Technical guide 3: Stoneport's cost savings

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 third guide in the series you will find 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 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.
- The second guide describes 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 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. Introduction

Joining Stoneport should be an obvious choice for employers and trustees alike.

The primary benefit to employers is the reduction in running costs that Stoneport brings. This and the other cost savings which will benefit employers, including lower investment management costs and capturing a good governance premium are the focus of this guide.

Of course, all such savings will benefit scheme members too, as a stronger employer will be better able to support its obligations. Moreover, by removing the management burden, Stoneport will allow employers to refocus on their businesses.

A modeller to help schemes and their advisers quickly gauge the potential reduction in running costs and assess the other cost benefits can be found on our website.

2. Reduced running costs

One of the key benefits to the sponsors of the smaller schemes that join Stoneport is gaining access to the economies of scale that are available to the sponsors of larger schemes, by spreading the fixed costs of running a complex defined benefit pension scheme across a much larger number of members.

When we consider the running costs of a defined benefit pension scheme, we mean all of the costs associated with its operation, with the exception of the costs incurred in managing the scheme's assets, and the various levies that schemes are required to pay, including the protection levy payable to the PPF. Running costs do however include any investment consulting costs that trustees incur, for example when choosing an investment manager or monitoring performance.

When gauging the performance of an investment or an investment manager, it only makes sense to do so after allowing for the cost of making those investments, i.e. to consider returns net of fees. We therefore consider investment management fees separately, and not as part of the running costs. The potential for reduced investment management costs in Stoneport are considered in Section 3 separately from the issue of running costs.

2.1. Stoneport's running costs

The running costs of Stoneport will be far lower than the cost of running the smaller schemes that are eligible to join it. The Trustees have entered into long-term contracts with two firms to provide most of the services they will require to operate Stoneport efficiently and effectively.

Barnett Waddingham will provide administration services plus the actuarial and investment advisory services the Trustees need. Before centralisation, although some standardisation of approach will be possible, each section will in effect be treated like an individual scheme. After centralisation, Barnett Waddingham will be able to treat Stoneport as if it were a large single employer scheme and advise the Trustees accordingly.

SPML will provide the Trustees with covenant review services and act as the interface between the employers and the Trustees, allowing the operation of Stoneport as one combined entity after centralisation.

Most of the fees that Stoneport will incur will be based on a combination of the following:

- the number of members in Stoneport;
- the value of the assets held in Stoneport; and
- the number of employers in Stoneport.

Additional fees may be payable to Barnett Waddingham and SPML in a relatively limited set of circumstances for work which falls outside of an agreed set of core services. Stoneport will also incur other professional fees from time to time, such as legal fees.

The fees agreed with Barnett Waddingham and SPML for these services have been structured to deliver an immediate cost saving on joining, i.e. employers will not have to wait until the Centralisation Date to start benefiting from the saving. The contracts in place with the key service providers provide a high degree of certainty over the future running costs of Stoneport. However, as the running costs can differ greatly between schemes, the extent of the savings that employers will enjoy (both immediately and after the Centralisation Date) will depend on the running costs of their current arrangement.

As well as the services discussed above, SPML is also responsible for promoting Stoneport, engaging with potential customers and their advisers and helping schemes through the joining process. As developer and promotor of the concept, Punter Southall is heavily invested in making Stoneport a success. To align those interests with the employers that join Stoneport, the return on Punter Southall's investment is structured so that SPML receive a share of the cost savings employers achieve.

2.2. Benchmarking running costs

In 2014, tPR published a report containing the results of some research it commissioned on the running costs incurred by private sector occupational defined benefit schemes in 2012 (the "tPR study"). Costs included administration, actuarial, covenant, legal, and investment and were expressed on an average cost per member basis. The tPR study is some years out of date, so we expect running costs to be higher today, but it still serves as a useful reference point for comparing scheme running costs.

The total annual average cost per member of running a defined benefit scheme reported in the tPR study, split by scheme size based on the number of members it has, are set out in the table below:

Number of members	Mean operating cost per member per annum
12 to 99	£1,054
100 to 999	£505
1,000 to 4,999	£281
5,000 or more	£182

TPR's study revealed that the larger the scheme, the lower the running costs and that moreover, the cost of running a large scheme is just a fraction of the cost of running a scheme with fewer than 1,000 members when expressed on a per member basis.

