Which endgame strategies are compatible with joining Stoneport?

STONEPORT
PENSIONS

Executive summary

Stoneport has been designed for the widest range of smaller defined benefit pension schemes.

The endgame strategies of most schemes and the time horizons they have for meeting those plans are likely to make them ideally suited to Stoneport. However, even schemes on a much shorter journey to buy-out should be compatible with Stoneport because:

- trustees want benefit security – Stoneport can provide it sooner;
- the reduction in running costs is so dramatic; and
- the additional costs savings that Stoneport brings are vast.

The strength and security of Stoneport allows employers the freedom to choose a slower route to buy-out, and with it, a lower cost and lower risk path.

We therefore expect Stoneport to be an appropriate choice for the majority of smaller scheme. If fact, we expect it to benefit any smaller scheme that doesn't expect to be fully funded to a buy-out level within the next five years.

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1. Introduction

Stoneport aims to be fully funded on a buy-out basis by the end of 2045, before a full buy-out of the remaining benefits is completed during 2046. That gives it a defined time horizon of around 25 years.

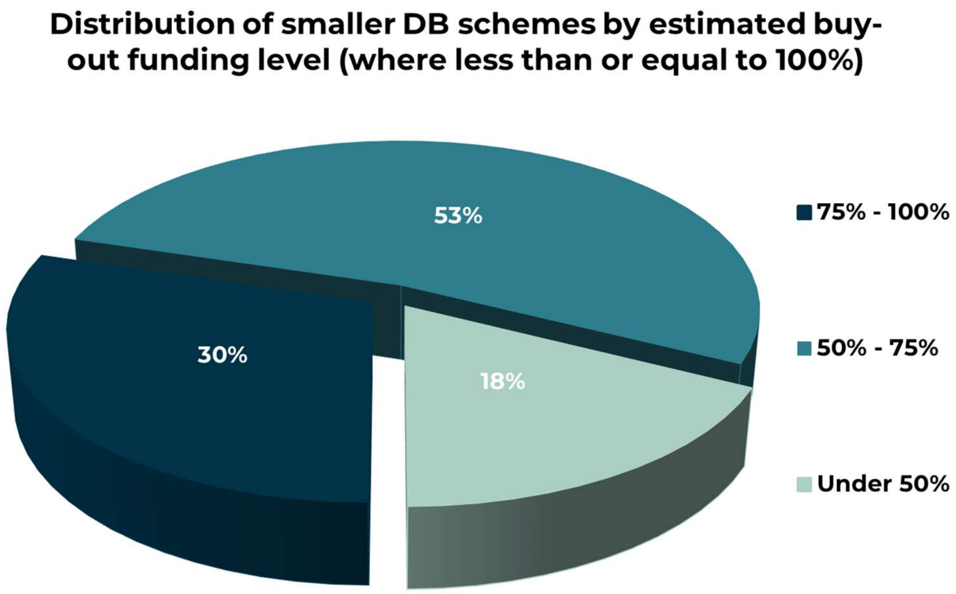
A proportion of the schemes in Stoneport's target market (i.e. smaller schemes with fewer than 1,000 members) will already have an endgame strategy they are working towards. Some will be targeting buy-out, others will be targeting something else, perhaps self-sufficiency. Whatever the target, many of these schemes will be aiming to get there much sooner than Stoneport's 25-year time horizon. Other scheme won't yet to have set a long-term objective; but will undoubtedly have their own views about what a suitable endgame strategy is for their scheme and the appropriate timeframe for reaching it.

The purpose of this report is to explore the range of endgame strategies and time horizons which might be compatible with joining Stoneport.

1.1. Market context

Industry data shows that the average scheme was just 72% funded on a buy-out basis at 31 March 2020. Adjusting the figures to remove schemes already in surplus, the average funding level falls to 69%.

Focusing on schemes in Stoneport's target market, the distribution of buy-out funding levels (excluding schemes in surplus on that measure), as estimated by the PPF at 31 March 2020 was as follows:



For the majority of schemes then, buy-out is at best a very long-term ambition, rather than a realistic short-term goal. For those schemes, joining Stoneport should not mean running on for significantly longer than was likely already.

