Technical guide 2: Stoneport's operational framework

STONEPORT PENSIONS

Forward

Stoneport is a consolidation vehicle for occupational defined benefit pension schemes in the UK with fewer than 1,000 members.

For schemes that join, it will dramatically **improve the security of members' benefits** and deliver substantial improvements in governance, whilst **significantly reducing the running costs** incurred by employers. These enhancements are achieved by operating Stoneport as one large centralised scheme.

This guide is part of a series of technical guides, aimed at pension professionals who advise trustees and/or employers, covering the full range of issues we think a consultant might wish to discuss with a client who is considering joining Stoneport. However, should you have any questions, please do not hesitate to contact the team at enquiries@stoneport.co.uk.

In this second guide in the series you will find a description of Stoneport's structure, how it will operate before centralisation, the centralisation process and what happens if Stoneport fails to centralise. It also covers the regulation of Stoneport.

The other guides in this series are as follows:

- The first guide provides a brief explanation of what Stoneport is, who it is aimed at, its conceptual origins and the key benefits it provides.

- Guide three details the cost savings that Stoneport will bring to the schemes that join. It also considers the potential upside on investment returns that improved governance can bring.

- The fourth guide covers the reduction in risk for employers and members alike, including the improvement in benefit security, the reduction in idiosyncratic risk and the reduction in risk that Stoneport will deliver by adopting higher standards of governance.

- The fifth guide in the series sets out Stoneport's funding and investment strategy, including the flexibilities that exist within them. It also covers the valuation process and the provisions for employers wishing to exit the structure if necessary.

- Guide six describes the allocation of liabilities between employers on centralisation and the tracking of notional asset accounts and notional liabilities thereafter. It also provides some simplified worked examples of the funding mechanism in order to aid understanding.

- Guide seven describes how the member option terms will be set.

- The eighth and final guide covers the entry terms and joining process.

Our technical guides are quite detailed, reflecting their intended audience. Separate guides specifically tailored for trustees and for employers can be found on the Stoneport website at www.stoneport.co.uk.

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1. Stoneport's structure

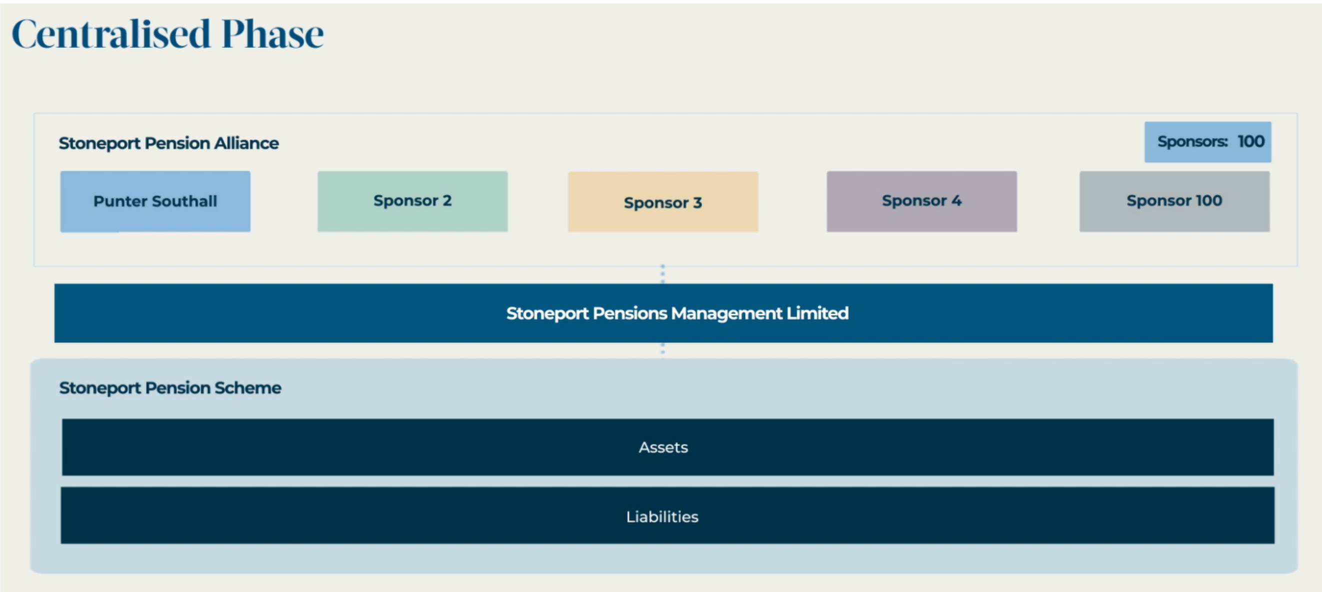
At the heart of Stoneport's structure is a single defined benefit pension scheme. Stoneport was created by amending and renaming the small defined benefit pension scheme operated by Punter Southall.

