Technical guide 7: Member option terms

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 seventh guide in the series you will find details of how member option terms will be set.

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 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.

- 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

To achieve the desired pooling of liability risk and to ensure fairness, it is necessary to have one standard approach to the setting of member option terms that operates across all members of Stoneport. Operating with a single approach to setting factors will also make the administration of Stoneport simpler and more cost efficient and limit the scope of the actuarial advice required by the Trustees. It is also much easier to communicate the retirement options available to members if there is only a single approach to the setting of factors in use.

The Trustees reviewed all the cash commutation terms along with all other member option terms on the advice of Scheme Actuary after setting the new SoFP in September 2020.

The underlying approach the Trustees adopted has been codified into a Statement of Actuarial Factor Policy ("SoAFP"), which will form the basis for future reviews of the commutation and other factors to ensure that such reviews are carried out on a consistent, clear and objective basis. The SoAFP can be found on the Stoneport website.

1.1. Implementation for joining schemes

The trustees and employers of joining schemes will be required to adopt Stoneport's member option terms with effect from the date that Stoneport is centralised. In the period before Stoneport is centralised, the factors in use by the individual schemes that join will continue to apply.

The Trustees of Stoneport will ensure clear and careful communication with members in the run up to centralisation regarding the changes that will come into effect on centralisation. Particular care will be taken in communicating with members at or approaching retirement or who request a retirement quotation shortly before centralisation.

2. Cash commutation

The option that members of defined benefit pension schemes have to exchange up to 25% of the value of their pension for a cash lump sum at retirement is an important and valuable aspect of benefit provision in the UK. Under current legislation, the cash lump sum is paid tax-free.

Where schemes already provide a cash lump sum as part of the benefit design, members can usually commute extra pension for cash up to the HMRC maximum. These flexibilities will be maintained in Stoneport.

We recognise that the terms upon which members are able to convert pension to cash lump sums at retirement will be important to the trustees of any schemes considering joining Stoneport, who will want to ensure their members are treated fairly. If Stoneport's cash commutation factors are less generous than a scheme's current factors, its trustees will need to weight this up against the material improvement in benefit security and the enhanced governance offering that Stoneport provides.

The cash commutation factors will also be important to any employers considering joining Stoneport, as they will have a bearing on both cash funding requirements and the ultimate cost of providing the benefits. If Stoneport's cash commutation factors are more generous than a scheme's current factors, its employer will have to weight this up against the significant reduction in running costs and other advantages that Stoneport brings.

We expect all schemes to consider the cash commutation terms and any changes required on centralisation as part of their considerations for joining Stoneport and have tried to address the issues in this guide. For most scheme, we expect cash commutation terms to be relatively minor consideration when taken in the wider context of the benefits that Stoneport can bring.

2.1. Power to set the terms

The terms upon which members of Stoneport can make an exchange of pension for a cash lump sum are set by the Trustees on actuarial advice. Rule 4.4 states:

"The pension payable to the Member shall be reduced by the Trustees on Actuarial Advice to take account of the lump sum".

The Trustees therefore have a unilateral power when it comes to setting the commutation factors, subject to having taken actuarial advice.

The trustees and employers of some schemes joining Stoneport will have to consider the ceding of power to the Trustees of Stoneport as part of the decision to join. The comments below set out some of the considerations trustees and employers might have, depending on the provisions of their rules.

2.1.1.Set by the trustees

Where the trustees of a scheme joining Stoneport have input in setting the commutation factors (be it unilateral, in consultation with the company or a joint power with the company), we do not envisage any issues arising on transfer to Stoneport and in particular in accepting the power which exists in the TD&R of Stoneport.

From a trustee perspective, the power will be as favourable to members or better and hence should be acceptable.

From an employer perspective, in most cases the power will be unchanged. In the rare case where the employer would be losing the right to be consulted, we do not see this as a material loss of power given the trustees could always choose to disregard the employer's views.

We recognise that where there is a joint power, this could be deemed a loss of control for some employers. However, that may depend on whether the employer has ever tried to exercise any control in the past and the extent to which that might have been successful. In our experience, it has been very difficult for employers to stand firm against any proposed increase in commutation factors where the trustees have actuarial advice that this is required on the grounds of fairness to members and under the weight of evidence of what other schemes are doing, as evidence by survey data prepared by the consulting industry.

