Technical guide 4: Risk reduction within Stoneport

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

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

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

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

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

Contents **Page**

1. Introduction

Stoneport dramatically reduces the risks faced by scheme members and employers alike, by bringing schemes together to diversify and better manage risk.

The primary advantage to the members of the schemes whose benefits are transferred to Stoneport is the enhanced benefit security that is achieved through the pooling of employer covenants. We consider this advantage in some detail in this guide before discussing the other risk reduction benefits that Stoneport provides, include the reduction in investment risk and the reduction in idiosyncratic risk.

By reducing risk, Stoneport provides employers with greater certainty of outcomes and further reduces the risk of benefit loss to members.

2. Reduced covenant risk

The current legislative and regulatory framework creates something of a binary outcome for members of the vast majority of occupational defined benefit pension schemes in the UK.

A scheme with a single employer remains reliant on that single sponsor, to be able to pay all members' benefits in full, until such time as it can, or moreover does, buy-out all benefits with an insurer.

Whilst a scheme with a single employer can be well-funded on an ongoing basis and run with only a small amount of risk, if the employer were to fail, members can still suffer a reduction in their pension benefits as a result of the high cost of securing a buy-out.

The same is typically true of multi-employer schemes for associated employers, where the employers are all part of the same group of companies – it is rare that an insolvency doesn't result in a crystallisation event across the group.

By coming together, Stoneport enables employers to recognise their ongoing funding strengths in such a situation. In turn, this removes the binary outcomes that occur where employers stand apart, operating their schemes individually. With this, Stoneport is able to radically reduce the risk of members ever having their pension benefits reduced. Even the strongest schemes face a risk that members pensions will have to be cut back. In contrast within Stoneport all members have a higher than 99% likelihood of receiving their benefits in full.

The risk to members' benefits that arises from the possibility that the employer could become insolvent and not be able to settle the section 75 debt then due in full is the single biggest risk that members of defined benefit pension schemes in the UK face. We refer to this risk as "insolvency risk".

In October 2016, the DB Taskforce set up by the Pensions and Lifetime Savings Association ("PLSA") published its interim report. The report contained the results of a modelling exercise that had been commissioned to determine the risk to members of benefit loss over a 30-year period. These results can be seen in the table on the next page:

tPR covenant category	Sponsor default	Scheme default	Total risk of benefit loss
CG1: Strong	5%	1%	6%
CG2: Tending to strong	16%	4%	20%
CG3: Tending to weak	37%	3%	40%
CG4: Weak	64%	1%	65%

As the table shows, the modelling revealed that a significant risk exists for all members, even those supported by an employer that is currently rated by tPR as strong – a 6% chance of benefit loss. For members of schemes sponsored by weaker employers, the risks are far greater. Indeed, for employers rated weak by tPR the modelling showed that members have little more than a one-in-three chance of getting their full benefits over a 30-year period.

By bringing employers together under Stoneport, the risk to members' benefits can be dramatically reduced.

We have carried out some modelling to illustrate the reduction in risk that might be achieved through Stoneport by consolidating smaller schemes. Our model shows that the total risk of benefit loss for members is virtually eliminated following centralisation and is below 1%. In other words, members have a higher than 99% likelihood of receiving their benefits in full. This represents a significant improvement in benefit security for the members of any scheme that joins Stoneport.

Our model and its results are detailed in a separate report entitled "Employer covenant enhancement on centralisation: a primer for trustees" which can be found on the Stoneport website.

3. Reduced investment risk

Stoneport's investment strategy will be made up of three elements.

- First is the matching fund, which is the fund used to match how insurers invest.
- Second is the derivative overlay, which should be considered with the matching fund, since its job is simply to complete the interest and inflation rate hedging the matching fund doesn't itself provide. The trustees of Stoneport have full discretion over the level of hedging the scheme adopts, but we expect they will hedge nearly all these risks.
- The final part is the investment fund. Over the longer-term, it aims to outperform the matching fund, by investing across a range of return-seeking assets like equities, credit and hedge funds.

Employers can choose the level of investment risk they want to take on joining Stoneport and throughout the journey to buy-out, by setting the mix between the matching fund and the investment fund. By the end, all employers must be fully invested in the matching fund, but their paths there can, and will, differ.

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.

