Report of the Director West Yorkshire Pension Fund to the meeting of Joint Advisory Group to be held on 25 July 2019

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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.

In addition, this year, the actuary was asked to provide advice on designating a default arrangement.

Recommendation:

1. To approve the removal of the Invesco High Income Fund and Standard Life Investments Global Absolute Return Strategies from the Scottish Widows approved funds
2. That the Prudential passive lifestyle option is approved as the default AVC arrangement

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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 2019 (5 April 2019 for Equitable Life) are as follows:

	Equitable Life	**Scottish Widows**	**Prudential**
Contributions	£8,104	£433,880	£5,806,327
Fund Value	£1,897,891	£12,020,619	£19,096,975
Scheme members with an AVC Policy			
31/03/2019	490	1,060	2,047
31/03/2018	573	1,178	1,982

1.3 In summary:

- Total membership has decreased by 4%, however the number of members with Prudential continue to increase
- There has been an increase of 7% in the total level of contributions over the last 12 months in comparison to the 12 months prior.
- Total assets have also increased by 4% 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 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 2019 there were 490 members in the plan, 108 members were actively contributing. 467 of the members were in the With-Profits Fund.

2.2 There are also 25 members contributing to the life assurance arrangement, with a total sum assured of £801,435.

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 ‘adequate’ future performance prospects.

2.4 Equitable Life announced on 15 June 2018 that it had entered into an agreement to transfer its business and all of its policies to Reliance Life (recently rebranded Utmost Life & Pensions). Equitable Life’s proposal is to:

- Close the With Profits Fund (which means the guaranteed value of With Profits policies would end, and with it any future annual guaranteed investment returns)
- Increase the capital distribution on the With Profits Fund to an expected level of at least 60% - 70% of the policy value
- Convert With Profits policies to unit-linked policies
- Transfer all policies to Utmost Life & Pensions.

2.5 The proposed transfer is subject to a vote by With Profits policyholders, and regulatory approval. If the transfer is approved, the enhancement to With Profits policies and the removal of the future guaranteed investment return, will take place at the point of transfer, expected to be early 2020.

WYPF will be granted the vote on behalf of members because it is the policyholder. There are two issues that will be put to the vote:

- the proposed uplift for With Profits policyholders and conversion of With Profits to unit linked funds; and
- the transfer of the business to Utmost Life & Pensions.

The voting process is expected to close by the end of October 2019. Equitable Life expects agreement to both votes

Aon understand a date has been set in November 2019 for high court approval.

2.6 If the planned transfer goes ahead, it will allow Equitable Life to release the capital it holds to With-Profits policyholders.

The enhancement to With Profits policies and the removal of the future guaranteed investment return will take place at the point of transfer.

Whilst not a prominent brand in the UK, Utmost Life & Pensions is rated by AKG as having 'very strong' financial strength and therefore this is an improvement compared to Equitable Life.

2.7 As Equitable Life's proposal introduces the risk that members may take their benefits from the Equitable Life With Profits Fund without being aware of the future potential uplift to the Capital Distribution, we have sent an initial communication to members to make them aware of Equitable Life's proposal. We also intend to follow this up with further communications, as and when important information is released by Equitable Life during the course of this year.

2.8 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, which has been broadly in line with the sector over the longer term.

2.10 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. However, Aon recommend that we review the suitability of investment options to members through Utmost Life & Pensions if the transfer takes place.

2.10 The annual management charges ('AMC') for the Funds that members invest in are re set out in the table below. Equitable Life applies a universal charging structure to all arrangements and there is no scope to review the charges on the AVC arrangement.

Fund	AMC(%)
Far Eastern	0.75
Fund of Investment Trusts	0.75
Managed	0.75
Money	0.5
North American	0.75
Pelican	0.75
UK FTSE All Share Index Tracking	0.5
With Profits	1.5

Source: Equitable Life

Aon regard the charges paid on unit-linked funds by the Fund's AVC members to be in line with current market rates, considering the number of members and level of assets under management.

2.11 Aon have no concerns over the quality of administration of Equitable Life policies at the current time. Aon understand Equitable Life's employees and its administration system will be transferred to Utmost Life & Pensions if the transfer is approved and this should provide continuity of administration service.

2.12 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.