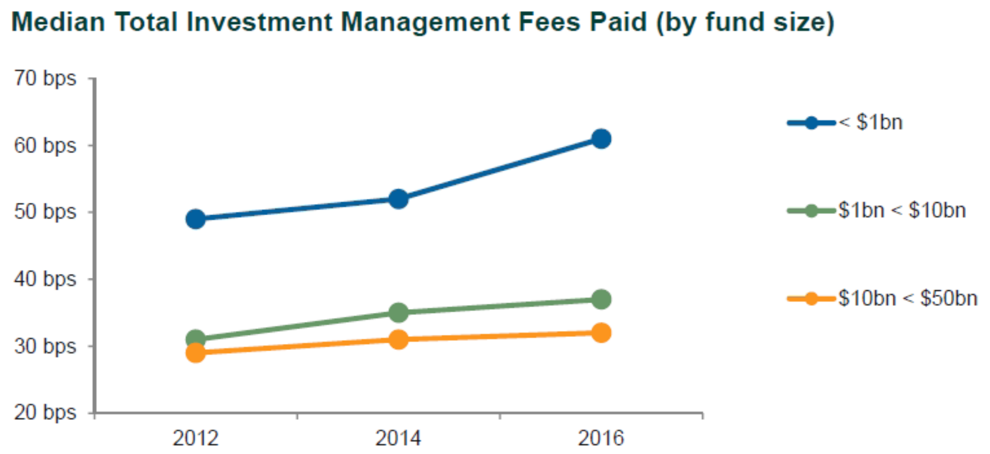
The modeler available on our website, which we urge schemes and their advisers to use to benchmark running costs against Stoneport, is based on the tPR data and supplemented with data in the public domain which we have collected on actual scheme running costs.

3. Lower investment management costs

As well as spending money on advisory costs, schemes have to employ asset managers to run their assets for them. In general, for the same underlying service, better fee terms are available to clients of asset managers with larger pools of assets than those with smaller pools of assets.

These economies of scale in investment management are the primary motivation of the establishment of the Local Government Pension Scheme ("LGPS") pooling arrangements by the UK Government. The UK Government believe, based on the Canadian and Australian experience, that cost efficiency in investment is not fully achieved until a portfolio reaches at least £25 billion. The average LGPS fund currently has around £3 billion of assets and this is therefore considered by the UK Government to be sub-optimal.

Purely as an illustration of the potential cost reductions that can be achieved on asset management fees by increased scale, we can consider some analysis completed for US funds and trusts by the Callan Institute in their 2017 Investment Management Fee Survey (mostly public and private sector defined benefit schemes) which gives a broad indication as follows:



The survey showed that a scheme with assets between £1 billion and £10 billion paid approximately 0.2% per annum less in asset management fees compared to a sub £1 billion scheme.

Smaller scheme joining Stoneport would be likely to make even larger investment management cost savings. For identical investment strategies, Stoneport would likely pay a much lower fee than any of the schemes that it consolidates might be able to achieve individually.

However, investment management costs are heavily driven by asset classes and by the strategy employed by the manager. In particular, more mainstream, passively managed investments are considerably cheaper than more esoteric actively managed investments. As such, a smaller scheme invested solely in index-tracking funds may be spending considerably less in percentage terms on investment managers than a very large scheme with significant investments in illiquid assets and alternatives.

It is therefore difficult to suggest what level of fee saving could be achieved, given that the investment strategy of the schemes being consolidated may be radically different to the more sophisticated investment strategy that Stoneport will follow. For example, smaller scheme may be invested solely in low cost index-tracking funds, with any hedging achieved through a pooled LDI fund. Meanwhile, Stoneport may employ active managers to gain access to certain asset classes in order to maximise the benefits of diversification and hold swaps as part of a more tailored solution to match its liabilities more closely.

However, with the buying power that its scale affords, the savings generated could be significant.

4. Governance boost to returns

Stoneport will be able to deliver higher investment returns by virtue of the fact that it is operates a more diversified asset strategy and a more robust governance framework than any smaller scheme that joins.

Furthermore, as experienced professionals in their field, the Trustees of Stoneport will be able to ensure any additional costs of investment are managed. These may include setting benchmarks that align the interests of the investment managers with the members and the employers that sponsor Stoneport. For example, investment strategies which focus on short-term performance may generate higher costs due to higher portfolio turnover. Such strategies might also fail to exploit fully the illiquidity advantages of pension funds in accessing higher quality assets available in less efficient markets.