In the matching fund, a much wider array of risk management techniques can be used to more closely match the scheme's assets to its liabilities. In the investment fund, increased diversification will be possible with scale providing access to a wider range of asset classes and specialist mandates.

Further details of Stoneport's investment strategy can be found in the fifth guide in this series.

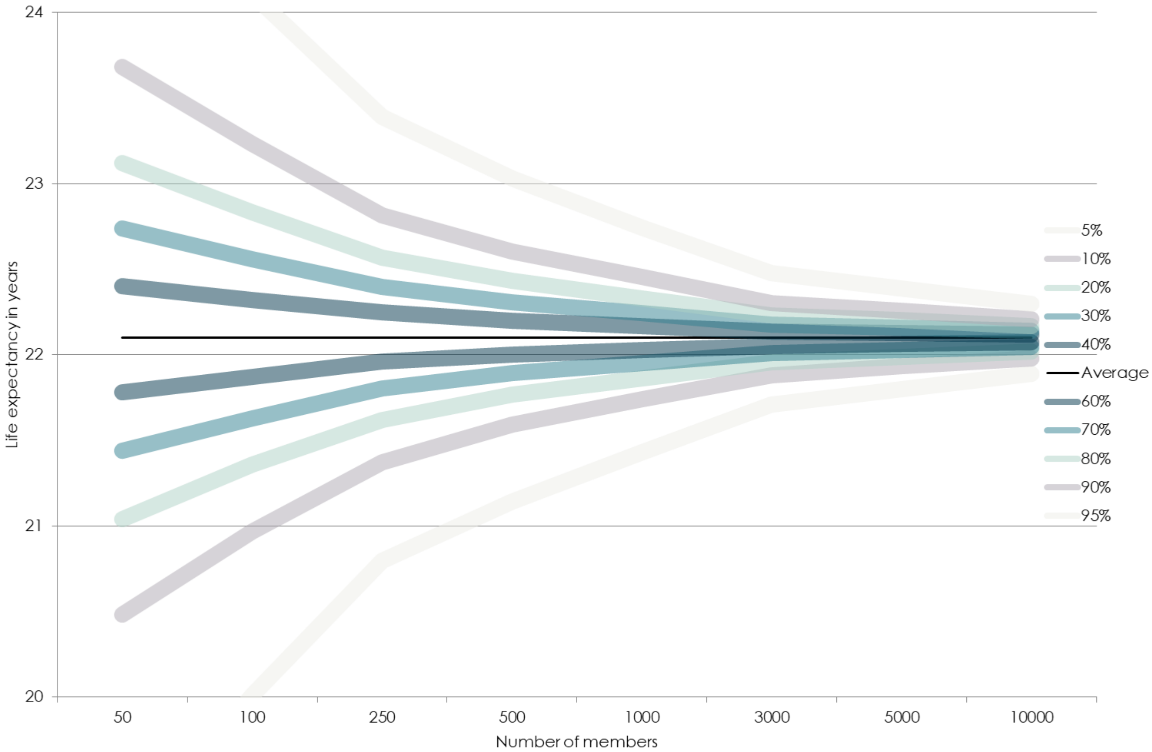
4. Reduced actuarial risks

Risk will also be reduced through the pooling of actuarial risks such as mortality.

Smaller schemes have fewer members and thus are more exposed to idiosyncratic risks than large schemes. Smaller schemes are more exposed to the actual experience of their smaller pool of members than movements in industry trends whereas large schemes have sufficient numbers such that the idiosyncratic variation of their membership's realised experience from industry trends is unlikely to be significant. The most common idiosyncratic risk in smaller pension schemes is mortality risk.

A mortality table shows the probability of dying at each age. If the correct mortality table is selected, then on average the experience of a scheme will follow the mortality table. Furthermore, if the pool of members is of sufficient size, then the random fluctuations will offset each other such that observed experience should be in line with the correctly selected mortality table. For smaller schemes, even if the correct mortality table has been selected, the random fluctuations inherent in such a small sample are significant enough to create large estimation errors.

The following chart, based on a pool of 65-year-old males using the latest available scheme mortality tables, shows how the potential range of outcomes narrows as more and more members are added to the pool and the potential for significant variation around the underlying average is all but eliminated. The chart shows the probability distribution of the range of average lifespans from age 65 in percentiles and how these percentiles narrow as more members are added to the pool of members.