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 2019 there was a total of 1,060 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 March 2019, 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 and that it would expect the company to receive all necessary parental support, should it be required, to achieve its objectives.

Aon have no concerns over Scottish Widows' financial strength

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

The internally managed funds have generally out-performed in each of the periods reported on.

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. Aon has therefore, said the Fund may wish to consider replacing the Invesco High Income Fund. Having considered this matter WYPF view is that this fund should be removed from our approved funds. Aon has also recommended that we remove the Standard Life Investments Global Absolute Return Strategies from our approved funds.

3.6 The bespoke lifestyle option initially invests in the SSgA 50:50 Global Equity Index Fund. It commences switching five years prior to a member's selected retirement age into the Cash Fund, so that 100% is invested in the latter fund one year prior to the member's selected retirement age.

Aon favour a more global approach to provide greater diversification and better long-term capital growth potential. The fluctuations in Sterling exchange rates have also strengthened Aon's preference to include an element of currency hedging for global equity exposure. Aon has therefore recommend we consider replacing the SSgA 50:50 Global Equity Index Fund within the bespoke lifestyle strategy. However, there are currently no other passively managed global equity funds available through the Scottish Widows contract, and therefore the bespoke lifestyle strategy would need to use more than one fund in the growth phase to achieve what Aon believe is an optimal asset allocation. In view of their comments regarding the asset allocation of the bespoke lifestyle strategy during the growth phase Aon has considered Scottish Widows' off the shelf lifestyle strategies (the Pension Investment Approaches). These strategies are reasonably well-aligned with their views on optimal asset allocation during the retirement savings journey. In particular, the Adventurous Pension Investment Approach targeting cash invests predominantly in overseas equities in the growth phase, with an allocation to emerging market equities (approx. 10%) and UK equities (currently 24%). It has a transition phase that lasts from 15 to 5 years before selected retirement age and gradually reduces equity exposure, increasing the allocation to bonds.

The pre-retirement phase switches funds to Pension Portfolio Five, which currently invests in the Aberdeen Liquid Fund (Lux) Ultra-Short Duration Sterling Fund and the Aberdeen Global Liquidity Sterling Sub-Fund, over the last 5 years to selected retirement age. The Scottish Widows Pension Investment Approaches do not currently hedge currency risk, but Scottish Widows' independent governance committee has raised this and encouraged Scottish Widows to review its position on currency hedging for the pension portfolio funds. WYPF are to await the outcome this before considering the matter further.

3.7 The AVC arrangements benefit from a discount of 0.4% on Scottish Widows' standard total annual fund charge ('TAFC').

The TAFC on approved funds, including the discount, are set out in the table below.

Fund	TAFC (% p.a.)
SSgA 50:50 Global Equity Index	0.603
SSgA International Equity Index	0.601
SSgA UK Equity Index	0.605
SW Cash	0.600
SW Consensus	0.600
SW Corporate Bond	0.600
SW Environmental	0.600
SW Indexed Stock	0.600
SW International	0.650
SW Invesco High Income	1.519
SW Newton Managed	0.788
SW Newton Global Equity	0.939
SW Pension Protector	0.600
SW Property	0.790
SW Standard Life GARS	1.440

Aon consider the level of charges paid by members to be reasonable given the complexity of LGPS arrangements, and the tasks carried out by Scottish Widows that are paid for by members.

3.8 Scottish Widows administer AVC policies within their corporate pension servicing team. Widespread issues with administration were experienced in 2013 – 2015 due to resource constraints caused by auto-enrolment, but these have now been resolved.

Scottish Widows has experience of providing AVC arrangements to LGPS clients. Aon regard 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 always appear to be the case.

Scottish Widows no longer allocates named individuals to manage schemes, and all requests are submitted to a central mailbox. In Aon's experience, this process has improved the speed and accuracy of dealing with information requests.

Despite Aon's criticism of Scottish Widows' reporting processes, it has no major concerns over standards of policy administration. As Scottish Widows carries out many of the tasks that would normally be performed by the employer, Aon has recommended that service levels should continue to be monitored to make sure that members are receiving the service they expect.

3.9 Scottish Widows has invested considerably in its member website following feedback from its Independent Governance Committee and Aon believe the site has improved significantly.

