

# **Report of the Director West Yorkshire Pension Fund to the meeting of Joint Advisory Group to be held on 26 July 2018**

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## **Subject: Review of Additional Voluntary Contribution Providers**

### **Summary statement:**

West Yorkshire Pension Fund has 3 Additional Voluntary Contribution Providers, namely:

- Equitable Life Assurance Society,
- Scottish Widows, and
- Prudential

Annually the West Yorkshire Pension Fund ask Aon's AVC Team to review the performance of the Additional Voluntary Contribution Providers in terms of investment performance, financial strength, investment capabilities, charging structure and administration. This report outlines the findings of the review.

### **Recommendations**

It is recommended that the Joint Advisory Group:

- note the outcome of the annual review of WYPF's AVC providers.

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## 1. BACKGROUND

- 1.1 An active scheme member may elect to pay additional voluntary contributions (AVC's) into a scheme established between the administering authority and an approved insurer.
- 1.2 WYPF has three AVC providers, Equitable Life, Scottish Widows and Prudential.

The contributions paid during the year, fund values and membership information at 31 March 2018 (5 April 2018 for Equitable Life) are as follows:

	<b>Equitable Life</b>	<b>Scottish Widows</b>	<b>Prudential</b>
Contributions	£13,693	£407,384	£5,440,841
Fund Value	£2,324,022	£13,424,951	£16,162,412
<b>Scheme members with an AVC Policy</b>			
31/03/2018	573	1,178	1,982
31/03/2017	611	1,288	1,797

### 1.3 In summary:

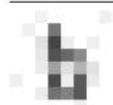
- Total membership has increased by 5% despite a reduction the number of members in both Scottish Widows and Equitable Life.
- There has been an increase of 20% in the total level of contributions over the last 12 months in comparison to the 12 months prior.
- Total assets have also increased by 21% as a result of contributions paid and strong investment returns on growth assets.

1.4 The Occupational Pension Scheme (Investment) Regulations 2005 require trustees to monitor AVCs in line with a number of criteria, including the security and quality of the arrangements in place. For best practice purposes Aon Hewitt have used these regulations to assess the Fund's AVC arrangements.

1.5 Aon continue to view Scottish Widows and Prudential as appropriate providers. They have no concerns over the suitability of Equitable Life as a legacy AVC provider at this time.

## 2. Review of Equitable Life Assurance Society (ELAS) AVC Plan

2.1 The Equitable Life AVC plan is closed to new members. At 5 April 2018 there were 573 members in the plan, with 546 of them in the With-Profits Fund.



- 2.2 There are also 27 members contributing to the life assurance arrangement, with a total sum assured of £849,435.
- 2.3 AKG Financial Analytics Ltd (AKG), the organisation used by Aon to review With Profits Funds, rate the With Profits Fund as having 'good' financial strength and 'poor' future performance prospects.
- 2.4 Equitable Life made an important announcement on 15 June, confirming it had entered into an agreement to transfer its business and all of its policies to Reliance Life, part of a specialist European life assurance group, Life Company Consolidation Group which specialises in managing funds as an insurer winds down.

The transfer requires policyholder and regulatory approval but if it goes ahead, the capital Equitable Life currently holds as a reserve to meet future liabilities, will be released to With Profits policyholders.

Equitable Life's proposal is to:

- Increase the current 35% capital distribution to a level expected to be between 60% and 70%
- Close the With Profits Fund (which means the guaranteed value of policies would end and with it any future guaranteed investment returns)
- Convert With Profits policies to unit-linked policies
- Transfer all policies to Reliance Life

The vote by With Profits policyholders is expected to take place in mid-2019, and the proposal will then be put before a High Court Judge for approval. If approved, the enhancement to With Profits policies and the removal of the future guaranteed investment return are expected to take place towards the end of 2019.