The Trust Deed & Rules ("TD&R") which govern the operation of the scheme were amended to allow non-associated employers to join, so that it can consolidate the schemes of other, otherwise unconnected employers. Further rule changes were made to facilitate the range of different benefit specifications that Stoneport will need to accommodate. The TD&R also contain new provisions that are designed to ensure the fair treatment of Stoneport's members and employers.

The employers of each of the schemes joining Stoneport will need to become participating employers. In addition, each employer will need to become a statutory employer of Stoneport.

The principal employer of Stoneport is Stoneport Pensions Alliance Limited. The principal employer will act as the membership body through which employers are consulted on various matters as required by legislation and under the TD&R. The principal employer is a company limited by guarantee. Its operations are governed by its articles of association. All employers, including Punter Southall, will be members of this company and have equal voting rights in any matters put to a vote.

The graphic below provides an illustration of the structure once it achieves centralisation:



2. The operational timeline for Stoneport

Stoneport will become a centralised scheme on 31 December 2022.

Schemes will have to join Stoneport before the Centralisation Date, i.e. 31 December 2022.

The TD&R of Stoneport contain an automatic provision for centralisation on 31 December 2022. The principal employer has the power to vary the Centralisation Date, subject to a vote of the employers.

Deferral of the Centralisation Date will only occur if sufficient scale has not been reached, in terms of the number and mix of employers who have already joined Stoneport.

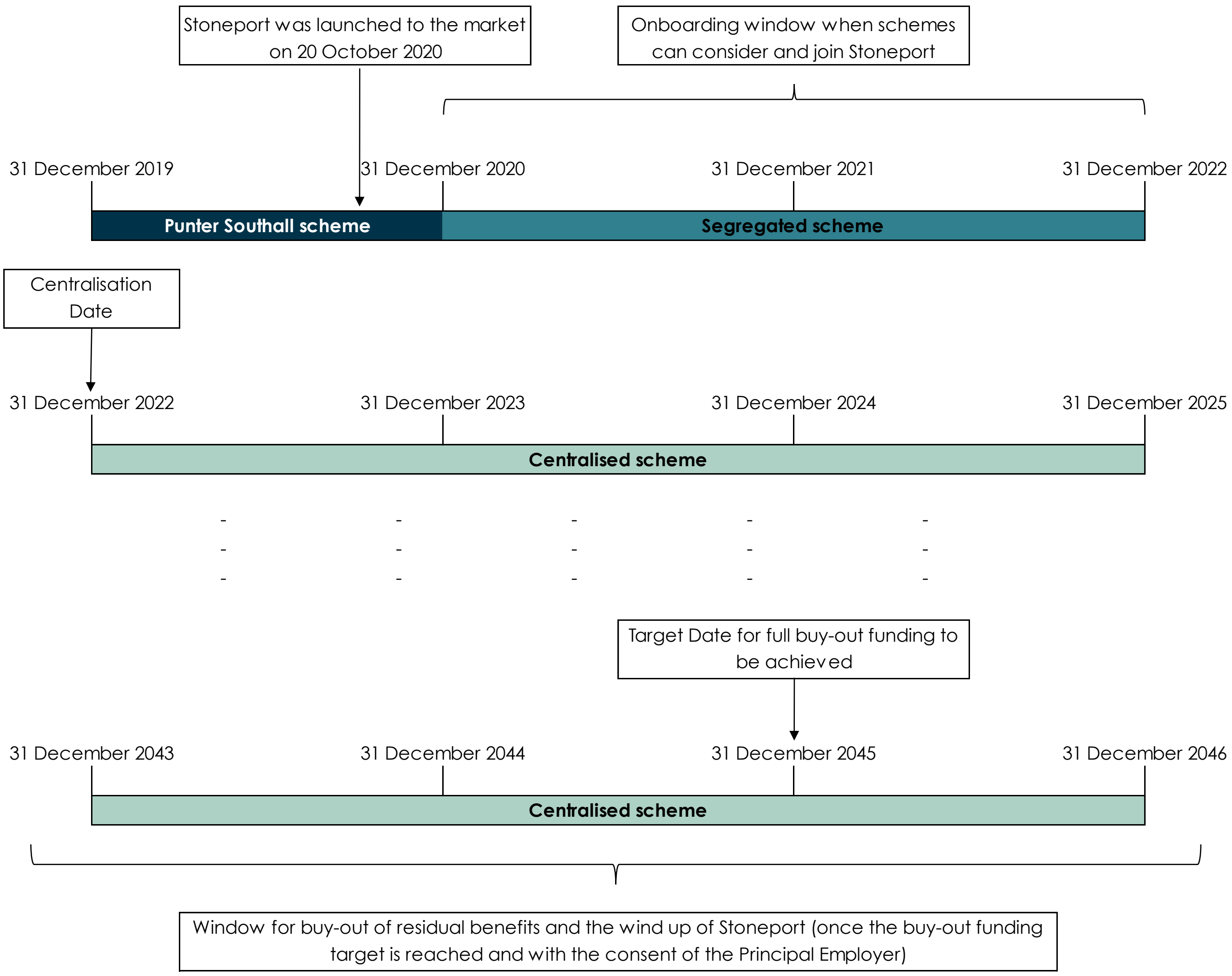
If centralisation is deferred, SPML will continue to promote Stoneport, with the aim of centralising as soon as sufficient scale had been reached.

