Technical guide 5: Funding and Investment

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 fifth guide in the series, you will find details of 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.

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.

- Guide three details the cost savings that Stoneport will bring to the schemes that join. It also considers the potential impact of employer insolvencies and 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.

- 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

Stoneport's aim is to be fully funded on a buy-out basis by the end of 2045, with the assets then fully invested in a strategy mirroring how insurers invest. Stoneport has been structured to give employers the flexibility they need to tailor their approaches to reaching its joint funding goal.

In this guide we describe the funding and investment approach of Stoneport in some detail, including how Stoneport will meet the new legislative requirements being introduced by the Pensions Schemes Bill and the regulatory requirements arising from the new code of practice on scheme funding.

We also consider the practicalities of carrying out actuarial valuations, what happens if after securing all the benefits there is a surplus and describe the provisions for employers to exit Stoneport should that ever become necessary.

2. Stoneport's investment strategy

2.1. Overview

Stoneport has a requirement under the TD&R for separate allocations to a Matching Fund and an Investment Fund. We believe that most schemes looking to join Stoneport will already notionally split their assets in a similar way, in line with standard market practice.

The Matching Fund is designed to align with the investment strategy adopted by UK insurers to back their bulk annuity business. The Investment Fund is designed to provide a return of between 2% and 5% per annum in excess of the return on the Matching Fund.

In addition, the Trustees have the ability to operate a Derivatives Overlay that can be used to hedge any interest rate or inflation risks not covered by the Matching Fund or the Investment Fund. Our current expectations are that the Trustees will hedge most, if not all, of the uncovered interest rate and inflation risks.

The employers will set the strategic allocation between the Matching Fund and the Investment Fund on an individual basis, with the aggregate allocation being just a weighted average of the individual allocations, subject to the comments made in section 2.2.

The Trustees are responsible for determining the composition of both the Matching Fund and the Investment Fund (as well the make-up of any Derivative Overlay) and for selecting third party investment managers to implement their decisions. The Trustees have appointed Barnett Waddingham to provide the investment advice they need to carry out this function.

As more employers join and the scale of Stoneport builds, the Trustees will be able to adopt a more sophisticated investment approach in both the Matching Fund and the Investment Fund. Whilst the level of complexity and detail in the investment approach will develop through time, the simple overarching framework of the two funds (the Matching Fund and the Investment Fund) will remain at its core.

The Statement of Investment Principles ("SIP") is available to the trustees and employers of schemes looking to join Stoneport and can be found on the Stoneport website.

2.2. Setting the strategic allocation

Each employer will have to agree a proposed split of assets between the Matching Fund and the Investment Fund, in terms of the desired amount of investment risk both initially on joining Stoneport and through time.

Alongside the agreed investment strategy, employers will agree a contribution schedule for the preferred level and length of cash contributions to reach the target to be fully funded on a buy-out basis by the Target Date, given their investment strategy.

As part of the entry process, SPML will ensure that each employer's proposed investment allocations are appropriate, having regard in particular to the level of covenant support they provide.

The overall investment strategy for Stoneport will simply be a weighted average across all the employers' asset allocations.

However, the Trustees are ultimately responsible for setting the investment strategy of Stoneport. Were the Trustees to consider the aggregate level of risk across Stoneport to be unacceptably high, they could amend the overall allocation between the Matching Fund and the Investment Fund. In particular, the Trustees would be able to set a more conservative strategy, reducing the aggregate exposure to the Investment Fund from the level implied by an aggregation of the individual employers' requests. This would be implemented on a practical basis by SPML, scaling down each of the employers' requested allocations to the Investment Fund in a proportionate manner. In practice, we consider this is a highly unlikely scenario, as the covenant of Stoneport as a whole will be far stronger than the covenant of the individual employers.

2.3. Composition of the Matching Fund

The Trustees currently invest the Matching Fund in a mixture of pooled LDI funds and an index-linked gilt fund. Interest rate risk and inflation risk are hedged through the investments in the pooled LDI funds.