- 2.5 Aon's Global Investment Manager Research Team do not research or monitor Equitable Life's Unit-linked funds held by the Fund's members. Aon have no concerns over performance of the Equitable Life unit-linked funds held by members which have all out-performed their sector, net of fees, over all the periods reported on with the exception of the UK FTSE All Share Index-Tracking Fund.
- 2.6 Aon's overall view is that the fund options currently available through the Equitable Life arrangement to be adequate given the closed nature of the arrangement. Aon recommend, given that Equitable Life is in run-off, that the Fund continues to monitor the investment options under this arrangement.



2.7 Aon have no concerns over the quality of Equitable Life's AVC administration at present; there is a risk that quality of service may deteriorate as the business contracts. This risk may be mitigated, at least in part, by the transfer to Reliance Life.

2.8 In regard to communication and reporting, Equitable Life supplies summary financial statements providing the information required for the Report & Accounts. It is unable to provide governance reports for the Fund and Aon believe this is unlikely to change, given the fact that Equitable Life is closed to new business, and the proposed transfer to Reliance Life.

Although members do not have online access to their policy, the Equitable Life website includes much useful information and is, in Aon's opinion, well set out and 'user friendly'.

### **3. Review of Scottish Widows AVC arrangement**

3.1 As at 31 March 2017 there was a total of 1,178 members in the Scottish Widows AVC arrangement.

3.2 Scottish Widows Limited is now Lloyds' Banking Group's sole long term insurance company.

As at February 2018, AKG rated the overall financial strength of Scottish Widows Limited as B+ (very strong). It also commented that Scottish Widows Limited is a core component within Lloyds Banking Group, in part due to its cash generation, and comments that it would expect the company to receive all necessary parental support, should it be required, to achieve its objectives.

3.3 There are 15 Scottish Widows funds available to new and existing members and members also have access to Scottish widows Pension Investment Approaches and a bespoke Lifestyle option. In addition there are a number of funds which existing members can continue to invest in.

The performance, relative to sector average, of the 15 current funds has been disappointing for many of the funds held by members over the periods Aon have reported on.

Following fund replacements made by Scottish Widows last year, nine of the 15 funds approved by the Administering Authority are internally managed. Aon have not raised any major concerns about the funds that are internally managed.

3.4 In regard to the externally managed funds Aon have a high regard for State Street as a passive fund manager and its Global Investment Manager Research Team has confirmed a 'buy' rating for SSgA's index tracking funds (the SSgA International Equity Index, SSgA Global Equity 50:50 Index and the SSgA UK Equity Index).

3.5 The other externally managed funds have generally under-performed their sector average. However, Aon has not recommended any changes to the funds available to members.



3.6 The WYPF's bespoke lifestyle invests 50% in the UK and 50% overseas whereas the concentration of the UK stock market and the increased uncertainty following Brexit leads Aon to favour a more global approach. The fluctuations in Sterling exchange rates have also increased Aon's preference to include an element of currency hedging in global equity exposure. Unfortunately Scottish Widows does not offer access to a suitable passively managed global equity fund. Aon therefore recommend the Fund considers replacing the 50:50 Global Equity Fund in the lifestyle strategy with the SSgA International Equity Index, or the World ex-UK Fund and the SSgA UK Equity Index Fund. Officers will discuss this with Aon after the issue of the final report, and report on whether the recommendation has been accepted.

3.7 Scottish Widows administer AVC policies within their corporate pension servicing team. This area of the Scottish Widows business was adversely impacted by automatic enrolment and the additional administrative burden as a result of the pension freedoms but Aon has since seen service standards and transaction timescales improve significantly.

Scottish Widows has experience of providing AVC arrangements to LGPS clients and Aon understand it is keen to develop its LGPS offering further. Aon regards its administration systems to be more up to date than some providers who offer LGPS customisation and this should enable Scottish Widows to operate these arrangements more efficiently, however in practice this does not appear to be the case. In our experience, service standards, for reporting in particular, are much slower than we would expect and do not appear to be structured.