Moreover, given the very significant scope to stray off course, particular for smaller schemes, where risk is so much more difficult to manage, we expect only a small proportion of our target market to be on track to buy-out with certainly within, say, the next five years.

2. Accelerated benefit security

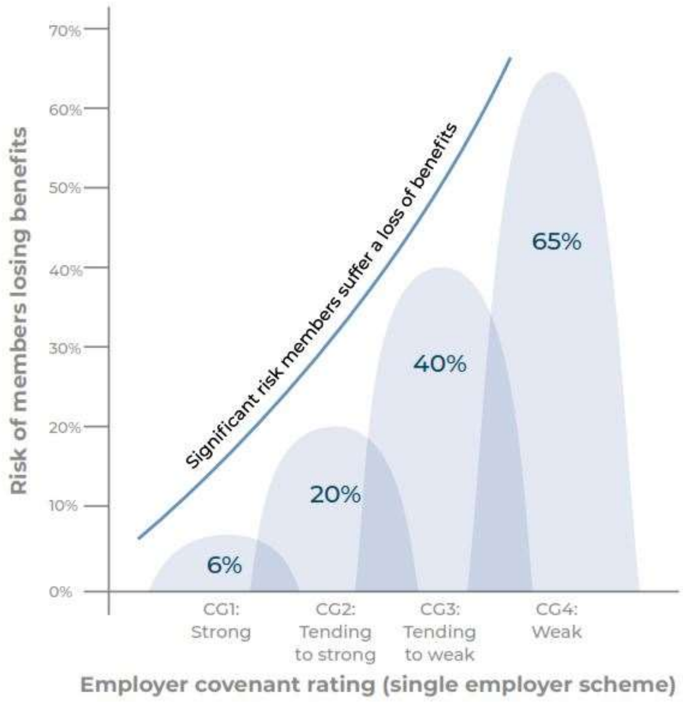
The main role of a trustee is to ensure benefits are paid in full and in this respect, buy-out with a regulated insurer is the lowest risk option, providing the best protection for members. It is therefore understandable that trustees should want to target buy-out, and to aim to reach that goal as soon as possible.

Stoneport recognises that buy-out is the gold standard for trustees, which is why it aims to secure all remaining benefits with a regulated insurance company during 2046.

2.1. The risk to members' benefits

The biggest collective risk to members' benefits is their sponsor becoming insolvent before benefits are secured, leading to a cutback. Over a scheme's lifetime, the risk of benefit loss is significant, even for employers that are rated as 'strong' today.

The risk to members' benefits



Source: PLSA's Interim DB Taskforce Report, April 2016

A buy-out with a regulated insurer practically removes this risk. Under Solvency II, regulated insurers are required to meet stringent capital reserving requirements. The PRA is responsible for ensuring that all UK based regulated insures comply with these rules. In the unlikely event that a regulated insurer does fail, the FSCS aims to provide full compensation to members whose benefits are covered by a buy-out.

2.2. The security that Stoneport provides

Stoneport reduces the chance of members suffering a cutback of their benefits to less than 1% (see the guide Employer covenant enhancement on centralisation: a primer for trustees on our website for details). It achieves this transformational improvement in benefit security as soon as it becomes a centralised scheme, which is targeted to happen on 31 December 2022.

Stoneport therefore offers trustees and the members of their schemes the protection and security they both desire; and expects to deliver that in relatively short order (i.e. by the end of 2022).

In doing so, the pressure to fund up to buy-out as soon as possible is removed, enabling a more balanced approach to be taken in respect of the (cash) commitments from the employer.

In the unlikely event that Stoneport fails to become a centralised scheme, because the number and mix of schemes that have joined it is insufficient, the security of members' benefits will not improve to any material extent.

Each scheme will continue to operate on a fully segregated basis, supported by its original employer. As such, the covenant provided to the schemes that join will not change. However, an anticipated (but more modest) reduction in running costs and improvement in governance could have a small positive second order impact on benefit security.

3. Reduced costs

By bringing the benefits of scale to the smaller schemes that join it, Stoneport can run on for much longer than a standalone scheme without necessarily incurring higher running costs in aggregate. This is because the reduction in running costs that economies of scale can deliver are so dramatic.