The TD&R require employers to target full funding of Stoneport on a buy-out basis by the Target Date of 31 December 2045.

If and when full funding has been achieved on this measure, whether that is before or after the Target Date, the Trustees will be expected, but not required, to seek the consent of the principal employer to secure the then remaining benefits in full with an insurance company, before winding-up Stoneport. If no further contributions are required from the employers in order to execute a full buy-out, we see no reason why the principal employer's consent would not be forthcoming.

If the buy-out funding target became too onerous for the employers based on the original Target Date of 31 December 2045, the Trustees could defer the Target Date and with it, the point at which full buy-out funding is targeted, again with the consent of the principal employer.

The chart on the next page shows the key dates in the development of Stoneport during its intended 25-year lifetime, the target being to reach full funding on a buy-out basis by 31 December 2045 before securing all remaining benefits in full with an insurance company and winding-up the structure:



Stoneport was launched to the market on 20 October 2020
Onboarding window when schemes can consider and join Stoneport
31 December 2019
31 December 2020
31 December 2021
31 December 2022
Punter Southall scheme
Segregated scheme
Centralisation Date
31 December 2022
31 December 2023
31 December 2024
31 December 2025
Centralised scheme
Target Date for full buy-out funding to be achieved
31 December 2043
31 December 2044
31 December 2045
31 December 2046
Centralised scheme
Window for buy-out of residual benefits and the wind up of Stoneport (once the buy-out funding target is reached and with the consent of the Principal Employer)

3. The operation of Stoneport before centralisation

In the period before centralisation, Stoneport will operate on a fully sectionalised basis, with each employer responsible only (and solely) for the liabilities in its section, exactly like a DB master trust.

To enable schemes to join, a new ringfenced section of Stoneport will be created for each one.

In the unlikely event of an employer's insolvency prior to centralisation, the Trustees would wind-up the relevant section of Stoneport. Employers are not exposed to the risk of the insolvency of other employers prior to centralisation.

3.1. Investment strategy

In line with standard market practice, Stoneport will operate a separate Matching Fund and Investment Fund. The Matching Fund is designed to broadly align with the investment strategy adopted by UK insurers for backing bulk annuity business. The Investment Fund is designed to provide a return that is significantly in excess of the return on the Matching Fund.

At the point a scheme transfers to Stoneport, its assets will be immediately allocated to the Matching Fund and the Investment Fund in the agreed proportions for joining (rather than waiting until centralisation).

The investment strategy of Stoneport, both initially and after centralisation, is discussed further in the fifth guide in this series.

3.2. Funding strategy

Before a scheme joins Stoneport, it will be required to agree a funding and investment plan which sets out the contributions the employer will pay and the allocation between the Matching Fund and the Investment Fund both initially and through time in order to meet Stoneport's shared funding target.