Despite Aon's criticism of Scottish Widows' reporting processes, it has no major concerns over standards of policy administration. However, at the recommendation of Aon, service levels will continue to be monitored to make sure that members are receiving the service they expect.

3.8 In Aon's opinion Scottish Widows' suite of communications tailored to LGPS clients is of a reasonably good quality and is accessible via the WYPF microsite. Relevant information is set out in a clear manner.



- 3.9 WYPF's AVC arrangement benefits from a discount of 0.40% on Scottish Widows' standard Total Annual Fund Charges ("TAFC"). The charges for the approved Scottish Widows' funds are set out in the table below:

Fund name	TAFC (% p.a.)
SSgA 50:50 Global Equity Index	0.603
SSgA International Equity Index	0.606
SSgA UK Equity Index	0.605
SW Cash	0.60
SW Consensus	0.60
SW Corporate Bond	0.60
SW Environmental	0.60
SW Indexed Stock	0.60
SW International	0.645
SW Invesco Perpetual High Income	1.52
SW Newton Global Equity	0.929
SW Pension Protector	0.60
SW Property	0.72
SW Standard Life GARS	1.43

Aon Hewitt regard the charges on the Scottish Widows AVC arrangement to be high compared to current market rates if we were considering the number of members and assets under management alone. However the level of charges for LGPS arrangements also take account of the fact that Scottish Widows deals with multiple employers and payrolls and it carries out a number of the duties typically undertaken by employers, such as joining new members.

As such, Aon regard the charges on the arrangement to be reasonable.

#### 4. **Review of Prudential AVC Arrangement**

- 4.1 As at 31 March 2018 there were 1,982 active members in the Prudential AVC arrangement. In addition 1 member buys life assurance through this arrangement.

- 4.2 AKG has not yet published its 2018 report for Prudential.

As at May 2017, AKG rated Prudential's overall financial strength as A (superior). This is the highest rating available.



4.3 Fund performance, relative to benchmark or sector average, has been disappointing for the majority of funds held by members, over the periods reported on, particularly considering this performance does not include charges.

4.4 Members are invested in three funds managed by M&G Investments (the in-house manager of Prudential funds); the Index-Linked Passive Fund, the UK Property Fund and the Cash Fund.

Aon regard M&G as strong UK bond managers and reasonable property and money market managers.

4.5 Aon Hewitt do not have any major concerns over the externally managed funds and believe that the investment capabilities of the fund managers that AVC members have access to are adequate.

4.6 Aon's view is that members investing through a lifestyle strategy should invest in equities in the early stages, as these assets are expected to provide good levels of growth over the long term, and members are able to withstand the increased volatility associated with equity investments. Therefore, Aon feel that the passive lifestyle option offered through the AVC arrangement is well-aligned with its investment thinking in this respect.

The passive lifestyle invests 50% in the UK and 50% overseas. Aon favour a more global approach due to the concentration of the UK stock market and the increased uncertainty following Brexit. The fluctuations in Sterling exchange rates have also increased Aon's preference to include an element of currency hedging in global equity exposure. Aon has therefore recommended that we consider whether the BlackRock Aquila 50:50 Global Equity Index Tracker Fund should be replaced with an alternative fund that provides greater exposure to overseas equities and includes an element of currency hedging such as the BlackRock Aquila (30:70) Currency Hedged Global Equity Index. Officers will discuss this with Aon after the issue of the final report, and report on whether the recommendation has been accepted.



- 4.7 Prudential recently announced that it was removing a number of externally managed funds from its platform with effect from 3 August 2018. This course of action was prompted by criticism from Prudential's Independent Governance Committee regarding the relatively high charges on a number of funds.

These changes impact all of the external actively managed funds held by WYPF's AVC members and will therefore also impact the active lifestyle strategy.

