.

As mentioned above, the sensitivity of the calculations to the main financial and demographic assumptions used are set out in the Schedule of Results.

Other risks

The other main risks are:

- ***Regulatory risks*** include the risk of changes to regulations or practice which increase the cost of the scheme, for example through increasing the benefits or by permitting retrospective membership of the scheme such as occurred with part-time employees. These risks could lead to unanticipated costs and hence underfunding on the Academy ceasing to participate in the Fund. Regulatory risks are usually entirely outside the control of both the Administering Authority and the employers. They should not be connected with termination of an employer's participation in the Fund.

- ***Governance risks*** include the risk that the Administering Authority is not aware of structural changes in an employer's membership which affect the liabilities such as a large fall in employee members or large number of retirements, or the Administering Authority is not advised of an employer closing to new entrants and hence this is not taken into account in setting employer contributions.

  It is not possible to assess the likely impact of governance risks on the amount of any underfunding which may arise over the period of participation. In order to mitigate these risks, the terms of participation should require the Academy to inform the Administering Authority of any material changes to its membership or other changes which could affect its liabilities or participation in the Fund.

Barry McKay

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For and on behalf of Hymans Robertson LLP

25 January 2013