As the only two sources of income for a pension scheme are the returns it makes on its investments and the contributions it receives from its sponsor, an increase in investment returns, for no additional risk, can in effect be viewed as a cost saving to the employer.

The Annex to the DWP's consultation entitled *"Protecting Defined Benefit Pension Schemes"* published in March 2018 makes reference to several academic studies which highlight the benefits of good governance. The following sources considered the potential quantum of the impact that good governance has on returns:

- *"Clark G & Unwin R (2008), Best-practice pension fund governance", which concluded "almost all of our best-practice funds had a performance margin of 2 per cent per annum or more over their benchmarks"; and*

- *"Ambachtsheer K, Capelle R, & Lum H (2006) Pension fund governance today: Strengths, weaknesses, and opportunities for improvement", which found that schemes with good standards of governance added 1-2% per annum in investment performance when compared to less-well governed schemes.*

It is therefore reasonable to expect that Stoneport, with professional trustees and a good governance framework, will provide a significant benefit to employers through additional investment returns.

5. Reduction in buy-out cost

Stoneport's buy-out funding target will be significantly less than the sum of the cost of buying out the benefits of each of the individual schemes it brings together. The schemes that join Stoneport will therefore each benefit from reaching their endgame at a lower cost than could be achieved were they to continue to operate on a standalone basis.

The reasons for the cheaper buy-out cost as part of Stoneport when compared to the cost of a buy-out for smaller schemes individually are as follows:

- The scale of the deal, which could be 100 times the size a smaller scheme's buy-out, is likely to attract interest from a greater number of insurers and the competitive tension created is likely to lead to a reduced price.

- The fixed expense loadings applied by insurers will be spread over a larger membership and liability base.

- The assets held by Stoneport will be aligned with the type of assets that an insurer wants to hold and hence can be transferred in-specie rather than incurring the cost and risks associated with realising and reinvesting them.

- Unlike a small scheme, where individual members can be a significant risk and the mortality experience is much less certain or clear, Stoneport has a large and diverse membership, improving pricing terms.

6. Other cost savings for employers

Whilst the anticipated reduction in running costs described earlier in this section is the key benefit to schemes joining Stoneport from an employer's perspective, there are potentially other benefits that will appeal to different employers which we discuss below.

6.1. Reduced management time

Employers will have a direct relationship with SPML, the firm appointed by the Trustees to act as the interface between themselves and the individual employers. SPML will provide employers with all the required information on Stoneport and liaise with them about any issues, specifically, in relation to their own liability to Stoneport. The employers will not have to engage with the Trustees. Where they wish to engage with the Trustees on the overall strategy of Stoneport, they may do so through the principal employer.

The proposed structure will therefore result in a significant reduction in the amount of management time spent dealing with pension matters for most schemes. The management time devoted to running a smaller scheme can be significant. Furthermore, spikes of activity can occur if any major projects are undertaken, for example to actively manage the scheme's liabilities, or if there is any corporate activity which materially alters the covenant afforded to the scheme. Time spent dealing with such matters, as well as the regular tasks such as negotiating valuations with the trustees, changing the investment strategy or amending the member option terms can place a significant burden on an employer's management team.

By way of illustration, if a transfer to Stoneport were to free up one day a month of a senior employee's time and assuming that employee earns a basic salary of £150,000, the capital value of that saving would be approximately £0.5 million over the lifetime of Stoneport (discounting future costs at the same rate as future salary increases and assuming the cost of employing the senior employee, taking into account the cost of the infrastructure of employing that person and their full benefits package and national insurance costs, is twice their basic salary).

For those employers which also have employees acting as trustees to their schemes, which will likely be the case for the majority of smaller schemes, the value of the time saving is likely to be considerably higher.

6.2. Reduced advisory fees

In the extensive experience of the SPML team acting in an employer advisory capacity, sponsors of smaller schemes that operate on a standalone basis tend to spend far more on advice than employers with similar sized liabilities that are part of a larger industry-wide or centralised scheme.

We would therefore expect employers in Stoneport to feel able to spend less on advisers than they do currently given the very high governance standards to which Stoneport will operate.