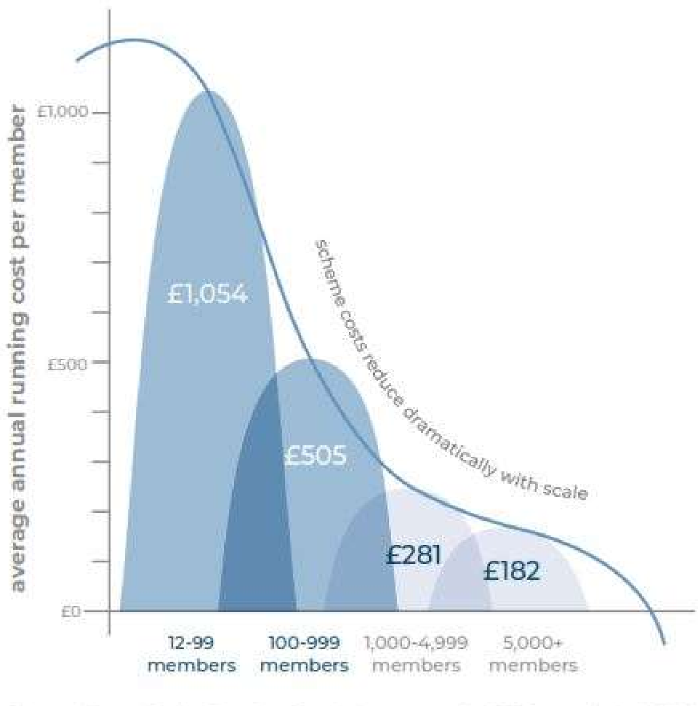
By running on for longer as one large scheme, Stoneport also brings substantial further savings, including a reduction in endgame costs, discounted investment management costs, higher expected investment returns and a reduction in PPF levies (of more than 90%).

3.1. Lower running costs

By operating like one large single employer scheme and through the long-term contracts it has in place with service providers, Stoneport is able to deliver running cost savings of up to 80% to the smallest schemes.

Smaller schemes are too small to ever run effectively or efficiently individually.

The substantial costs of smaller schemes



Source: Report for the Pensions Regulator prepared by IFF Research, April 2014

We expect schemes in Stoneport's target market to be paying running costs of more than £500 per member each year on average, rising to well over £1,000 per member for the smallest. In Stoneport, those annual running costs would be less than £200 per member.

Punter Southall's own small scheme spent around £1,750 per member in running costs during 2019. As part of Stoneport, Punter Southall expects to save around £1.4 million in running costs alone.

3.2. Endgame savings

Joining Stoneport is expected to provide the smaller schemes that join it with significant endgame savings.

During the 25-year period prior to the buy-out of the remaining benefit obligations in full during 2046, Stoneport's membership will mature and an increasing proportion of its members will start to receive their pensions. This is important, because securing a buy-out is expensive, particularly for deferred pensioners. There are therefore significant advantages to waiting until the majority of members have retired before implementing a buy-out. By securely running on for longer in Stoneport, employers are able to capture those benefits.

Furthermore, by bringing together many smaller schemes with a joint target to buy-out as one large scheme during 2046, Stoneport brings considerable bulk buying power. The size of the buy-out will result in a significant saving in the buy-out premium and avoid the difficulties each of the smaller schemes may face in trying to buy-out on their own.

The scale of the deal, which could be 100 times the size a smaller scheme buy-out, is likely to attract interest from a greater number of insurers, whose fixed cost associated with bidding for a transaction can be significant. The competitive tension created by this is likely to lead to a significantly reduced price. Furthermore, because the assets held by Stoneport in its matching fund will be aligned with the type of assets that an insurer wants to hold, they can be transferred in-specie, removing the need to incur the cost of (or bear the risk associated with) realising and reinvesting assets.

We expect the buy-out price achieved by Stoneport to be around 5% lower than a small scheme could achieve by approaching an insurer alone.

3.3. Lower investment management costs

Stoneport expects to reduce investment management costs for the smaller schemes that join it by exploiting the economies of scale that come with size.

For the same underlying service, better fee terms are available to clients of asset managers with larger pools of assets than those with smaller pools of assets. These economies of scale in investment management are a key motivation behind the establishment of the Local Government Pension Scheme ("LGPS") pooling arrangements by the UK Government.