This approach is expected to be retained whilst Stoneport is being operated on a segregated basis, albeit that the number of LDI funds available is likely to be increased to provide a wider range of 'buckets' of differing durations to allow the liabilities of each segregated section to be more closely matched.

On centralisation, the hedging initially established on a pooled fund approach, will be collapsed into a single segregated portfolio. This portfolio will then be refined to most accurately match the overall liabilities of Stoneport.

2.4. Composition of the Investment Fund

The Investment Fund is currently invested on a discretionary fund management basis.

The new monies coming into Stoneport as employers join (i.e. before centralisation) will flow to progressively enrich the diversification in the Investment Fund. The focus initially will be on increasing the range of asset classes used, before then adding more specialist mandates, and a wider mix of different management styles. As the Investment Fund moves from a dynamic asset approach to one more focused on specialist mandates, a tactical asset allocation is expected to be layered back in, to sustain the rotational element.

3. Stoneport's funding strategy

We start by explaining how the statutory funding regime is expected to apply, noting Stoneport's ultimate aim to be fully funded on a buy-out basis by the Target Date of 31 December 2045 and in the context of the contribution rule in Stoneport's TD&R to achieve that goal.

Employers will be provided with as much flexibility as is possible, in terms of the degree of choice available to them for determining how individually, to reach full funding on a buy-out measure by the Target Date. In doing so, appropriate regard will be had to their respective covenant strengths and the implications of their approach, given the need to ensure any individual choices do not result in undue or inappropriate risk for the other employers or Stoneport as a whole.

The funding strategy of Stoneport has a number of interrelated elements that are explained in turn below, driven by the statutory funding framework as well as the requirements set out in the TD&R of Stoneport for the level of contributions required from each employer both before and after centralisation.

3.1. Statutory funding and regulatory framework

In designing an appropriate framework for the funding of Stoneport and the associated investment of its assets, the Trustees had regard to the code of practice on funding defined benefits (the "Code") published by tPR as well as the relevant regulations.

There is currently some uncertainty as to what the future regulatory framework for scheme funding will look like. The Pension Schemes Bill (the "Bill") is currently making its way through parliament. Meanwhile, tPR is in the process of drafting a new version of the Code.

The Bill sets out provisions for a new requirement for trustees to set a "funding and investment strategy" (or "FIS") to ensure pension and other scheme benefits can be provided over the long-term. This strategy must specify both the funding level the trustees intend the scheme to have achieved on the relevant date (or dates) under legislation and the investments the trustees intend the scheme to hold at that time. Furthermore, technical provisions must be set consistent with the overall funding and investment strategy.

The first of two consultations on the new Code (on the regulatory approach and the principles underpinning the new framework) took place between February and September 2020. The second consultation on the new draft Code itself is currently expected to take place later in 2020, before it comes into force in 2021. We note that TPR refer to the new requirements set out in the Bill for schemes to have a FIS as a Long-Term Obligation ("LTO").

Stoneport's funding strategy was set before the first consultation on the new Code was complete (and moreover, the second consultation on the new draft Code and the new Code coming into effect) and before the enactment of the Bill. The funding approach that has been set for Stoneport is anticipated, as far as possible, to meet these new requirements.

We stand ready to modify certain aspects of the funding approach, if necessary, in order to comply with any new requirements once they come into effect. Our approach however is framed in the context of the broad expectations with sufficient flexibility and conservatism in approach to hopefully avoid the need for any material changes.

We note that all defined benefit pension schemes will want to have regard to and will ultimately have to comply with the new Bill and Code that come into force. A significant advantage for pension schemes looking to join Stoneport would be that they would not have to consider the new requirements and make the necessary changes to their funding and investment approach individually, which is likely to be quite a costly exercise for many of them.

3.2. Applying the Bill in the context of the Code

Using the language of the Bill, Stoneport's FIS will be to achieve the following by the Target Date of 31 December 2045:

- A fully de-risked investment strategy i.e. to have a 100% allocation to the Matching Fund.

- Full funding on a low-risk basis, reflecting the 100% allocation to the Matching Fund.