As can be seen, smaller schemes, even if they select the correct underlying mortality table, run considerable risk as to whether that table will describe their actual experience because of the limited numbers of members in their pool. For these schemes it is entirely conceivable that actual experience will be a year or more different from that expected. However, large schemes like Stoneport have sufficient numbers of members to ensure that if they select the correct mortality table, the table will fairly accurately describe their actual experience.

The above analysis is based on an even distribution of the pension liability across the pool of members and a well-known feature of smaller schemes is that they tend to have an uneven distribution of liabilities with some executive members having benefits that are a multiple of the average benefit. Schemes with such a skew have been shown to suffer even higher idiosyncratic mortality risk. Section 11.5 of a paper presented to the Staple Inn Actuarial Society on 26 October 2004 entitled "Financial aspects of longevity risk" provides an illustration of the additional funding required to address these risks.

Analysis by JLT in 2018 showed that for the smallest schemes (those with fewer than 100 members), reserving with a high degree of confidence for the random fluctuations in how long people live would almost double their funding deficits.

Whilst idiosyncratic mortality risk is the most commonly cited idiosyncratic risk, such risks arise in a number of areas of pension scheme operation. For example, idiosyncratic risks arise as regards to:

- the proportion of members in respect of whom dependent's pensions are payable; and
- the incidence of ill-health early retirements.

Idiosyncratic risks also arise where members have a choice over when their benefits are paid or the form in which they are taken. For example, significant variations in experience can occur in the following areas:

- the level of cash commutation;
- the volume of transfers-out; and
- the incidence of early or late retirement.

All of these risks can be mitigated by pooling them across a larger group of exposures, as we have illustrated for mortality risk. As such, Stoneport provides a benefit to employers, by reducing the risk that their obligations increase as a result of adverse experience relative to the average scheme or relative to the population as a whole. These risks can place a significant financial burden on the sponsor of a smaller scheme if they materialise. Furthermore, there are no cost-effective ways in which smaller schemes can manage these risks (the only way is expensive and requires settling the liabilities with an insurance company).

5. Better operational and governance outcomes

As part of Stoneport, members and employers alike will benefit from reduced operational risk and improved governance outcomes.

It is a well-documented fact that large schemes are more likely to operate with a strong governance framework than smaller schemes. This is because more time and resources tend to be dedicated to the effective running of large schemes than is generally the case for smaller schemes.

For the smaller schemes that join Stoneport, we expect its professional set up and its scale to provide a number of significant advantages from both a member and an employer perspective.

Even for the best run smaller schemes, trustees and employers should recognise that more could be done in certain areas were the budgetary restraints that exist for a smaller scheme operated on a standalone basis to be removed.

5.1. Improved governance

Stoneport will provide members of any scheme that joins with a far more secure and better governed pension arrangement. This should be attractive to trustees and employers alike, particularly those with a paternalistic nature (as members of the joining scheme will all be, in most cases, either current or former employees of the sponsor).

Furthermore, by using lessons we have learned from our extensive experience of advising employers in industry-wide schemes, we will put in place arrangements and processes to ensure that employers' needs are met in a timely, efficient and appropriate manner. This will include agreeing funding valuations and reporting pension costs for accounting purposes, as well as ensuring sufficient and appropriate information flows.

A further factor for smaller schemes could be the shrinking pool of people with the relevant knowledge and experience to act as trustees and to manage the scheme on behalf of the employer in the future. This may lead to a decline in standards over time and/or increase in costs from current (high) levels. Schemes that join Stoneport will eliminate this risk.

5.2. Professional trustees

Stoneport will be run by three paid independent professional trustees, chosen from the Pensions Regulator's register of independent trustees, who are committed to delivering the best outcome for its members. For professional trustees, there is a commercial imperative that the schemes they are associated with operate with the highest standards of governance.

One of the three independent trustees will be appointed by Punter Southall. We have chosen Stuart Southall for this role, who is an actuary and an experienced professional independent trustee and chair of the current trustee body. The remaining independent trustees will be selected by the other employers that join Stoneport in due course.

As experienced professionals in their field, all of Stoneport's Trustees will have the knowledge and experience to challenge their advisers' views and ensure they have been presented with all the facts before making decisions that affect Stoneport.