By way of illustration, the following research by the Callan Institute 2017 Investment Management Fee Survey found that a scheme with assets between £1 billion and £10 billion paid approximately 0.2% per annum less in asset management fees compared to a sub £1 billion scheme.

We expect the smaller schemes joining Stoneport to make even larger investment management cost savings.

3.4. Governance boost to returns

Stoneport's improved operational governance framework will provide higher expected investment returns to the smaller schemes that join it.

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

Good governance is recognised by the Pensions Regulator as the bedrock of a well-run scheme. In its consultation on "Protecting Defined Benefit Pension Schemes" the DWP cite several academic studies, the conclusions of which reveal that good governance through effective investment can add between 1% and 2% per annum to returns.

Stoneport's size will provide access to the best investment opportunities, including a wider range of asset classes. Its more stable and predictable benefit cashflows and long-term strategy will allow it to exploit the illiquidity advantages of accessing higher quality assets available in less efficient markets.

Furthermore, as experienced professionals in their field, Stoneport's trustees will ensure the costs of investment are managed and set benchmarks that align the interests of the investment managers with the members and the employers.

3.5. PPF levy saving

Stoneport's unique pooled approach is expected to deliver a reduction in the risk-based element of the protection levy payable to the PPF of more than 90% to the schemes that join it.

3.6. Modelling the cost savings

To assess the cost savings that Stoneport delivers, we created a model capable of comparing the costs for a smaller pension scheme which:

- joined Stoneport and therefore continued to run on for the next 25 years, before buying out the remining benefits in full during 2046; or instead

- continued to run on alone, until full funding on buy-out was achieved and all benefits then secured in full with an insurer.

Our model shows that a smaller scheme with five years or more to buy-out would be expected to save money overall by joining Stoneport.

For illustrative purposes, we set out the results of our modelling, comparing the costs in Stoneport to running on alone for ten years before buying out, in the appendix to this report. The appendix also contains details of the assumptions underlying our model.

If Stoneport fails to become a centralised scheme, the reduction in running cost achieved will be much lower and some of the other anticipated cost savings may also be lower or fail to materialise. In those circumstance, schemes will not be bound by Stoneport's funding target and may instead choose to adopt their own approach.

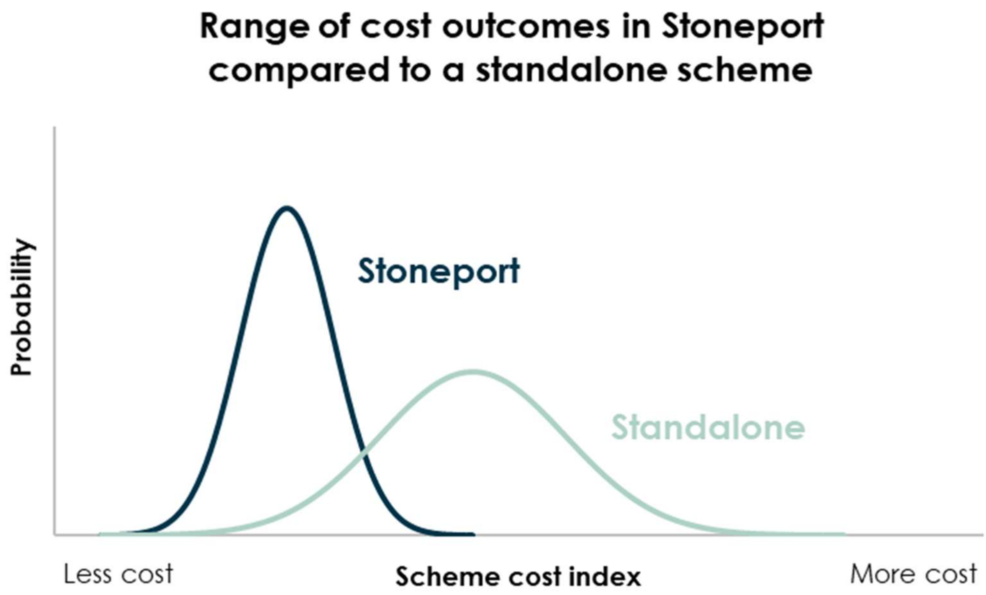
4. Reduced risk

Whilst cost is a very important factor, it is by no means the only consideration. Risk is also very important.