We believe that this proposed FIS for Stoneport is consistent with tPR's own interpretation and language of LTOs, albeit we cannot know exactly where the consultation process on the new Code will lead. Our view is informed by a presentation from tPR we attended in November 2019 at the Autumn Pensions seminar run by the Institute and Faculty of Actuaries ("IFoA"), where tPR provided some insight into its views on how an LTO should be set. Notably, tPR:

- Described the LTO as "low dependency funding" which should be targeted to be achieved on or before a scheme reached "significant maturity". For the average scheme this was indicated to be perhaps 15-20 years in the future.

- Indicated that the LTO would be less onerous than buy-out. Slide 17 in the Annex to tPR's presentation further indicated an expectation that the LTO would be set below the cost of moving to a commercial consolidator. Based on the indicative ranges of the two commercial consolidators currently operating in the market, their price is equivalent to approximately 90% of the cost of a buy-out.

- Noted that the new regime will allow schemes to follow either a "fast track" or a "bespoke" approach: pension schemes operating within certain parameters will be subjected to limited scrutiny, whilst those that wish to operate outside of those parameters will be subject to greater regulatory oversight and be required to evidence their decisions for why their bespoke approach is reasonable and appropriate.

- Alluded to what the industry could expect in terms of its future guidance on setting an LTO and scheme funding more generally.

The 25-year time horizon proposed for Stoneport to reach its LTO, namely of being fully funded on a low-risk basis by the Target Date of 31 December 2045, is longer than the 15-20 years that tPR indicated might be appropriate for the average scheme. Stoneport will however have a far stronger covenant than almost any scheme operating on a standalone basis and therefore, we would expect this to be acceptable to tPR.

Where possible, we will try and ensure that Stoneport meets tPR's "fast track" requirements. However, as Stoneport has a different structure and approach to most other schemes, we may decide that in certain areas it is not possible or desirable to fit in with the particular requirements of the fast track approach. In these circumstances we would ensure we have a robust explanation for our bespoke approach.

It is important to note that the envisaged FIS of Stoneport, or equivalently, in the language of tPR its LTO, is framed as reaching full funding by the Target Date on a low-risk basis, not full funding on a buy-out basis. Whilst the ultimate aim *is* to reach full funding on a buy-out basis, again by the Target Date, this is codified into the employers' and Stoneport's approach through the employer contribution rule set out the TD&R and not through application of the statutory funding regime and associated regulatory framework.

Furthermore, whilst the FIS will be set for Stoneport as a whole, consistent with the comingled nature of its assets and liabilities and the covenant supporting it, the employers' strategies for achieving full funding on a buy-out basis by the Target Date will be set individually. In the subsections below we explain how this will operate, as well as providing further commentary on tPR's approach and how Stoneport's technical provisions are expected to be determined.

3.3. Employer contributions under the TD&R

Separate to the anticipated requirement to agree a FIS (under the Bill) or equivalently, an LTO (under the new Code, to be consulted on), each employer in Stoneport will have to comply with the employer contribution requirements set out in the TD&R. In particular, each employer must agree a Funding and Investment Plan ("FIP") which targets full funding on a buy-out basis, with a 100% allocation to the Matching Fund, by the Target Date of 31 December 2045.

The FIP must document the allocation between the Matching Fund and the Investment Fund both initially (when set as part of the entry process) and through time, and the contributions payable by the employer in order to meet the funding target by the Target Date. The FIP will include a legally binding schedule of contributions.

3.3.1. Flexibilities

In agreeing a FIP, and/or revising one as part of a future actuarial valuation or otherwise, employers will have a considerable degree of flexibility. In particular, employers will have flexibility as to how they set the following:

- The level of investment risk, by choosing the allocation between the Matching Fund and the Investment Fund.

- The period over which the investment strategy is de-risked, and the shape of the de-risking journey e.g. is it in a straight line or stepped and over what period.

- The level of contributions and the length of the period over which they are paid, as well as the profile of those contributions.

The flexibilities afforded to each employer will always be subject to their ability to support the risks they are underwriting, such that they do not create any undue risks for other employers.