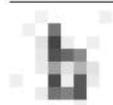
The table below shows the current funds and the replacement funds recommended by Prudential and their investment objectives:

Current Fund	Replacement Fund
<b>Invesco Perpetual Income</b> - aims to achieve a reasonable level of income, together with capital growth.	<b>UK Equity</b> - To outperform the FTSE All Share Index by 0.75% - 1.0% a year (before charges) on a rolling three year basis.
<b>MFS Meridian Global Equity</b> - to seek capital appreciation, measured in US dollars. The fund focuses on larger-cap companies with growth characteristics whose stocks are selling at reasonable levels.	<b>International Equity</b> - To outperform the internal composite benchmark by 1.0% a year (before charges) on a rolling three year basis.
<b>Schroders Diversified Growth</b> - to invest in a broad range of asset classes to aim to generate a return of UK inflation (as measured by the UK Consumer Price Index) +5% per annum over an economic cycle, typically a five year period, with a volatility less than two thirds of global equities.	<b>Absolute Return</b> - To target a return of 5% per year above inflation (CPI) over a 5-year rolling period. This is a target and not a guarantee.

The replacement funds recommended by Prudential have a similar asset allocation to the current funds, though their investment objectives differ. Aon does not have any major concerns over the performance achieved by these funds in the past.

- 4.8 In January 2018, Prudential announced a new 10-year partnership with Tata Consultancy Service (TCS), a global leader in IT, business process and digital services. The administration of over four million life and pension contracts moved from Capita to Diligenta, the Financial Conduct Authority-regulated subsidiary of TCS with effect from 1 July 2018.

Diligenta has transferred more than 11 million policies to its digital platform to date. Aon expect the transfer of policy administration to Diligenta to provide



significant improvements in technology and reduce manual processes, as well as providing members with better online access to their AVC policy.

Aon has no concerns over standards of administration and expect the transfer to Diligenta will provide improvements in technology and straight-through processing.

- 4.9 Aon believe Prudential's suite of communications tailored to LGPS clients is of good quality. Aon regard Prudential's literature as informative and well written, and the Fund's members benefit from its customisation to the LGPS. Relevant information is set out in a clear manner.

Prudential recently announced that it will be withdrawing its worksite marketing team and will therefore not be able to deliver presentations to members. The main reason for this decision was the cost associated with offering this service and its withdrawal brings Prudential in line with its peers in this respect.



4.9 Prudential reduced the annual management charge ('AMC') on the Fund's AVC arrangement by 0.1% with effect from 1 March 2018, with the exception of the Cash Fund on which the AMC was reduced to 0.55% with effect from 31 May 2017.

Prudential has confirmed that, with the exception of the UK Property Fund, there are no additional expenses to the AMCs (i.e. the total expense ratio is the same as the AMC).

<b>Fund name</b>	<b>AMC (%)</b>
Prudential Deposit	N/A <sup>1</sup>
BlackRock Aquila Consensus	0.65
BlackRock Aquila All Stocks Corporate Bond Index	0.65
Prudential Index-Linked Passive	0.55
BlackRock Aquila (50:50) Global Equity Index	0.65
Prudential Cash	0.55
Schroders Diversified Growth	1.30
Prudential UK Property	0.65 <sup>2</sup>
BlackRock Aquila Over 15 Years UK Gilt Index	0.65
BlackRock Aquila UK Equity Index	0.65
BlackRock Aquila World ex-UK Index	0.65
HSBC Amanah Global Equity Index	0.80
Invesco Perpetual Income	1.30
MFS Meridian Global Equity	1.35
LGIM Ethical Global Equity Index	0.85
BlackRock Aquila Emerging Markets Equity	0.80

<sup>1</sup> There are no explicit charges for this fund.

<sup>2</sup> There is an additional expense of 0.94% p.a. charged for this fund.

Aon believe the reduction in charges with effect from 1 March 2018 brings the charges more in line with current market rates considering the number of members and assets under management alone. Aon therefore regard this level of charges to be competitive for an LGPS AVC arrangement.