Small schemes are particularly risky, because of their size, and can easily be thrown off course. Not only does a lack of scale often limit what actions they can take, being small inherently means that there is much greater variability in the experience of the membership, i.e. idiosyncratic risk – such as how long each member lives and therefore, how long their benefits are paid for.

By gaining significant scale Stoneport is able to bring the benefit of operating like a large scheme, including more sophisticated risk management techniques, and reduced demographic risks.

The graph below shows an illustrative range of the potential cost outcomes for a typical smaller scheme inside of Stoneport, compared to the illustrative range of the potential costs for the same scheme operating alone for ten years, before securing a buy-out:



As you can see, for a typical smaller scheme, Stoneport is expected to be both:

- **the lower cost option**, with the vast majority of possible outcomes falling to the left of those for a standalone scheme; and

- **the lower risk option**, as illustrated by the narrower range of outcomes.

4.1. Reduced investment risk

Joining Stoneport will significantly reduce the amount of investment risk that smaller schemes take (for the same expected return).

Stoneport's size allows it to tailor its matching fund so that its assets more closely match its liabilities. Its scale will also provide access to a wider range of asset classes and specialist mandates, facilitating increased diversification within the investment fund.

By removing unrewarded investment risk, Stoneport cuts the volatility that smaller schemes would experience running on alone.

4.2. Reduced actuarial risks

Smaller schemes joining Stoneport radically reduce their actuarial risks by pooling them so that their exposures more closely reflect the average. Running on alone, smaller schemes are far more exposed to idiosyncratic risks than large schemes. Statistics like "10% of the liabilities are in respect of just 1% of the membership" are commonplace.

The most common idiosyncratic risk in smaller pension schemes is mortality risk. Analysis by JLT in 2018 showed that for the smallest schemes, reserving with a high degree of confidence for the random fluctuations in how long people live would almost double their funding deficits.

Idiosyncratic risks arise in a number of other areas of pension scheme operation too, like the proportion of members who have a dependant on death, the level of cash commutation and the volume of transfers-out.

Stoneport mitigates these risks through diversification, spreading them across all of the schemes that join, and in doing so provides a more predictable pathway to buy-out.

4.3. Reduce operational risk through enhanced governance

The smaller schemes that join Stoneport will benefit from the reduced operational risk that comes from having professional independent trustees, along with the scale and resources to consider all issues in appropriate depth.

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

As experienced professionals in their field, Stoneport's trustees will have the knowledge and experience to challenge the advice they receive to ensure the decisions they take are fully informed.

Many smaller schemes operate without a professional independent trustee as the cost can be prohibitive. It can also be difficult for smaller schemes to recruit and retain trustees with the required skill set. This can increase the likelihood of operational risks materialising. The smaller schemes that join Stoneport will eliminate this risk.

5. Reduced hassle

Not only is Stoneport both the lower cost and lower risk option, it also removes a lot of the hassle of running a smaller scheme alone. Moreover, its size and professional set up make it better able to adapt to changes in the regulatory environment.

5.1. Reduced management time

For the smaller schemes that join Stoneport, employers are provided with what they need when they need it and are supported by experienced advisors who, on their behalf, manage the engagement with Stoneport's trustees. This simplifies the process for employers, making it quicker and easier to take decisive action (with appropriate support), freeing management to focus on their businesses.

5.2. Adapting to new regulatory and governance challenges

Although a strong governance framework is entirely necessary and appropriate, to protect members' retirements, it places a very heavy burden on smaller schemes in particular.

2021 has already seen the Pension Schemes Bill receive Royal Assent and the Pensions Regulator launch a consultation to combine ten existing codes of practice, which also seeks to impose a number of new governance requirements. The long-awaited new funding code is expected later this year too. This comes on top of schemes needing to practically address GMP equalisation, protect members from pension scams, safeguard member data and ensure good governance generally, all in the face of a global pandemic.

Stoneport has the size and scale to address these challenges efficiently and effectively.