2.1.2.Set by the company

In cases where the employer sets the commutation factors, we will require the employer to accept the provisions of Stoneport and cede that power to the Trustees. We expect this relatively modest concession to be acceptable to employer in most cases in order to access the significant benefits that Stoneport will provide.

As an alternative and if the trustees of the joining scheme were to agree, we may permit factors to be hardcoded into the rules of Stoneport, either those in use by the joining scheme at the point of transfer or some other agreed set of factors.

2.1.3.Set by the actuary

In cases where the actuary sets the commutation factors, we would require both the trustees and the employer of the joining scheme to accept the provisions of Stoneport and cede that power to the Trustees.

We do not expect this to be an issue for either party. For the trustees, they should be satisfied that the Trustees are required to take actuarial advice and be confident they will discharge their duties appropriately. From an employer perspective, having the power transferred from the actuary alone to the Trustees having taken actuarial advice should be viewed as a broadly neutral change.

2.1.4. Hardcoded

In our experience, schemes which operate using commutation factors that are written into the rules use factors that are much lower than is typical. As such, these schemes are less generous to members and cheaper for employers (where members do take cash on those terms).

In cases where the factors are hardcoded, we will replicate those terms for the relevant members in Stoneport. The calculation of the technical provisions, the funding target under the contribution rule and the setting of the funding and investment plan will reflect those factors, both for determining the employer's share of Stoneport's future benefit cashflows and buy-out premium on the Centralisation Date and for ongoing funding purposes.

Due to the centralised nature of Stoneport and the way that risks are pooled within it, any differences between member experience and the assumptions used to allocate the liabilities as part of the centralisation date valuation will be shared proportionately across all employers.

This will mean for those employers operating schemes with fixed factors, they will only receive a small fraction of the benefit of any favourable experience if more members exchange pension for cash assumed for funding purposes. Conversely those employers will only be subject to a small fraction of the full risk that their members exchange less pension for cash than assumed.

From the perspective of other employers, they will bear a small proportion of the risk that members of any schemes that join Stoneport with fixed factors do not take as much cash as assumed. However, we do not expect this to be significant when spread across all schemes that join given the low prevalence of fixed factors. Furthermore, those other employers would stand to benefit in the event that members took more cash than assumed on the fixed factors and have diversified away the cash commutation risk as part of the liability pooling.

2.2. Current cash commutation factors

The commutation factors were set by the Trustees on 30 September 2020 after considering the advice of the Scheme Actuary. In setting the current terms, the Trustees had regard to the SoFP dated 30 September 2020 and the funding target in the contribution rule of Stoneport. Further details can be found in the SoAFP. Both the SoFP and the SoAFP can be found on the Stoneport website.

The same methodology will be used to derive all the commutation factors that are required in respect of any schemes that join Stoneport, reflecting in each case the nature of the different increases that apply to the pension in payment.

Stoneport's commutation factors are unisex and will be linearly interpolated as required when a member retires between birthdays.

We set out below a sample of the commutation factors currently in use by Stoneport at some key ages for the two types of increase that Stoneport provided when it was created (i.e. pensions that increase in line with the increase in the Retail Prices Index ("RPI") up to a maximum of 3% per annum, and pensions that increase in line with the increase in RPI up to a maximum of 5% per annum, commonly referred to as LPI increases):

Age	RPI increases up to 3%	LPI increases
55	26.09	29.47
60	22.05	24.57
65	18.24	20.04

A full set of factors can be found in the SoAFP which is on the Stoneport website.

2.3. Implications for entry

Consideration of the cash commutation factors in use by Stoneport and how they compare to the factors in use by schemes whose trustees and employers are considering joining is likely to be one of many considerations. We hope that the benefits of joining Stoneport, combined with the flexibility in our approach, will mean that appropriate compromises can be reached in most cases. We have considered separately the standpoints of trustees and employers in the sub-sections which follow.

2.3.1. Trustee concerns

We would anticipate concerns being raised by the trustees of a scheme if the cash commutation factors in Stoneport which would apply to their members after centralisation were (significantly) lower than the factors currently in use by that scheme.

