

Hermes Group Pension Scheme

Statement of Funding Principles

Introduction

This Statement of Funding Principles sets out the Trustee's policy in relation to scheme funding and other related matters. It has been prepared by Hermes Pension Trustees Limited, the Trustee of the Hermes Group Pension Scheme ("the Scheme") to satisfy the requirements of Section 223 of the Pensions Act 2004, after obtaining the advice of the Scheme Actuary, Emma Palfreyman. The Trustee has discussed and agreed it with BT Pension Scheme Trustees Limited ("the Employer").

This statement covers the Scheme's statutory funding objective, the principles used to determine and reach that objective and the agreements reached between the Trustee and the Employer on the contents of this statement. It contains other information required under the Act and applies to the actuarial valuation as at 31 December 2017.

Statutory funding objective

The statutory funding objective is that the Scheme should have sufficient and appropriate assets to cover its technical provisions and this statement sets out the Trustee's policy for ensuring that this objective is met.

Technical provisions

The method and assumptions used to calculate the technical provisions (as defined in Section 222(2) of the Pensions Act 2004) are set out in the Appendix. As part of each valuation the Trustee and the Employer shall agree if the method and assumptions need to be updated in light of circumstances at that time.

The Trustee must be of the opinion, having considered the advice of the Scheme Actuary, that these are appropriate and prudent for the purpose of the Scheme's statutory funding objective.

Method

The Trustee and the Employer have agreed that the technical provisions for the Scheme at any given date are to be calculated as the capital value of the prospective benefits arising from service completed before that date, including allowance for prospective Pensionable Salary increases for final salary benefits or revaluation for career average revalued benefits, as appropriate, for those members in employed-deferred service at that date. This method of calculating technical provisions is commonly known as the projected unit method.

Assumptions

The Trustee and the Employer have further agreed that:

- The assumed rate of return on investment for funding purposes will have regard to the Scheme's anticipated future investment strategy. The discount rate assumption used to determine the past service liability will be determined based on the yield on long-term Gilts plus a premium. The premium is intended to allow for some asset outperformance over Gilt returns reflecting the Scheme's future investment strategy.
- The discount rate will be term-dependent based on an appropriate yield curve (e.g. the Willis Towers Watson Fixed Interest Gilt curve) adjusted by an appropriate margin.
- The remaining financial assumptions, in particular future Retail Price Inflation (RPI) will take into account information available in respect of the bond markets at the effective date of the actuarial

valuation. Inflation will be term-dependent based on an appropriate curve (e.g. the Willis Towers Watson break-even RPI inflation curve). The assumption for future Consumer Price Inflation (CPI) will be set by reference to the RPI assumption and will allow for a prudent view of the expected long term gap between RPI and CPI.

- The future pensionable salary increase assumption will be determined after consultation with the Employer.
- Demographic assumptions will have regard to an analysis of the recent changes in the Scheme membership as well as relevant statistics applicable to similar pension schemes, information published by the UK actuarial profession's Continuous Mortality Investigation Bureau and the Office for National Statistics (in relation to mortality) and the Trustee's and the Employer's views about how these may change in future. Mortality assumptions will be selected with the intention that they should reflect a prudent estimate of life expectancies across the Scheme membership.
- The strength of the covenant provided by the Employer will be taken into account.
- Assets will be taken at market value.

Taken together, the financial and demographic assumptions adopted at a particular date will be prudent and consistent with the Trustee's desired level of confidence that assets equal to the technical provisions should prove adequate to meet benefits already accrued as they fall due without the need for further contributions from the Employer.

Discretionary benefits and benefit enhancements on redundancy

At the request of the Employer and upon payment of any contributions that the Trustee (with the advice of the Scheme Actuary) may consider appropriate, the Trustee will increase any benefit or provide additional benefits under the Scheme. The Trustee and the Employer have agreed that only discretionary benefits actually granted will be taken into account in the calculation of technical provisions.

Under the Scheme rules, some employed-deferred members are entitled to enhanced retirement benefits on redundancy and some other cases of early retirement. The Trustee has agreed with the Employer that advance provision for future redundancy and early retirement cases will not be made and that the Employer will meet the cost of such enhancements when they arise, as certified in each case by the Scheme Actuary, unless the Employer and the Trustee agree otherwise, based on actuarial advice and having regard to the Scheme's funding level and its funding and investment strategy at the time.

Future service contributions

The Scheme closed to future accrual on 31 October 2011.

Actuarial valuation as at 31 December 2017

The Trustee (having taken the advice of the Scheme Actuary) and the Employer have agreed assumptions for the valuation as at 31 December 2017. The financial and statistical assumptions for calculating the technical provisions as at 31 December 2017 are set out in the Appendix.

Expenses

Expenses (excluding PPF levies) are paid by the Scheme and so an allowance has been made for such expenses in the funding of the Scheme. The Employer will meet the PPF levies directly when they fall due.

Eliminating a shortfall

If the assets of the Scheme are less than the technical provisions at the effective date of any actuarial valuation, a Recovery Plan will be put in place. A Recovery Plan is not required for the 31 December

2017 valuation as the assets of the Scheme exceed the technical provisions at the effective date of the actuarial valuation.

The Trustee and the Employer have agreed that any funding shortfalls identified at an actuarial valuation should be eliminated as quickly as the Employer can reasonably afford by the payment of additional contributions over the recovery period. In determining the actual recovery period at any particular valuation, the Trustee's principles are to take into account the following factors:

- The size of the funding shortfall;
- The risk that the value of the Scheme's assets may deteriorate further against the technical provisions and the solvency liabilities of the Scheme;
- The impact of any potential recovery plan on the future viability of the Employer;
- The impact on the Employer and its plans for sustainable growth;
- The ability of the Employer to meet the shortfall during the recovery period;
- The Employer's covenant.