It is anticipated that most employer will be able to continue to pay the same level of contributions they were paying under their existing schedule of contributions prior to joining Stoneport. This is expected to be possible and moreover, reasonable, as to join Stoneport, employers will have to demonstrate that their covenant can support the obligations they will transfer and also, that they could handle an immediate, material shock to their scheme's financial position.

The funding strategy of Stoneport, both initially and after centralisation, is discussed further in the fifth guide in this series.

3.3. Actuarial valuations

Each new section created in Stoneport will trigger a requirement for that section to carry out a statutory funding valuation with an effective date no later than 12 months from its establishment.

Any valuation carried out on a sectionalised basis will have regard to the covenant support provided by and the investment strategy of the individual employer. It would also be based on the members that each employer transferred into Stoneport.

For schemes that join Stoneport during 2021 (in terms of the date when their new section is created), the Trustees will carry out a formal actuarial valuation for all such sections in bulk, with an effective date of 31 December 2021.

For schemes that join Stoneport during 2022, the requirement to carry out a statutory valuation within 12 months would be met by the statutory funding valuation which will be carried out at the Centralisation Date of 31 December 2022.

Further details of the valuation process, both initially and after centralisation, can be found in the fifth guide in this series.

4. The centralisation process

In this section we explain the process for centralisation. We also set out further information on the decision process around centralisation, which will take place on 31 December 2022 if it is not deferred. In section 6 we cover in more detail the operation of Stoneport if centralisation is deferred for an indefinite period, as a result of it not having reached sufficient scale, in terms of the number and mix of employers.

4.1. Centralisation

The TD&R of Stoneport contain a provision for its centralisation on 31 December 2022. Schemes wishing to join Stoneport will be required to do so before this date.

As 31 December 2022 approaches, we will perform the Combined Covenant Test and provide advice to the principal employer on whether Stoneport should, as expected, centralise on that date, or if the Centralisation Date should be deferred. The principal employer will have the power to defer the date that Stoneport is centralised, subject to a vote of the employers (who will all be members of the principal employer and have equal voting rights).

We would only expect to recommend deferral of the Centralisation Date if the Combined Covenant Test was not met, i.e. sufficient scale had not been reached in Stoneport by 31 December 2022, in terms of the number and mix of employers that had already joined.

4.2. Deferral of centralisation

The principal employer has the power to vary the date that Stoneport is centralised, subject to a vote of the employers. The Centralisation Date will only be deferred if sufficient scale had not been reached in Stoneport by 31 December 2022, in terms of the number and mix of employers that had already joined.

If centralisation is deferred, we will continue to promote Stoneport, with the aim of centralising Stoneport as soon as sufficient scale is reached.

4.3. Excluding a weak employer

Shortly before centralisation, we will reassess the covenant of each of the employers. In extremis, an employer that has become significantly weaker since joining Stoneport, such that it would now fail the entry requirements, may be excluded from the centralisation process. The schemes of any employers excluded from the centralisation process would continue to participate in Stoneport but on a sectionalised basis, separate from the centralised schemes.

4.4. Allocating liabilities

A formal actuarial valuation of Stoneport will be carried out with an effective date of the Centralisation Date. The Centralisation Date valuation will be used to notionally (and fairly) allocate the liabilities of Stoneport as a whole to each of the employers (or the liabilities across all the sections included in centralisation, across the relevant employers, should any employers be excluded from centralisation). Further details are provided in the sixth guide in this series.

4.5. Crystallisation of any necessary benefit changes

Stoneport has been set-up to mirror the benefits members have built-up in their own schemes, reflecting that those choices were made, at least originally, for a reason. It also recognises that the greatest cost savings are achieved through harmonisation of services, not harmonisation of benefits. Whilst comprehensive benefit simplification is not a feature of Stoneport, some smaller changes are needed for ease of administration and for fairness to employers under our liability pooling mechanism. These are discussed in the eighth and final guide in this series.

At the point of centralisation, any changes necessary will come into effect. The trustees and employer of the schemes that join will need to agree to any such changes coming into effect on centralisation before they are admitted.

4.6. Implementation of Stoneport's member option terms

For ease of administration and for fairness to employers under our liability pooling mechanism, Stoneport operates a single policy for setting member option terms, which will be applied across all members upon centralisation.