The trustees would need to be convinced that the benefits to members of Stoneport outweigh any potential reduction in the value of their benefits should they elect to exchange part of their pension for a cash lump sum at retirement.

From a trustee perspective, we would hope that in most cases the dramatic improvement in the security of members' benefits and the anticipated improvement in the quality of the member experience over time would outweigh any perceived loss as a result of adopting lower cash commutation factors. Accordingly, we would expect most trustees to be supportive of a transfer to Stoneport, even if it meant cash commutation terms would be less favourable for their members after centralisation.

Other factors which trustees may wish to consider are that the cash commutation terms will be reviewed regularly by the Trustees and that whilst members have the right to exchange part of their pension for a cash lump sum, there is no requirement for them to do so, meaning any exchange is entirely voluntary and with full knowledge of the cost in terms of the reduced pension it leave them.

2.3.2. Employer concerns

Employers faced with a (significant) increase to the cash commutation factors on centralisation were they to join Stoneport might view this negatively in weighing up the pros and cons of joining.

However, we would expect most employers to consider any increase to the expected cost of providing the benefits to be relatively insignificant in the context of the reduction in running costs and other benefits that Stoneport provides. Moreover, any increase in the expected cost of providing the benefits would likely be spread over many years.

Employers of schemes with commutation factors that are at the lower end of the range typically adopted will also need to recognise that it may not be possible to hold factors at those low levels indefinitely, or that doing so could reduce the take-up rate amongst members and that in either case, the expected cost of providing the benefits would increase. Over time, we would expect employers to face increasing pressure from the trustees and the Scheme Actuary to review and improve the factors and for those pressures to increase as the funding level of the scheme improves.

2.4. Allowance for commutation in valuations

The technical provisions and the Funding and Investment Strategy ("FIS") for Stoneport have been set using a best estimate assumption for the take-up rate of the cash commutation option. The estimate of the buy-out premium on 31 December 2045 required to set the FIPs under the contribution rule will make no allowance for future cash commutation, as this is the basis upon which insurers price bulk deferred annuity business (albeit the overwhelming majority of members will likely have taken any cash lump sums by the Target Date).

The assumed take-up rate of the cash commutation option made in the Centralisation Date valuation that is used to allocate a share of future benefit cashflows and the projected buy-out premium to each of the employers will use a consistent best estimate assumption. Furthermore, the assumed rate of exchange of pension for cash will be based on the post centralisation methodology for setting the factors.

The Trustees took the advice of the Scheme Actuary in determining the best estimate assumption for the take-up of the cash commutation.

3. Other member options

As well as the option to exchange part of their pension at retirement for a cash lump sum, members of UK defined benefit pension schemes have a number of other benefit options.

In particular, deferred pensioners (more than one year from their scheme's normal retirement age) have a statutory right to take a cash equivalent transfer value ("CETV") to another registered pension scheme. In addition, members usually have a right under the rules of their schemes to draw their benefits early or to defer them beyond the scheme's normal retirement age.

Stoneport will provide both the statutory right to a CETV and give members the option to retire before or after their normal retirement age.

In this section we consider the cash equivalent transfer value basis and the early and late retirement factors that will be adopted in Stoneport. We anticipate that many of the same issues will arise when setting the terms for other member options as those regarding setting the cash commutation factors. In particular, where Stoneport offers less generous terms to members, trustees will need to balance this against the improvement in benefit security and other advantages that Stoneport brings. Conversely, where Stoneport offers more generous terms to members, the cost implications for the employer may partially offset some of the benefits of joining. We do not intend to repeat these arguments in this section other than to note that they apply.

We do not expect Stoneport to require trivial commutation factors as schemes that join will be expected to offer winding-up lump sums to any eligible members at the point of transfer to Stoneport. However, in the event that trivial commutation factors are required, the Trustees will set them consistently with the cash commutation factors, as most of the same principals apply. Consequently, we do not comment further on trivial commutation factors in this report.

3.1. CETVs

The CETV basis was set by the Trustees on 30 September 2020 after considering the advice of the Scheme Actuary. In setting the current terms, the Trustees had for regard for the expected cost of providing the members' benefits within the Scheme. Details of the method and assumptions used by the Trustees can be found in the SoAFP, which is on the Stoneport website.

