Technical guide 8: Entry conditions, terms and joining process

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 final guide in the series you will find details of the entry terms and joining process.

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.

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

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

In this guide we explain how the entry process operates for Stoneport, from how we evaluate whether a scheme and its employer wishing to join Stoneport may do so (including the application of the Covenant Test), through to the practical steps to transfer into Stoneport when they are accepted, and the issues that will need to be addressed as part of that.

The entry terms are based on the expectation that Stoneport centralises; particularly, that the assets and liabilities will become comingled. The employers and schemes that decide to join will have different structures and will have operated differently before joining Stoneport.

To ensure fair treatment of both the scheme members and their employers joining Stoneport, we need to apply the Covenant Test and standardise the different approaches which schemes previously applied. In addition, we need to review and analyse various sources of information to provide all parties with confidence in the operation and management of Stoneport.

Whilst a single-entry approach will apply, there will be some flexibility in the entry terms, in terms of the level of standardisation between schemes and employers joining Stoneport, to allow for the range and breadth of differences that currently exist between them.

A number of the changes contended for as part of the entry process would not come into effect until Stoneport centralises, such as changes to member option terms.

2. Entry conditions and assessment

Once Stoneport centralises, the assets and liabilities will be fully comingled, with each employer jointly responsible for all the other employers' obligations. On an ongoing basis, each employer remains responsible for a given share of the overall assets and liabilities of Stoneport. Were an employer to become insolvent however, the other employers are required to support that employer's obligations.

To protect the security of members' benefits and the interests of other employers, ensure fairness, and minimise any cross-subsidies, the TD&R require that any employer that joins Stoneport meets the Covenant Test.

The Covenant Test is defined as follows in the TD&R:

"Covenant Test" means an assessment as to whether the Employer is of sufficient size and financial strength such that an immediate increase of 50% in the assets and the liabilities (as measured on a range of underlying assumptions which the Trustees deem appropriate):

(a) in its Section (or Sections, if more than one) where the Covenant Test is applied pursuant to Rule 11.2; or

(b) that are intended to be transferred to the Scheme at the Participation Date where the Covenant Test is applied 5pursuant to Rule 21(a)

would not result in a short term risk of the Employer being unable to support such increased liabilities and manage the risks relating to those liabilities, taking into account such factors as the Trustees shall decide, including the Employer's proposed Investment Allocation through time up to the Target Date and the extent of any potential recovery of the Section 75 Debt in the event of the immediate insolvency of the Employer."

The analysis that would be undertaken as part of the Covenant Test is considered in more detail below, but in broad terms, we expect to exclude any employer with a covenant rated as weak (equivalently, CG4) under tPR's four covenant categories. We will also need to carry out a higher level of due diligence on any employer rated as tending to weak (equivalently, CG3), excluding those that would be reclassified as weak (CG4) were the size of their pension obligations to (be assumed to) increase significantly.

This is not intended to be an exhaustive list of the employers that would fail the Covenant Test and therefore be precluded from joining Stoneport, or by implication those that would meet the Covenant Test and be permitted to join, only those we can more definitively say that would likely fail the Covenant Test.

2.1. Data gathering

The first step in assessing whether an employer wishing to join Stoneport will be permitted to do so, is for us to obtain the following:

- the formal report on the last actuarial valuation of the scheme and the associated documentation required to be produced as part of that process i.e. the statement of funding principles, recovery plan and schedule of contributions;
- the latest scheme return; and
- any actuarial reports and other funding updates provided since the last formal actuarial valuation was completed.

In addition to the scheme documentation, we would need to know:

- the identity of the employer and, if not publicly available, a copy of it latest annual report and account;
- details of any contingent assets pledged to the scheme (if applicable); and
- the latest independent covenant assessment (if applicable).

2.2. Applying the Covenant Test

We will review each of the employers looking to join Stoneport to assess whether they pass the Covenant Test and are therefore eligible to join Stoneport. The Covenant Test has been designed to facilitate the creation of a sufficiently strong and diverse pool of employers to allow covenant risks to be pooled effectively whilst protecting the security of members' benefits and the interests of all employers.

The Covenant Test will be performed as a condition of entry and again for each employer when Stoneport becomes a centralised scheme. Any employer failing the Covenant Test at the time of centralisation will be excluded from centralisation, remaining in their own fully segregated section.