3.3.2. Pre-centralisation

The first FIP will be agreed between the employer and the Trustees as a condition of entry to Stoneport. It is anticipated that in most cases, employers will be able to maintain the contributions in force prior to joining Stoneport when agreeing their first FIP. This is expected to be possible and moreover, reasonable, as to join Stoneport, employers will have to demonstrate not only that their covenant can support the obligations they will transfer but also allowing for any potential for adverse deviation that could be reasonably expected to occur post centralisation.

The contributions of employers would not then be reviewed until their first formal actuarial valuation as part of Stoneport. When this occurs will depend on when they joined Stoneport and whether or not centralisation occurs as expected on 31 December 2022. The first review would either occur when the formal valuation of Stoneport as a whole is carried out at the Centralisation Date, or as part of a bulk exercise proposed as at 31 December 2021.

The new FIPs agreed as part of the 31 December 2021 valuation will be set having regard to the terms upon which the employer was originally admitted to Stoneport. Specifically, each employer will have agreed a proposed split of assets between the Matching Fund and the Investment Fund both on joining and through time, as well as a profile for the preferred level and length of cash contributions to be paid in order to reach full funding on a buy-out basis by the Target Date.

3.3.3. Post-centralisation

FIPs agreed subsequently, as part of a future actuarial valuation or otherwise, will be set having regard to the FIP already in force for that employer at the time.

3.3.4. Operational envelope

To ensure the risks remain within acceptable levels, both for Stoneport as a whole and in relation to individual employers, limits will be set on the amount of investment and funding risk that can be taken in determining each employer's FIP. The level of flexibility granted to any employer will depend on their ability to robustly demonstrate adequate covenant support, including the use of contingent assets where appropriate, for the risks presented by their proposed approach.

The bounds relating to an individual employer will be set to limit the risk that the chosen FIP presents to other employers given the pooling of covenant risks post centralisation. The bounds on the overall level of risk across Stoneport as a whole will be set having regard to the aggregate employer covenant provided, to limit the risk that Stoneport becomes unsustainable.

SPML will advise the Trustees on the appropriate framework within which individual employers will be permitted to operate, whilst ensuring that the aggregate position is also appropriate having regard to the level of covenant support available to Stoneport as a whole and the risks presented to it.

The flexibilities will allow employers the ability to set the pace at which they choose to fund their share of Stoneport's liabilities. We consider this to be an important feature of the proposed design of Stoneport. Without it the employers of schemes that are currently a long way off full funding on a buy-out basis might be required to significantly increase their cash contributions on joining.

By utilising these flexibilities, we anticipate that the majority of employers will be able to pay the same level of contributions to Stoneport as they were paying immediately before joining it (and possibly less). For some employers, this may mean committing to contributing for longer and to paying more contributions in aggregate over the duration of the FIP agreed with the Trustees of Stoneport.

Whilst this may be a concern for some employers, we do not consider it to be an insurmountable problem for the majority, given the material benefits from joining Stoneport, most notably, the significant reduction in running costs. Employers may in any case face an unavoidable increase in their contributions once the Bill and a new Code come into force if, as expected, all schemes are required to implement a FIS or LTO targeting full funding on a low-risk basis.

3.4. Stoneport's technical provisions

Whilst sectionalised, any statutory funding valuations that are carried out will be completed at the level of individual employers, with regard to the covenant and investment strategy of each specific employer. Once centralised, the technical provisions will be set for Stoneport as a whole on the basis of the aggregate covenant and investment strategy.

Once centralised, the aggregate covenant provided to Stoneport will comprise the direct support by each of the employers, as well as contingent assets that have been provided by them (if any). Given the requirement for there to be a sufficiently strong and diverse pool of employers before centralisation can occur, the overall covenant of Stoneport is almost certain to be assessed as "strong" or CG1 on tPR's broad covenant scale, given its centralised nature.

The technical provisions of Stoneport and by implication, each employer within it, can therefore be set at a lower level post centralisation than was justifiable before, due to the increase in covenant strength provided by a sufficiently strong and diverse employer base when compared to the pre-centralisation position of sole reliance on a single employer for each section.