3.1.1. Power to set the terms

Under overriding legislation, trustees are responsible for setting the method and assumptions used to calculate CETVs from their schemes. As such, the provisions in the governing documentation of Stoneport and the joining schemes are irrelevant.

3.1.2. Allowance in valuations

The SoFP makes no allowance for the payment of CETVs to members.

There is limited industry data on the incidence of transfer values, which have only started to increase following the introduction of freedom and choice in 2015, hence there is no statistical basis upon which an assumption about the incidence of future transfer values could reasonably be made. We also expect to make no allowance for transfer values in the actuarial valuation at Centralisation Date which will be used to allocate liabilities to each of the employers.

After Stoneport has been centralised, it may be of sufficient size to use any data collected on transfer values to inform an appropriate assumption for transfer values in future actuarial valuations. Any data available from Stoneport could be supplemented with any additional evidence that becomes available from the industry as a whole. We would expect the Trustees to instruct the Scheme Actuary to advise them on these matters as part of future actuarial valuations of Stoneport.

3.2. Early and late retirements

The early and late retirement factors were set by the Trustees on 30 September 2020 after considering the advice of the Scheme Actuary. In setting the current terms, the Trustees had regard to the SoFP dated 30 September 2020 and the funding target in the contribution rule of Stoneport. Further details can be found in the SoAFP. Both the SoFP and the SoAFP can be found on the Stoneport website.

The early and late retirement factors are unisex and will be linearly interpolated where a member retires between birthdays.

We set out below a sample of the early and late retirement factors currently in use by Stoneport:

Years early/late	Early retirement factor	Late retirement factor
1	0.96	1.06
3	0.89	1.20
5	0.83	1.36

A full set of factors can be found in the SoAFP which is on the Stoneport website.

3.2.1. Consent requirements for early retirement

The TD&R of Stoneport provide for early retirement under Rule 4.2(a) as follows:

"A member who has not reached Normal Retirement Date but…is aged 55 or above…by notice to the Trustees has requested an immediate annual pension payable during his lifetime, shall be entitled to a pension, calculated in accordance with Rule 4.2(b) from the date requested in the notice or such other date agreed to by the Trustees."

As such, members of Stoneport have an automatic right to draw their benefits early.

As employers joining Stoneport effectively exchange their liabilities for a share of Stoneport's liabilities, it would be illogical if they were able to exercise any influence over the incidence of early retirements for a particular group of members. The lack of any consent requirements will simplify the administration procedures necessary to implement members' wishes and reduce the potential for delays.

3.2.2. Consent requirements for late retirement

Rule 4.3(a) of the TD&R of Stoneport states the following in relation to late retirement:

"A Member may elect not to take a pension at Normal Retirement Date by notifying the Trustees in writing and may subsequently elect, by notice in writing to the Trustees any time thereafter, for the pension to commence."

As such, members of Stoneport have an automatic right to draw their benefits late.

We consider this necessary purely on administrative grounds in the event that the administrators are unable to contact members before normal retirement date. We do not envisage the trustees or employer of any joining scheme to wish to retain any consent over late retirement on the grounds that we expect very few members to retire late and because Stoneport's late retirement factors have been set to be broadly cost neutral.

3.2.3. Allowance for early and late retirements in valuations

The SoFP makes no allowance for any early or late retirements – all retirements are assumed to occur at normal retirement age.

We consider this to be a reasonable assumption for the purpose of funding Stoneport, as long at any reduction applied to pensions paid early or uplift to pensions paid late, are calculated on terms that are broadly cost neutral. We also consider it an appropriate assumption for the valuation used to determine employers' Funding Target Cash Flow Shares.

For schemes joining Stoneport that provide any benefits that are payable earlier than normal retirement age without actuarial reduction, those benefits will be valued at normal retirement age with an uplift applied for late retirement, or equivalently, for all benefits to be valued at the earliest age they are payable without reduction.

After Stoneport has centralised, experience data collected may be sufficient to form a statistical basis for setting reasonable assumptions for the future incidences of early and/or late retirement. We would expect the Trustees to instruct the Scheme Actuary to advise them on this issue as part of future actuarial valuations of Stoneport.