Many schemes operate without a professional independent trustee. For smaller schemes in particular, the cost of an independent trustee can be seen as prohibitive. However, it can be difficult for schemes operating without a professional trustee to recruit and retain trustees with the required skill set.

Furthermore, for many schemes and particularly for smaller schemes, trustees can only devote a limited amount of time to fulfilling their duties as trustees, with other commitments (i.e. those for which they are remunerated) often taking precedent.

5.3. Comprehensive advice

The DB Taskforce's interim report stated that *"a large minority of schemes suggested that costs considerations force them to be selective in terms of the advice that they commission"*. Stoneport will have the budget to commission whatever advice its Trustees deem necessary to ensure that members' benefits are secure and that members receive the best possible service.

The Trustees will be able to justify considering more of the issues that might impact upon Stoneport than a smaller scheme would. Furthermore, it should be possible to consider each issue in much more depth and with a greater degree of sophistication than could be justified by a smaller scheme individually. As the costs of this increased diligence would be spread over many times the number of members, significant cost savings would still be realised on a per member basis.

The Trustees will also have the budget to appoint the best third-party advisers to assist them in running Stoneport and in providing the best possible service to members. In our experience, the quality of the administration is of utmost importance to members. It is the administrators who carry out the day-to-day tasks that members most commonly need to engage with their schemes about. Therefore, how quickly and efficiently the administrators deal with enquiries and the manner in which they go about their tasks is critical to the experience of members.

The Trustees have appointed Barnett Waddingham LLP, one of the leading providers of third-party administration in the market. Barnett Waddingham is an accredited member of both the Pensions Management Institute and the Pensions Administration Standards Association. It won the third-party administrator of the year award in 2018 at the Pension and Investment Provider Awards and was ranked first in the Professional Pensions Survey 2020. Barnett Waddingham was also awarded a gold rating by independent assessor Investor in Customers ("IIC") in 2019.

Obtaining high quality actuarial and investment advice is also important. There are a number of providers in the market capable of fulfilling these roles. However, we believe that for maximum cost efficiencies, the actuarial and investment advice should be commissioned from the same provider as the administration. The Trustees have therefore retained Barnett Waddingham on a full services mandate. Barnett Waddingham's gold rating from IIC covered their consultancy services as well as their administration services and that they won Actuarial/Pensions Consultancy of the Year by Professional Pensions in 2017.

The Trustees have entered into a long-term contract with Barnett Waddingham to provide stability and certainty to the members of schemes that join Stoneport. In return, Barnett Waddingham are committed to investing in the relationship and building the systems that will allow Stoneport to operate as efficiently and effectively as possible.

The Trustees will need to use other professional advisers from time to time e.g. pensions lawyers and covenant advisers. Again, the budget available for advice and the experience of the Trustees should allow Stoneport to secure the best advice on competitive terms.

5.4. Member engagement

Levels of member engagement with their schemes can be low and this can sometimes result in sub-optimal decisions being made by members. We will work with the Trustees to design and implement a comprehensive communication strategy which will be far more extensive than any that a smaller scheme would be able to provide on its own.

This will mean keeping members up to date with developments which might affect their benefits and disseminating information in the most effective and easily digestible ways. This should ensure a high level of member understanding and engagement, which will help to empower individuals to make the appropriate choices when it comes to their benefits.

The communication strategy will include access to a member portal on the Stoneport website, annual benefits statements, a regular newsletter and a dedicated telephone helpline to provide the members with a better proposition.

5.5. Employer engagement

In our experience, a common problem for smaller schemes can be gaining the engagement of the employer, particularly when it comes to matters such as setting long-term strategies or meeting new governance standards. This may be because the employer cannot afford to devote a significant amount of management time to dealing with its scheme. Without the support of the employer, trustees can sometimes feel exposed and may make decisions that are suboptimal decisions from an employer perspective.

Under the TD&R of Stoneport, many of the things that would usually require (or be desirable to have) employer buy-in will be the sole responsibility of the Trustees. Where employer agreement is required, the principal employer will take on that role, acting as the voice of the employers.

However, where the employer wishes to take an active involvement, that will be possible, through the principal employer. Moreover, each employer will be required to set a funding and investment plan on joining Stoneport, which aims to meet the buy-out funding target by 31 December 2045, and to review and amend it as part of each formal actuarial valuation.