Stoneport's technical provisions will be set to be consistent with its FIS of achieving full funding on a low-risk basis by 31 December 2045, at which point the investments would be 100% allocated to the Matching Fund. Given the strength of covenant provided to Stoneport, particularly the ability to withstand adverse deviation from its diversified nature and the greater covenant certainty in the longer-term, it would be reasonable to incorporate a lower degree of prudence into the technical provisions than would otherwise be the case.

The technical provisions basis will be set by the Trustees. Noting the above, they may consider it appropriate to project Stoneport's future benefit cashflows, and to discount those cashflows, using best-estimate or close to best-estimate assumptions.

As the FIP each employer will have to agree with the Trustees is based on their individual investment and funding choices to reach the aim of being fully funded on a buy-out basis by the Target Date, whereas the technical provisions are set for Stoneport as a whole to achieve full funding on a low-risk basis by the Target Date, the FIP is expected to drive employers' cash contributions rather than the technical provisions basis.

4. Timing of the next valuation

A formal actuarial valuation of Stoneport was carried out as at 31 December 2019. The 2019 valuation took into account the changes made to the TD&R of Stoneport which came into effect on 30 September 2020 and in particular, the changes made to the contribution rule which requires targeting full funding to a buy-out basis by 31 December 2045.

The next statutory funding valuation of Stoneport falls due on 31 December 2022.

To provide additional clarity and certainty to employers, trustees and advisers of schemes considering joining Stoneport, the Statement of Funding Principles is available on the Stoneport website.

Statutory funding valuations of the schemes of all employers joining Stoneport during the 2021 calendar year would be carried out in bulk with a single effective date of 31 December 2021. For pension schemes that join Stoneport during the 2022 calendar year, their first statutory funding valuation will be carried out at Centralisation Date, 31 December 2022.

Carrying out the necessary valuation for each new section as part of a bulk exercise for all sections created during 2021 will create significant efficiencies compared with carrying out valuations for each section at their individual dates of entry.

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.

If the Centralisation Date is deferred, the statutory funding valuation of the single section covered by the 2019 valuation and the sections created for schemes joining Stoneport during 2022 would still be completed in bulk at 31 December 2022, to satisfy the requirement for the effective date to fall within 12 months of those sections being created. The first valuation of Stoneport as a whole would then be deferred until the eventual date of centralisation.

5. Valuation process

There are two interrelated but ultimately separate (other than in their timing) actuarial valuation processes covered in this section, both valuations being carried out at the same time at each periodic assessment of the financial position of Stoneport and its employers:

- First is the statutory funding valuation and associated regulatory framework. This requires the Trustees to set appropriate technical provisions for Stoneport and comply with tPR guidance, including the current to be revised Code, and the new Bill which is going through Parliament. Post centralisation, these valuations will be carried out for Stoneport as a whole, based on the overall investment strategy and the overall covenant provided to it, on advice from the Scheme Actuary.

- Second is the valuation required to agree the FIP of each employer which sets out in particular the cash contributions they will pay under the employer contribution clause of Stoneport. At each actuarial valuation it will be necessary to reassess and agree the revised and updated cash contribution requirements for each employer. Again, post centralisation the liabilities will be calculated for Stoneport as a whole. SPML will then advise the Trustees to ultimately agree each employer's FIP.

The FIPs agreed by each employer will be separate from and in addition to the requirement to meet the SFO, or to comply with the FIS or LTO. Whilst the SFO and the FIS or LTO will be set for Stoneport as a whole, consistent with the comingled nature of its assets and liabilities and the covenant supporting it, each employer's FIP for achieving full funding on a buy-out basis by the Target Date will be set individually.

5.1. Reviewing the method and assumptions

Once Stoneport centralises, its circumstances are expected to change materially, as the legal change will result in a radical improvement in the strength of the employer covenant and with it a material strengthening of each member's benefit security. It is expected therefore that there would be a change in approach to the statutory funding valuation once centralisation has occurred.

More generally, under current funding regulations, the Trustees would need to review the technical provisions adopted for the last statutory funding valuation of Stoneport in light of any changes to the legal, demographic or economic circumstances. The method and assumptions upon which the funding and investment strategy of Stoneport are based would be reviewed at the same time. A similar approach would be undertaken for the assumptions used to determine the overall liabilities of the Scheme for setting the FIPs.