The rationale for this single approach and what it means for schemes that join Stoneport is discussed in the fifth guide in this series. Stoneport's current member option terms can be found in the Statement of Actuarial Factor Policy on our website.

5. Operation of Stoneport as a centralised scheme

The purpose of Stoneport is to bring schemes together to operate as one larger, stronger, centralised scheme.

The remaining guides in this series focus primarily on its operation after it has become a centralised scheme and the benefits arising as a result of that.

For the purpose of this guide on the operational framework of Stoneport, it suffices to note these points.

6. Continuing as a DB master trust

In the event that the Centralisation Date is deferred from 31 December 2022 as Stoneport has failed to reach the necessary scale to centralise, it will continue to operate on a fully sectionalised basis. The next step depends on what has happened by the original date for centralisation, particularly in terms of the number and mix of employers who have joined Stoneport. This is considered further below.

6.1. Continue to promote Stoneport until centralisation is possible

The Combined Covenant Test has no fixed trigger point where we define the number of employers required for scale to be reached. This is because the number of employers required to provide the appropriate covenant diversification to Stoneport will depend on the distribution of the risks across the employers and also, to some degree, the quality of the individual employers' covenants.

We also set no time limit for reaching scale, as we want to ensure there is sufficient time for all the smaller defined benefit schemes that might benefit from joining Stoneport to have considered it and it is hard to predict in advance how long this might take. It would be undesirable for employers who have already joined Stoneport to have the door closed to the possibility of ever reaching scale too early. For these reasons, the Principal Employer will have the power under the rules to defer the Centralisation Date.

Under the terms of our management contract with the Trustees, SPML is required to inform the Trustees if we reach the point where, after every effort had been taken to promote Stoneport, we no longer believe Stoneport is going to reach scale.

6.2. Cease promotion Stoneport and remain a DB master trust

If SPML were to make the commercial decide not to continue promoting Stoneport, the Trustees could appoint a third party to take on that role. Alternatively, the Trustees could take the decision to cease the promotion of Stoneport and remain as a DB master trust. The Trustees would notify existing employers that have already joined Stoneport were this to happen.

The Trustees would then need advice on the continued suitability of the funding and investment approach adopted by Stoneport. However, we would not expect the Trustees to need to make any immediate changes to the way that Stoneport's assets are invested, or the way the liabilities are being funded. Instead, we would expect the Trustees to wait until the next formal actuarial valuation fell due, unless they considered the existing approach presented an unacceptable risk to the security of members' benefits.

Any formal actuarial valuations of Stoneport would need to be undertaken on a sectionalised basis, having regard to the covenant support provided by and the investment and funding strategy of the individual employer. It would also be based on the members that each employer transferred into Stoneport (as centralisation would not have occurred).

The failure to reach scale would not affect members' benefits in any way: they would be unchanged. Any discretionary benefits and awards due to be crystallised into the members' benefits on centralisation would never come into effect. Instead, the original discretions would continue to exist. Furthermore, each scheme's member option terms would continue to apply, with Stoneport's methodology never having been adopted.

In the event of the insolvency of an employer, the Trustees would calculate the debt on the employer under section 75 and wind-up the relevant section of Stoneport. As Stoneport would never have been centralised, there would be no cross guarantee of the liabilities and the section would be assessed for PPF entry on a ring-fenced basis.

7. The regulation of Stoneport

Stoneport will operate within the current regulatory framework for occupational defined benefit pension schemes. In particular, it will be regulated by tPR and eligible for the PPF.

In this section we explain why that is and why we believe the DWP, tPR and the PPF should all be supportive of Stoneport.

7.1. Department for Work and Pensions

The DWP have produced both a Green Paper and a public consultation document which provide insight into their thinking around consolidation.

In the Green Paper, published on 20 February 2017 entitled *"Security and Sustainability in Defined Benefit Pension Schemes"*, the DWP identified the smaller end of the market as being the place where consolidation could provide the greatest benefit. For example, paragraph 350 stated:

"This evidence and analysis is well recognised and has led many stakeholders to argue that small schemes should be encouraged to merge or aggregate into one or more consolidation vehicles. Such a move would not only reduce running costs and be likely to improve governance but would also reduce the considerable administrative burden on small employers of managing their own pension scheme."

Stoneport has been designed specifically with smaller schemes in mind, which is one of the reasons its development was welcomed by the DWP.