The application of the Covenant Test will ensure that each employer is of sufficient strength that it is well placed to support its own liabilities as well as be well placed to cope with any adverse deviation that could be expected to arise under the centralised Stoneport structure.

Where we conclude that the Covenant Test is met, we would provide confirmation that we expect, based on the information provided and the scheme and the employer's current circumstances, the scheme to be permitted to join Stoneport.

This would not be a guarantee that we would permit the scheme to join, which would be subject to further diligence at a later stage once the scheme had taken the necessary advice and reached a decision in principle to join Stoneport. We would then need to agree a Funding and Investment Plan with the employer before the joining process could be completed.

Where we consider the available covenant support to be insufficient, we will inform the employer that unfortunately, they are ineligible to join Stoneport.

If we consider the available covenant support to be insufficient but identify a possible source of additional covenant support or contingent covenant support that, if granted, would pass our Covenant Test, we will notify the employer to allow consideration of that particular option.

3. Funding implications of joining

Once schemes are satisfied that they meet the Covenant Test and hence could in theory join Stoneport, the next thing to do will be to understand what that means in terms of the cash contributions the employer would be required to commit to.

We anticipate that a scheme would first need its advisers to calculate the funding target it would have to meet should it join Stoneport. Details of the method and assumptions the Trustees currently adopt are set out in the Statement of Funding Principles, which can be found on the Stoneport website.

The scheme, with the help of its advisers, would need to consider the desired amount of investment risk on joining and through time. The adviser would then be able to show the scheme the range of options available for meeting the funding target over the life of Stoneport's operation, given the preferred investment approach. The adviser could also illustrate the impact of varying the investment approach on contribution requirements.

Armed with this information, the scheme would be able to see if its current contribution commitments are sufficient to meet Stoneport's long-term funding target and if not, what additional contributions might be required and over what time period.

For comparative purposes, Schemes may also wish to consider the funding implications of meeting the new legislative and regulatory requirements for scheme funding as a standalone scheme, and in particular the need to target a low-dependency basis by the time that significant maturity is reached.

4. Review of member benefits and option terms

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 to achieve its dramatic cost and risk reductions.

Under Stoneport, once centralised, the assets and liabilities will be fully comingled. Each employer will swap the specific liabilities they transfer to Stoneport for a proportionate share of the larger and more diverse set of liabilities of Stoneport as a whole. To minimise the potential for cross-subsidy arising from differences in the quality and accuracy of individual schemes' data, as well as differences in benefit and option terms between them, we need to standardise the different approaches which previously applied. This also has a governance benefit of improving the data that will be used by Stoneport and reducing administration issues.

In the sections below we consider in turn various aspects the trustees and the employers of schemes will need to address to join Stoneport (where they have passed the entry conditions and agreed a covenant, funding and investment approach). Dealing with these issues at the outset delivers the certainty which is necessary to ensure fairness to all employers once Stoneport becomes a centralised scheme.

4.1. Data quality and completeness

Each employer will sign a Participation Deed which includes a schedule of their transferring members and respective benefit entitlements, together with an accompanying benefit specification and an Information Sharing Protocol. Stoneport will only pay the benefits set out in the Participation Deed in respect of each of the employers that join.

We anticipate that trustees will want to complete a benefit audit and data cleansing exercise before they transfer their schemes to Stoneport, to ensure that all benefits are accurately captured by the transfer and their scheme's obligations are discharged in full. We also anticipate that schemes will be wound up when they join Stoneport, which will allow winding-up lump sums to be offered to all eligible members, potentially reducing the number of members that the liabilities that are transferred to Stoneport.

A data audit and cleansing exercise was undertaken by the Trustees of the Stoneport Penson Scheme in January 2020 to ensure its records are accurate and complete. This should provide comfort to other employers that when they join Stoneport there will be no unexpected liabilities arising from its historic operation.

4.2. Member option terms

Member option terms were discussed in detail in the seventh guide in this series. For this guide it suffices to note that to be able to administer Stoneport effectively and reduce the volume and cost of actuarial advice the Trustees would otherwise require, Stoneport will have a single approach for setting member option terms, which will apply to all members of Stoneport once centralisation has occurred.