In making this latter assessment, the Trustee may take account of external market information concerning the Employer or obtain specialist covenant advice.

The assumptions used for determining the Recovery Plan will generally be the same as those used for determining the Scheme's technical provisions and an allowance for asset out-performance may be incorporated.

Frequency of actuarial investigations

An actuarial valuation of the Scheme is being carried out as at 31 December 2017. In the normal course of events the Trustee will require subsequent valuations three years after the preceding one. The Scheme Actuary will provide an estimate of the up-to-date financial positions of the Scheme, relative to the statutory funding objective and the solvency liabilities, as at each Scheme year end for which a full valuation is not requested.

The Trustee may call for a formal funding valuation at any date if they are of the opinion that events have made it unsafe to rely on the results of the previous valuation for funding purposes. In reaching such a view, the Trustee will consider the advice of the Scheme Actuary and consult with the Employer.

Arrangements for other parties to make payments to the Scheme

There are no arrangements for a person other than the Employer or a member of the Scheme to contribute to the funds held by the Scheme.

Paying funding surpluses to the employer

There is no power to make payments to the Employer out of funds held whilst the Scheme is ongoing. On winding up, however, if surplus assets remain after all liabilities have been met in full on a buy-out basis with an insurance company these will be paid to the Employer.

Cash equivalent transfer value calculations

The Trustee will ask the Scheme Actuary to advise them at each valuation of the extent to which assets are sufficient to provide cash equivalent transfer values for all non-pensioners without adversely affecting the security of the benefits of other members and beneficiaries. The legislation allows the Trustee to reduce cash equivalent transfer values paid to members if (but only if) the Scheme Actuary advises that the Scheme's assets are insufficient to provide cash equivalent transfer values in full to all members, on the method and assumptions adopted for that purpose.

Signed on behalf of the Hermes Pension Trustees Limited

Signature: ALB

Print Name: ALAN BOSTOCK

Date: 29/11/18

Position: Authorised Signatory

Appendix

Financial and demographic assumptions for calculating the technical provisions as at 31 December 2017

Financial assumptions as at 31 December 2017

	Technical provisions	Approximate single equivalent rate
Discount rate:	Willis Towers Watson gilt curve + 0.75% p.a.	2.41%
Price inflation (RPI):	Willis Towers Watson implied inflation curve	3.37%
Price Inflation (CPI):	Willis Towers Watson implied inflation curve – 1% pa	2.37%
Pensionable Salary increases	CPI curve	2.37%
Revaluation for career average benefits	RPI curve capped at 5% pa with fixed volatility of 2.4% pa	3.16%
Revaluation for deferred pensioners	CPI curve	2.37%
Revaluation for GMP (S148)	RPI curve + 1%	4.31%
Pension increases:		
■ former HPS members	CPI curve uncapped (floor of 0%) with fixed volatility of 1.9% pa	2.61%
■ other members	RPI curve capped at 5% pa with fixed volatility of 2.4% pa	3.07%
■ Post 88 GMP	CPI curve capped at 3% pa with fixed volatility of 1.9% pa	2.05%

Demographic assumptions as at 31 December 2017

Details of the demographic assumptions are shown below:

Retirement

Employed-deferred and deferred members are assumed to retire on reaching normal retirement age. No allowance is made for early retirements (including on the grounds of ill-health) or withdrawal from employed-deferred service.

Mortality: All members

SAPS Light ("S2 Light normal health pensioner tables") series with a 95% multiplier for males, and SAPS ("S2 Normal health pensioner tables") with an 85% multiplier for females, based on member's year of birth and projected from 2007 in line with the CMI 2017 Core Projections model with a long term rate of 1.5% pa.

Marriage: All members

The proportion of members assumed to be married at retirement or earlier death is 85% for males and 75% for females, in line with the current PPF methodology for Section 179 valuations.

Withdrawal

No allowance is made for withdrawal from employed-deferred service.

Age difference between member and spouse

It is assumed that male members are 3 years older than their female partner and female members are 3 years younger than their male partner.

Allowance for option of members to commute pension for cash at retirement

Allowance is made for members to commute 15% of their pensions at retirement. The commutation factors used in the technical provisions are higher than those currently in force to make some allowance for potential changes in commutation factors in the future. The basis to calculate these assumed factors uses a discount rate of gilts + 1.5% pa and a long-term best estimate basis for the other assumptions.

Allowance for members to transfer out of the Scheme

No allowance is made for members to transfer out of the Scheme.

Expenses

A reserve of 5 years of Scheme expenses has been included in the technical provisions with expenses assumed to be £600,000 per annum. PPF levies will be met by the Employer.

GMP equalisation

For the 2017 valuation, a reserve of £1,000,000 will be included in the technical provisions in respect of the requirement to equalise benefits to compensate for unequal Guaranteed Minimum Pensions between men and women. Some estimated calculations were done as part of the 2017 valuation which determined this was not an unreasonable allowance and that the liability reserve held in the technical provisions in this respect is in line with the Trustee's desired level of prudence, noting that the actual cost of this exercise could be higher or lower than the reserve held in the technical provisions.

Recovery plan

A Recovery Plan is not required for the 31 December 2017 valuation as there was a surplus on the technical provisions basis at this date.