In Aon's opinion, Scottish Widows' suite of communications tailored to LGPS clients is of a reasonably good quality and is accessible via an internet search engine. Relevant information is set out in a clear manner.

Scottish Widows provide governance reports for LGPS AVC arrangements on a quarterly basis. However, these appear to be very basic in terms of the management information provided and to lack structure.

4. Review of Prudential AVC Arrangement

4.1 As at 31 March 2019 there were 2,047 active members in the Prudential AVC arrangement. In addition 1 member buys life assurance through this arrangement.

4.2 AKG currently rates Prudential's overall financial strength as A (superior). This is the highest rating available and, as such, Aon have no concerns over Prudential's financial strength.

4.3 There are 15 funds available to new and existing members, and 1 fund (the Prudential Deposit Fund) available to existing contributors as at 31 May 2017 (when this fund closed to new money). There is also a passive lifestyle option and an active lifestyle option.

4.4 Members are now invested in seven funds managed by M&G Investments (the in-house manager of Prudential funds). Aon regard M&G as a strong UK bond manager (relevant to the Index-Linked Passive Fund) and a reasonable property and money market manager (relevant to the UK Property Fund and the Cash Fund). Aon's manager research team do not currently undertake active research on any M&G equity strategies, however it has met with M&G from time to time to discuss specific equity strategies but have not found these compelling enough compared to their existing buy-rated equity managers to warrant further research. The performance of these funds do not warrant any action to be taken at this time.

4.5 All externally managed funds available to members are passively managed. The fund performance reported by Prudential indicates a far higher tracking error than that reported by the underlying funds, particularly over the year to 31 March 2019 but Aon are satisfied with the explanation that Prudential provides for this discrepancy. Aon do not have any concerns regarding the performance of these funds.

4.6 Aon have said the range of funds offered through the Prudential arrangement provides access to all the main asset classes and both active and passively managed funds and lifestyle strategies, an ethical fund and a Shariah fund. Aon therefore believe it is capable of satisfying members' investment objectives, although the range of external actively managed funds has reduced significantly as a result of the fund closures made by Prudential last year.

4.7 Aon believe the asset allocation of the lifestyle options at retirement targets the format in which members are most likely to take these benefits (i.e. cash) and is therefore appropriate.

In connection with the passive lifestyle option, Aon have said that it favours a more global approach to provide greater diversification and better long-term capital growth potential. The fluctuations in Sterling exchange rates have also strengthened Aon’s preference to include an element of currency hedging for global equity exposure. Aon have therefore recommended we consider replacing the BlackRock Aquila 50:50 Global Equity Index Tracker Fund within the passive lifestyle approach with an alternative fund that provides greater exposure to overseas equities and includes an element of currency hedging. Of the funds available through the Prudential platform, the BlackRock Aquila (30:70) Currency Hedged Global Equity Index Fund fits these criteria best. However given that Aon do not monitor performance of these Funds, WYPF will undertake to monitor the performance of these Funds over the next 12 months before making a final decision.

The active lifestyle option now invests in the Prudential Absolute Return Fund until 5 years before selected retirement age, then switches to the Prudential Cash Fund. Although Aon do not research or actively monitor the Prudential Absolute Return Fund and cannot therefore comment on its conviction it will meet its investment objectives in future, it appears to offer a well-diversified investment strategy and has achieved returns of 5% p.a. above CPI before charges over 3 years and 5 years to 31 March 2019. It is also subject to lower charges than the Schroder Diversified Growth Fund it replaced, which will have a positive impact on member outcomes, all other things being equal.

4.8 Prudential has recently launched a number of 'off the shelf' multi-asset lifestyle strategies using Prudential's range of Dynamic Growth funds in the growth and transition phases which could be made available to the Fund's members.

The new strategies target cash, annuity or drawdown at retirement. Prudential has also launched a 'universal' strategy which aims to provide a lower-risk investment as retirement approaches and may therefore suit members no matter how they access their funds. The universal strategy assumes members will take 25% of their fund as tax free cash at retirement.

Although Prudential's new off the shelf strategies offer a number of advantages over its previous offering (in terms of greater diversification and the choice of targeting different benefits at retirement), Aon do not recommend us making the new lifestyle strategies available to members because their allocation to growth assets, particularly in the growth phase, is far lower than we would regard as optimal. Aon therefore believe the growth phase of these strategies provides insufficient potential for capital growth.