4.3. Benefit ambiguities

To ensure fairness to all employers, any ambiguities in their schemes' respective benefits will need to be resolved before joining Stoneport.

For example, in 2010 the government announced a change to the index for the future statutory minimum revaluation of pensions from RPI to CPI. However, depending on the drafting of a scheme's rules, this change did not necessarily override the specific pension increase drafted. For some schemes, the position was clear cut over whether they could switch from RPI to CPI or not, but for others the position was and remains ambiguous. There have and continue to be various legal cases concerning the ability or not to switch from RPI to CPI.

To be able to join Stoneport, trustees and employers of schemes will need to clearly set out their members' benefits in the transfer deed without any such ambiguities. Where any ambiguities exist and require resolution to be able to definitively set out members' benefits, these will need to be resolved by schemes prior to joining.

4.4. GMP equalisation

Following the Lloyds Bank judgement in October 2018, whilst it is now a legal requirement for pension schemes to equalise for sex-based inequalities of Guaranteed Minimum Pensions ("GMP"), many technical issues remain to be resolved. Furthermore, given the complexity and need to carry out the process in an efficient and effective way, whilst schemes will want to begin the process as soon as reasonable, in practice this is unlikely to commence immediately and once it does, could take an extended period to complete. We therefore anticipate that the majority of schemes joining Stoneport will not have made the necessary amendments to equalise GMP benefits prior to transfer.

For those schemes that have equalised, as part of our due diligence process, we propose carrying out a high-level check to ensure that it had been carried out appropriately and that no further liabilities could arise in respect of GMP equalisation issues which might fall upon Stoneport. Our checks will focus on the overall method and approach to individual benefit events. This will include for example whether a de minimis level has been set (to equalise) and if so, the level and choice, as well as the application of limitation and forfeiture rules (amongst other aspects).

For those schemes which have not yet equalised GMPs prior to joining, we intend to carry out a bulk exercise to implement the necessary amendments to future benefits with effect from the date Stoneport became centralised, as well as addressing past underpayments. Past underpayments will be deducted from the notional asset accounts created in respect of each employer at the Centralisation Date.

We consider it advantageous for schemes to join Stoneport before they have equalised, as it is expected to be much cheaper administratively for them to equalise GMPs as part of a major bulk exercise within Stoneport. The one-off costs of the GMP equalisation project would be met through a proportional adjustment to the assets of each of the schemes whose benefits required equalising. Those schemes that had already equalised or did not have any GMPs would not be charged for the exercise. We comment further on how such "special project" expenses would be applied in guide six.

4.5. Discretionary benefits

Some benefit decisions are made at the discretion of one of more parties to a scheme. This means there can be or is uncertainty as to whether or not a benefit will be paid, until the discretion is exercised in each case. Typical examples include whether benefits can be paid earlier or later than normal retirement age, and whether they are reduced or increased in each case, and how death benefits should be distributed. Another example is where a scheme provides additional increases to pensions over and above the level required under law or set out in the scheme's rules.

In guide seven, we set out the early and late retirements clauses of the TD&R. For schemes joining Stoneport, these provisions will only come into force from the Centralisation Date.

The trustee discretions applying to death benefits will unchanged, for reasons of beneficial tax treatment, albeit they will be exercisable by the Trustees of Stoneport.

Whilst discretionary pension increases used to be a common feature of schemes, the changing nature of obligations coupled with rising costs led to most discretionary practices being discontinued. Consequently, it is our expectation that very few schemes considering joining Stoneport will still provide discretionary pension increases.

In the rare case that schemes do still operate one or more discretionary practices (such as providing non-statutory discretionary pension increases), or if there any historic practices that the trustees are not comfortable giving up entirely, we will require a firm decision to be taken so there can be certainty over the level of benefits Stoneport will be required to provide. This is necessary to ensure fairness across all employers.

Determining any additional benefits to be crystallised in lieu of future discretionary practices would be a matter for the trustees and the employer of a scheme to agree. We anticipate that any changes required would only come into effect once Stoneport centralises (setting out in the transfer deed the relevant terms from the scheme for the operation of Stoneport in the pre-centralisation period).