Stoneport also acts as a gateway to ESG and a greener portfolio, which are difficult and costly for small schemes to achieve individually today.

5.2.1 Meeting new long-term funding requirements

The new scheme funding code will require all schemes to set a long-term funding objective. Addressing this challenge alone could be tough for smaller schemes in particular.

Whilst the Pensions Regulator is not going to require schemes to target full funding on buy-out basis, schemes will be required to reduce the reliance on the employer covenant, by funding to and investing consistently with a low dependency basis. Precisely what that means is yet to be defined, but the Pensions Regulator has indicated that the low dependency discount rate will be somewhere in the range of gilts + 0.5% to gilts + 0.25% and that significant maturity will be around 15 to 20 years from now for a scheme of average maturity.

For most schemes, these new requirements will result in a significantly higher funding target than their current technical provisions and likely take them very close to full funding on a buy-out basis by the time they reach significant maturity.

Because of the endgame savings that Stoneport delivers, targeting a buy-out within Stoneport in 25 years' time could be significantly cheaper than targeting full funding on a low dependency basis over 15 to 20 years.

6. Conclusion

In our opinion, Stoneport should be an appropriate choice for any smaller scheme that does not expect to be fully funded on a buy-out basis and secure all benefits in full with an insurer within the next five years.

It may, initially, seem a surprising result, that any scheme which will run on for more than five years will be better off joining Stoneport, given Stoneport is expected to run for 25 years before securing a buy-out.

The key reason is the very dramatic cost reductions Stoneport achieves. Whilst joining Stoneport does mean running costs continue for longer, those costs are substantially lower within Stoneport. Moreover, joining Stoneport brings very significant costs savings in other areas, on top of the dramatic reduction in day to day running costs.

Not only are costs much lower overall for smaller schemes that join Stoneport, but the risks that schemes face are much lower also.

Joining Stoneport provides the benefit security that trustees and members both desire. It achieves this sooner, freeing the employer to choose the longer, safer, lower cost, less hassle, shared path to buy-out that Stoneport provides.

Appendix: Comparing the costs

Intuitively, one may think that running a scheme for 25 years in Stoneport would be more expensive than running it for, say, ten years alone. However, because Stoneport delivers such a significant reduction in running costs, and because of the other substantial cost savings it brings, the opposite is true: Stoneport is (by far) the cheaper option.

Amongst other cost savings, Stoneport leverages its scale to reduce investment management charges, deliver a 'good governance premium' (estimated to add 1% to 2% per annum to returns) and secure a lower price from the insurer when it comes to buy-out the benefits.

To illustrative the significant cost savings that Stoneport provides, we undertook some indicative high-level modelling to compare the cost of Stoneport with the cost of running on alone. In doing so, we took a conservative approach, allowing for only the following:

	Stoneport	**Small scheme alone**
Years of running costs paid before buy-out is achieved	25	10
Reduction in investment management fees/benefit of good governance premium	0.5% per annum (for ten years only)	Nil
Reduction in buy-out premium	5%	Nil

Our model showed that **the 'average' 50-member scheme would be better off joining Stoneport than running on alone for 10 years based on a comparison of running costs alone, and around £800,000 better off overall** - a saving of around 9% of the scheme's assets.

The results are similarly impressive for all schemes in Stoneport's target market, as illustrated in the table over the page:

Number of members	Aggregate cost saving inside Stoneport	Saving as a proportion of scheme assets
250	£3.6 million	8%
500	£7.0 million	8%
750	£10.4 million	8%

Whilst schemes running on alone for five years would expect to pay more in total in running costs if they joined Stoneport, they would be better off after taking account of the savings described above.

The assumptions used to prepare these illustrations can be debated. Schemes can take advice and form their own views as to what factors should be taken into account and what assumptions to make when comparing the costs of joining Stoneport to the costs of running on alone. The purpose of our modelling was to demonstrate as simply and as clearly as possible that Stoneport is the lower cost option for any smaller scheme not able to buy-out alone in the next five years.

We did not therefore seek to model the advantage of waiting until the scheme is significantly mature before securing a buy-out, or the reduction in PPF levies. We also model only ten years of lower investment management costs and higher investment returns from good governance and allow for a saving of just 0.5% per annum combined from those factors.