Aon also believe the inclusion of a transition phase in the lifestyle strategy, which targets cash at retirement and the switch to cash from 5 years before selected retirement age, further reduces capital growth potential and is likely to result in poorer member outcomes, compared to the lifestyle strategies currently in place.

4.9 Prudential operates a standard charging structure for all LGPS AVCs, although it has previously indicated it may consider scheme-specific pricing in future. It reduced the annual management charge ('AMC') on the Cash Fund to 0.55% with effect from 31 May 2017 and reduced the charges on other funds by 0.1% p.a. with effect from 1 March 2018.

Current charges are shown in the table below:

Fund	AMC (%)
Prudential Deposit	N/A
BlackRock Aquila Consensus	0.65
Prudential International Equity	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 Absolute Return	0.75
Prudential Cash	0.55
Prudential UK Property	0.65
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 Islamic Global Equity Index	0.80
LGIM Ethical Global Equity Index	0.85
BlackRock Aquila Emerging Markets Equity	0.80

Although Prudential has a reputation for relatively high charges compared to other insurers, for LGPS arrangements the provider deals with multiple employers and payrolls and carries out a number of the duties typically undertaken by employers, such as joining new members, and this makes policies more expensive to administer. Aon therefore regard the current level of charges to be reasonable.

4.10 Aon had no concerns regarding the outsourcing of policy administration to Capita, although administration processes remained relatively manual. Prudential transferred policy administration from Capita to Diligenta with effect from 1 July 2018. Aon expect this to provide significant improvements in technology (straight-through processing) and reduce manual processes, as well as providing members with better online access to their AVC policy.

Employees were transferred from Capita to Diligenta as part of the outsourcing arrangement, so continuity of knowledge of policies will have been maintained.

4.11 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.

Last year Prudential withdrew its worksite marketing services to participating employers. However, it is still able to support us with a range of additional communication materials, such as flyers to include with annual benefit statements, wording for member newsletters, emails and case studies.

Prudential provide governance reports for LGPS AVC arrangements on a regular basis. We also have regular meetings with Prudential's Client Manager, where the governance report is presented and related matters discussed.

5. Designating a default AVC arrangement

5.1 The Local Government Pension Scheme Regulations 2013 now require that where a member aggregates a deferred member's pension account or a deferred refund account with an active member's pension account, the realisable value in any deferred AVC account also must be transferred. Therefore, in the event that these members do not specify how their AVCs should be invested we need to designate a default AVC arrangement.

5.2 Having considered the key features of the Prudential and Scottish Widows arrangements, Aon have recommended that we designate our Prudential policy as the default arrangement for the following reasons:

- Prudential has a well-developed proposition for LGPS AVCs and they are more convinced by its commitment to this market sector than Scottish Widows';
- Prudential offers better support to members and employers;

- Following reductions in recent years, the charges members pay for the majority of funds available through the Prudential AVC arrangement are lower than the charges on the Scottish Widows arrangement;
- Prudential is the predominant AVC provider to LGPS, so members aggregating a deferred pension account, or a deferred refund account, to their active member account in the Fund, may already be familiar with the proposition and hold AVCs with Prudential.

5.3 Further, Aon recommend the passive lifestyle option is designated as the default investment strategy because:

- It provides good potential for capital growth whilst the member is some years from selected retirement age, and gradually reduces investment risk as retirement approaches, so the member is not required to manually switch funds as retirement approaches;
- The 'at retirement' asset allocation targets the format in which the majority of members are expected to take their AVC funds at retirement (i.e. cash);
- If the Administering Authority replaces the BlackRock Aquila 50:50 Global Equity Index Tracker Fund with the BlackRock Aquila (30:70) Currency Hedged Global Equity Index Fund in the growth phase, this lifestyle strategy fits well with Aon’s current views on optimal asset allocation during this phase;
- The use of a passively managed fund in the growth phase minimises manager risk.

6. Recommendations

6.1 To approve the removal of the Invesco High Income Fund and Standard Life Investments Global Absolute Return Strategies from the Scottish Widows approved funds.

6..2 That the Prudential passive lifestyle option is approved as the default AVC arrangement.