4.6. Benefits provided on a defined contribution basis

For reasons of cost, Stoneport has not been set up and authorised as a master trust capable of providing benefits on a defined contribution basis.

For a scheme wishing to join Stoneport that provided benefits on both a defined benefit and a defined contribution basis, their existing advisors can guide them through the necessary changes to the defined contribution element. We anticipate that for most this will be a relatively straightforward process, either dealing with a trust based AVC facility, or with a defined contribution section that is in the same trust as the defined benefit section that wants to join Stoneport.

5. Advice required

The trustees and the employer of any scheme considering joining Stoneport will need to take suitable advice.

Alongside the many benefits of Stoneport, including the transformational cost savings that it can bring, the employer in particular will need to understand the funding implications of meeting Stoneport's shared funding target as discussed in section 3.

Similarly, as well as understanding the dramatic improvement in benefit security which Stoneport provides, the trustees will need to ensure they are meeting their fiduciary duties by discharging their obligations via a transfer to Stoneport. In practical terms, the trustees will need to consent to the necessary bulk transfer. The trustees will therefore need to take appropriate independent professional advice, which is likely to include actuarial, covenant and legal advice.

5.1. Certification required for a bulk transfer

Before a bulk transfer payment can be made to Stoneport, the scheme actuary to the ceding scheme will be required to sign a certificate under Regulation 12 of the Occupational Pension Schemes (Preservation of Benefit) Regulations 1991 ("Regulation 12"). The purpose of the certificate is to confirm that the benefits provided in Stoneport will be "*broadly no less favourable*" than those the members were entitled to in the ceding scheme.

In making this assessment, where there is an established custom of awarding discretionary benefits in the ceding scheme, the scheme actuary is required to consider those as part of the "broadly no less favourable" assessment.

As Stoneport will provide mirror image benefits in respect of each pension transferring to it, we do not anticipate any material issues for scheme actuaries in signing off on the "broadly no less favourable" test.

6. The joining process

Once the terms for joining Stoneport have been agreed, the following practical steps will need to be completed.

6.1. Participation Deed

Employers and trustees will be required to sign a Participation Deed before the bulk transfer to Stoneport can take place. This deed will include a full benefit specification, as well as a schedule of the members transferring and the benefits to which they are entitled. It will also set out the member option terms which currently apply in the scheme (such as early and late retirement, and cash commutation) so that those terms can continue to apply in Stoneport until centralisation.

Stoneport will become contractually obligated to provide these benefits for the members specified in the Participation Deed. It will not be liable for any other obligations of the scheme, only those set out in the Participation Deed for the transferring members.

In this regard, our requirements will be similar to those of an insurance company undertaking a buy-out. Any errors or omissions in terms of the benefits and/or the membership will be a matter for the employer and the trustees of the transferring scheme to deal with (as part of the wind-up process). The trustees and the employer of the transferring scheme may wish to consider insuring against this risk by purchasing appropriate cover. A template of the Participation Deed will be made available on the Stoneport website.

6.2. Other administrative matters

Employers joining Stoneport would need to sign a deed of adherence to become a new participating employer in Stoneport. This forms part of the Participation Deed.

Each new employer would also need to nominate one member to become an active member of Stoneport for a day (this member receiving only a notional benefit such as a pension of say, £1 per annum). This is necessary for the new employers to become statutory employers for the purpose of Section 75 of the Pensions Act 1995. The paperwork required for the addition of an active member with a notional benefit forms part of the Participation Deed.

On the grounds of administrative simplicity, we would only permit schemes to join Stoneport once a month, most likely with effect from the last day in each month, to tie in with administrative and investment reporting cycles.

We would expect to seek the formal approval of the Trustees of Stoneport for each of the schemes that meet the Covenant Test and be eligible to join Stoneport. We would regularly share information with the Trustees of Stoneport about the schemes that were looking to join and the terms upon which they would be accepted. Accordingly, we would hope that approvals could be provided on a monthly conference call.

Once approved, the transfer process and associated administrative matters can be set in motion. For example, the pensioner payroll will need to be transferred to the administrators of Stoneport and the scheme's existing advisers would need to liaise with the investment consultants to Stoneport about the transfer of assets (to be allocated to the Matching Fund and the Investment Fund in the agreed proportions).