Once Stoneport has centralised and carried out the first valuation, we would not expect a material strengthening or weakening of the overall employer covenant between valuation cycles. We will however carry out a covenant assessment on behalf of the Trustees as part of each valuation, on the covenant of Stoneport as a whole, for informing the approach to the statutory funding valuation. Within this we would provide commentary, as and where appropriate, on the covenant considerations of individual employers. Primarily this would be to confirm to the Trustees, through some high-level checks, that in focusing on any change in the aggregate covenant, they were not missing any potentially material issues at the individual employer level that could be considered relevant.

In the absence of any such concerns, we would not expect any material changes to the technical provisions through time, based on covenant considerations. In the event that there was an issue, notably a weakening of the covenant, we would provide advice to the Trustees on a range of possible actions, such as strengthening the technical provisions or reducing the level of investment risk. The type of actions and nature of them would depend on the particular circumstances in question.

For agreeing the FIP of each employer, as previously set out, we will agree an operational envelope with the Trustees for the extent of the flexibilities that can be afforded to individual employers, based on the covenant they provide to Stoneport and the implications of their choices for the risk to the other employers. The requirement for and level of detail of investigations at the individual employer level will depend on the particular circumstances at the time, the individual employer and where they were and would be in the operational envelope given the materiality of any changes that have occurred in the covenant strength.

We will adopt a proportionate approach to any covenant analysis carried out, reflecting the results of the covenant screening applying on entry and centralisation. In most cases this will result in a "light-touch" approach, given the strength of the covenant support provided at entry. However, it may be necessary to carry out more detailed analysis should situations develop that warrant further scrutiny.

The Trustees would be advised by the Scheme Actuary on any changes to the economic circumstances which might justify a change in the financial assumptions for statutory funding purposes, as well as any changes in demographic circumstances. The Trustees will consider appropriate advice from the Scheme Actuary as part of this for whether they should take into account the experience of Stoneport's membership in setting future demographic assumptions for the statutory funding valuations.

The Trustees will take account of the mortality experience of Stoneport once sufficient experience has built up for this to be statistically credible. Not only is this a key demographic assumption that could have a material impact on the results of the valuation, the mortality experience of Stoneport could differ from the population as a whole and may be different from the population of UK pension schemes in general. We note that the projected size of Stoneport ought to mean that any experience analysis should provide results that are statistically credible.

The experience of Stoneport's membership with regard to the following may also be considered:

- The incidence and pattern of early retirement (to more accurately project cashflows, even if the terms are cost neutral).

- The proportion of pension exchanged for a cash lump sum at retirement.

- The proportion of members in respect of whom a dependant's pension is payable on death.

- The age difference between members and their dependant's when a pension is payable following the death of a member.

What is possible will depend on the quality of the information held by the administrators of Stoneport and the breadth and volume of the experience collected.

As part of the valuation process, we will ask employers to notify us of any preferred changes to the allocation of their notional investments between the Investment Fund and the Matching Fund. Any changes will only be approved subject to ensuring adequate covenant support for the risks presented.

Once the Trustees have taken advice from the Scheme Actuary and chosen their proposed method and assumptions to be used in the calculation of the technical provisions, SPML will run a consultation process with the employers to garner their feedback, giving those employers that wish to comment on proposed method and assumption the opportunity to do so.

We will then collate any comments on the method and assumptions and relay them to the Trustees for their consideration. We will also provide the Trustees with an update on the aggregate allocation between the Investment Fund and the Matching Fund. Armed with this information, the Trustees will then make a final decision on the method and assumptions to be adopted, noting that the key discount rate assumptions will (of course) need to be supportable by the investment strategy.

Alongside the statutory funding process, the valuation for determining the updated FIP for each employer will be completed. The Scheme Actuary will provide the Trustees with advice on the appropriate method and assumptions, having regard to the analysis prepared for statutory funding purposes, whilst recognising the different drivers and requirements for the two valuations and SPML's role in the FIP process under the TD&R.