In the DWP consultation, entitled *"Consolidation of defined benefit pension schemes"*, published on 7 December 2018, the characteristics of a "superfund" were defined as follows:

- a superfund is, or contains, an occupational pension scheme set up for the purposes of effecting consolidation of DB pension schemes' liabilities;
- a transferring scheme's link to a ceding employer is severed on transfer to the superfund;
- the 'covenant' is a capital buffer provided through external investment that sits within the superfund structure; and
- there is a mechanism to enable returns to be payable to persons other than members or service providers.

Stoneport is not a superfund and will not be subject to the new regulations or authorisation regime that the DWP are looking to introduce for such vehicles. Indeed, Stoneport has just one of the four characteristics of a superfund, as shown in the table below:

Characteristics of a superfund	**Stoneport**
Contains an occupational pension scheme	✓
Link to a ceding employer is severed	✗
Covenant is a capital buffer	✗
Returns payable to investors	✗

In paragraph 92 of the Green Paper, the DWP state "The critical risk to members (and the PPF) is, therefore, insolvency of the sponsoring employer(s) at any point when the scheme is underfunded." The DWP recognise the binary nature of member outcomes under the current regulatory regime. Stoneport largely remove this key risk.

The DWP consultation set out views on the governance arrangements that should apply to superfunds. Whilst Stoneport is not a superfund, we aim to meet all of the relevant standards of governance, including the following:

- **Fit and proper persons** – the test would apply to all those whose actions have the potential to impact member outcomes, meaning the Trustees, the directors of SPML, the director of the principal employer and the directors of Punter Southall.

- **Governance** – the corporate board should have plans to monitor and manage any conflicts of interest, whilst the trustee board should consist entirely of independent trustees.

- **Systems and processes** – robust administrative systems and governance processes in place to assess and control risk, to protect member data and monitor delivery against service level agreements.

We have kept the DWP fully informed of the development of Stoneport from its earliest days and provided them with a full briefing on the final product specification.

7.2. The Pensions Regulator

Our aim for Stoneport is to consolidate at least 100 smaller occupational defined benefit pension schemes. Each of the joining schemes are currently regulated by tPR. Stoneport will also be regulated by tPR and be subject to all the same regulations and guidance as any other occupational defined benefit pension scheme.

We believe that tPR view Stoneport in a positive light, recognising that Stoneport will assist tPR in meeting all of its statutory objectives to the extent they relate to DB schemes.

- **to protect the benefits of members of occupational pension schemes** - The key risk to the benefits of members of occupational defined benefit pension schemes is the risk of employer insolvency. By pooling employer covenant risk, the risk to members' benefits inside Stoneport will be drastically reduced.

- **to reduce the risk of situations arising which may lead to compensation being payable from the PPF** - Once schemes are transferred to Stoneport, the risk of a PPF assessment being triggered would be very substantially reduced. This is because on the insolvency of an employer, the remaining employers would continue to provide financial support to Stoneport. This reduction in risk is reflected in the risk-based element of the protection levy charged by the PPF to a centralised scheme.

- **in relation to our functions for DB scheme funding only, to minimise any adverse impact on the sustainable growth of an employer** - Employers within Stoneport will be better able to utilise the flexibilities that exist within the scheme funding framework because of the improved employer covenant. This should make it easier for tPR to balance its conflicting objectives of protecting benefits whilst minimising any adverse impact on the sustainable growth of an employer. The reduction in running costs that Stoneport delivers and management time it frees up should both aid the sustainable growth of employers.

- **to promote, and to improve understanding of, the good administration of work-based pension schemes** - We are promoting good administration and good governance generally as one of Stoneport's benefits, its scale and budget being capable of delivering outcomes which are difficult for smaller schemes to achieve.

We briefed tPR on our proposals quite early during the developmental phase of Stoneport and again after the Stoneport proposition had been fully developed.

7.4. The Pension Protection Fund

The PPF has a very limited role in the regulation of defined benefit pension schemes. Perhaps its most significant roles are in setting the protection levy and in entering into compromise agreements with employers.

We note that Stoneport will be eligible for PPF entry and will be treated as a centralised scheme for the purpose of determining the size of the risk-based element of the protection levy. We do not envisage a situation where the employers would seek to enter a compromise agreement.

Like the DWP and tPR, the PPF were briefed early in the design of Stoneport and again once the offering you see today had been fully scoped out.