The method and assumptions to be used in the calculation of the notional liabilities for FIP purposes proposed by the Trustees as well as the operational envelope for agreeing the FIP would also form part of the consultation process with employers described above.

5.2. Producing the valuation results

Once the method and assumptions have been agreed by the Trustees for the two approaches, following a consultation process with the employers managed by SPML, the Scheme Actuary would calculate the resulting technical provisions and FIP valuation results for Stoneport a whole.

As set out in the sixth guide in this series, for the purposes of the tracking mechanism outlined within it, there is no need to record member experience by employer and adjust for it through time as the member experience risk is pooled across Stoneport as a whole. The experience adjustments will automatically flow to each employer through their allocation of Stoneport's liabilities as a whole.

Once the Scheme Actuary has prepared the results for Stoneport as a whole, we will then calculate the updated share of the liabilities attributed to each employer and communicate the results to them as part of the process of agreeing the revised and updated contribution requirements from each employer.

5.3. Revising Funding and Investment Plans

Once the valuation results are available and have been communicated to the employers, we will liaise with each of the employers to agree:

- Where applicable, a revised recovery plan.
- An updated FIP recognising the updated valuation and any changes to the funding and investment approach.

For this purpose, we will carry out a high-level desktop review of the covenant of each employer. Should this indicate any material change in the strength of an employer's covenant, this would be considered in discussions with the employer and Trustees on agreeing a revised funding and investment approach supporting the resulting updated FIP to be agreed.

We would usually expect a revised and updated FIP to reflect as a minimum, the contributions already committed to under an existing FIP, unless the updated valuation results for an employer indicated that the contributions were no longer required to achieve full funding on a buy-out basis by the Target Date.

Where a statutory funding deficit exists and consequently, a recovery plan is required, likewise, if a recovery plan was already in place following the last valuation, we would expect the new recovery plan to contain as a minimum, the contributions already committed to.

We do not anticipate any need to engage with the Trustees regarding the individual arrangements made with employers as long as their FIP approach falls within the agreed operational envelope. However, in the event that an employer can demonstrate it cannot reasonably afford the minimum level of contributions required to remain within the agreed operational envelope, we would revert to the Trustees for approval of any bespoke proposals.

6. Annual reports

The Trustees will be required to commission an annual report which provides an update of the statutory funding position of Stoneport.

A full actuarial valuation where the SoFP is reviewed and the contribution requirements reset will not be carried out. The valuation will however be based on full membership data, to update for member experience, as well as changes in assumptions due to movements in market conditions (based on the assumptions derivation agreed at the previous triennial valuation). This will allow the member experience to be reflected in the notional liabilities of each employer once every year rather than only once every three years.

7. Addressing a notional surplus

When the expected growth of an employer's notional asset account, after allowing for its share of the future benefit cashflows up to the Target Date, exceeds the net present value of its share of Stoneport's projected buy-out premium at the Target Date, it will have a notional surplus and will be able to cease contributing to Stoneport under the TD&R requirement for a FIP. Employer contributions may need to recommence however if its notional assets underperform, if Stoneport as a whole suffers adverse experience, or if other employers were to become insolvent leaving a shortfall to address.

Subject to any constraints imposed by the funding and investment strategy for Stoneport as a whole and with regard to individual employer's covenant strength, it will be a matter for each employer to determine whether and to what extent they choose to reduce the level of investment risk they run as they approach full funding of their obligations and potentially, move into a notional surplus. For example, an employer may choose to take a limited amount of investment risk with a view to building up a buffer to reduce the risk of having to contribute to Stoneport in the future in the event of adverse experience.

We note however that an employer with a notional surplus may not ultimately receive any financial benefit for that notional surplus, depending on the financial position of Stoneport as a whole at the relevant time. The primary reason for this is because the Trustees, with the consent of the principal employer, will have the power to secure the benefits of Stoneport in full with an insurance company and wind-up Stoneport in the event that there are sufficient assets in Stoneport to achieve this (whether that is before the Target Date of 31 December 2045, or after it). Thus, if Stoneport as a whole reaches full funding on a buy-out basis before the Target Date, an employer with a notional surplus might see that notional surplus used to help secure the obligations of employers with a notional deficit. This may limit the appetite for employers to continue to take investment risk once they have a notional surplus.

The most likely practical scenario under which surplus assets are likely to be returned to employers is if the cost of securing the benefits with an insurer is lower than expected after the Trustees start to process of winding up Stoneport. In the event that assets remain in Stoneport following the discharge of all the liabilities, the remaining surplus assets will be distributed to the employers.

The only other circumstance where a refund of surplus might hypothetically arise is if the principal employer does not consent to a buy-out of Stoneport's residual liabilities and instead chooses to run on until all the benefits have been settled directly.

8. Funding requirements on early exit

In the normal course of events, voluntary exits from Stoneport will not be permitted: essentially, employers joining Stoneport are doing so on the expectation that they will remain in the structure for its intended lifetime through to the Target Date of 31 December 2045.

The reason for this is Stoneport is designed to be a long-term strategic approach to scheme funding. It operates most efficiently, delivering the greatest cost savings, risk reduction and improvement in benefit security, the more employers there are.

A further reason for not permitting voluntary exits is that the statutory minimum debt calculated in accordance with the provisions of section 75 of the Pensions Act 1995 ("section 75") do not align with the flexibilities which employers will be afforded in meeting Stoneport's buy-out funding target or the tracking mechanism underlying the notional asset and liability shares of each employer (as the section 75 debt provisions do not allow for pooling of actuarial risks, or differences in asset allocations between employers).

We understand however that circumstances can change and that a back-stop voluntary exit provision is a necessary requirement for Stoneport. The Trustees will therefore consider a voluntary exit proposal from any employer that has a sound reason for wishing to cease to participate in and exit Stoneport.

The terms of any exit will be a matter for the Trustees to determine. We anticipate that an employer wishing to exit would likely be required to pay the higher of the following to do so:

- A debt calculated in accordance with the TD&R which govern the operation of Stoneport, reflecting the funding position on an immediate buy-out.

- The statutory minimum debt calculated in accordance with section 75, based on its pro-rata share of the buy-out deficit in Stoneport as a whole.

The provisions set out in the TD&R require an employer to pay the difference between:

- The value of its notional asset account, and

- Its share of the projected future benefit cashflows up to the Target Date, adjusted to reflect buy-out pricing, plus its share of the projected final buy-out obligation at the Target Date.

These provisions are designed to give employers the appropriate credit, where relevant, for funding their obligations faster than average (i.e. funding their notional share of Stoneport's liabilities quicker than the rate at which the Scheme as a whole is being funded), and to avoid the moral hazard risk that would exist were only the statutory provisions to apply. For example, in the absence of the provisions in the TD&R, under the section 75 debt obligations alone, employers could otherwise exit on a share of fund basis, having funded their obligations slower than average or having transferred obligations into Stoneport that have a longer than average duration, either of which would be likely to present a moral hazard risk.

If the debt calculated using the TD&R methodology is less than the statutory minimum, the Trustees will attempt to reallocate the difference between the figure under the TD&R and the section 75 debt within Stoneport, such that the employer can exit by paying the lower TD&R based figure. However, it cannot be guaranteed that this outcome will be achievable in practice. Employers may be required to pay a higher exit debt than the approach set out in the TD&R.

The Trustees also have a further option available to them under the TD&R, to require an exiting employer to pay a larger debt than the higher of the amount calculated in accordance with the TD&R and the statutory section 75 minimum, in the event that the exit of the employer would create additional costs and/or uncertainties for the remaining employers.

These provisions are designed to protect the security of members' benefits and may result in an employer having to pay more to exit than it might have anticipated.

However, on average, employers that join Stoneport are likely to see an immediate reduction in the contingent section 75 debt payable on wind-up, insolvency or voluntary exit because the section 75 debt for Stoneport as a whole is expected to be smaller than the sum of all of the section 75 debts calculated individually for each of the consolidated schemes. This is because the buy-out cost for Stoneport is expected to be significantly cheaper than the sum of the cost of buying-out the benefits of the schemes it brings together individually, for the reasons described in section 5 of the third guide in this series.