Report of the Managing Director of West Yorkshire Pension Fund to the meeting of Joint Advisory Group to be held on 25 January 2023

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Subject: AVC Review

Summary statement:

West Yorkshire Pension Fund has 3 Additional Voluntary Contribution Providers, namely:
- Utmost Life and Pensions (previously Equitable Life),
- 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.

In addition for this review we asked Aon to comment on the availability of other AVC providers.

This report outlines the findings of the review.

A further report will be provided at the next meeting regarding the recommendations made by Aon in their review.

EQUALITY & DIVERSITY:
Not Applicable

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1 Background

1.1 An active scheme member may elect to pay additional voluntary contributions (AVCs) into a scheme established between the administering authority and an approved insurer.

1.2 WYPF has three AVC providers, Utmost Life and Pensions, Scottish Widows and Prudential.

The contributions paid during the year, fund values and membership information at 31 March 2023 are as follows:

	Utmost Life and Pensions	**Scottish Widows***	**Prudential**
Contributions	£27,706		£9,881,187
Fund Value	£1,629,682		£35,189,646
Members with an AVC Policy	307		3,329 (TBC)

*Aon have been unable to obtain any information.

1.3 Aon continue to consider Prudential's LGPS AVC proposition to be fit for purpose and recommend it is maintained. At the current time Aon do not regard Scottish Widows arrangement to be fit for purpose and has recommended that we set a deadline by which it must resolve ongoing issues or consider replacing Scottish Widows as an AVC provider. Aon has not identified any issues with Utmoist's closed arrangement and recommend it is maintained.

2. Review of Utmost Life and Pensions AVC Plan

2.1 The former Equitable Life AVC arrangement was transferred to Utmost Life and Pensions on 1 January 2020.

2.2 Utmost Life and Pensions is rated B ('Strong') by AKG (an independent organisation that assesses financial strength). Utmost Group reported a Solvency II Coverage Ratio of 191% as at 31 December 2022 (177% as at 31 December 2021)

2.3 Utmost Life and Pensions offers 13 unit-linked funds and members invest in 11 of these, namely Global Equity, US Equity, UK Equity, UK FTSE All Share Index Tracking, Multi-Asset Moderate, Managed, Multi-Asset Captious, Sterling Corporate Bond, UK Government Bond and Money Market Funds.

2.4 The 'Investing by Age' Strategy was the 'default' strategy proposed by Equitable

Life for funds transferred from the With Profits Fund when it closed. As at 31 March 2023, 92% of the assets held with Utmost Life and Pensions were invested in this strategy.

2.5 The predominant underlying fund manager of the former Equitable Life funds is abrdn, whilst the new Utmost funds are managed by JP Morgan Asset Management.

Aon's investment manager research team do not research any of the funds members invest in, neither do they 'buy' rate any strategies offered by the underlying managers as they are not regarded as 'best of breed' in any particular asset class, however Aon have no major concerns with respect to the overall investment capabilities of the underlying managers.

The actively managed Global, US and UK Equity funds out-performed their sector average over all periods reported. The Performance of the majority of funds, relative to the ABI sector average reported, has been strong over the year. The UK FTSE All Share Tracker Fund tracked its benchmark index within an acceptable margin (before charges) over time periods reported here.

The relative performance of the new multi-asset funds has been mediocre, with the Multi-Asset Growth and Moderate funds under-performing their sector average over 1 and 3 years, and the Multi-Asset Cautious Funds under-performing over the year, though it was marginally ahead over 3 years. Returns for the Multi-Asset Moderate Fund over the 3-year period were in line with those assumed by Equitable Life in its 'fairness' projections and we believe over the longer term both the Multi-Asset Moderate and Cautious Funds have the potential to achieve the returns required to ensure members would not be worse off as a result of the closure of the With Profits Fund.

The Managed Fund out-performed its sector average over all periods reported above.

The Sterling Corporate Bond was slightly behind its sector average over 3 years but performed in line with the sector over the year. Since launch on 1 January 2020 until 31 March 2023, this Fund has experienced a loss of 12.5% however this has been due to market conditions rather than the quality of the fund.

The UK Government Bond Fund has out-performed its sector average over all periods reported above, though it has experienced a loss over all periods reported above due to market conditions.

The Money Market Fund out-performed its sector average and provided a positive return after charges over all periods reported above, with returns reaching 1.8% over the year to 31 March 2023, as a result of rising interest rates.

2.6 The investment options offered through the Utmost arrangement provide access to the main liquid asset classes, and the Investing by Age Strategy.

The Investing by Age Strategy automatically reduces investment risk as members get older however it has some limitations:

- Asset allocation is determined by age attained rather than term to selected retirement age and

- It provides no flexibility for members to choose the age at which their fund is de-risked.

The strategy retains a multi-asset approach until members are age 75 and is therefore best suited to members who access their funds by flexi-access drawdown. Aon believe the Fund’s members are more likely to access their AVC funds as cash at the same time they access their main scheme pension. This means that the at-retirement asset allocation of this Strategy is not well-aligned to how members are expected to access funds, however there is no alternative strategy available.

From a member point of view, the key investment objective of the multi-asset funds underlying the Investing by Age strategy is to provide sufficient returns to ensure members are not worse off at retirement than if they had remained invested in the With Profits Fund. Although the performance history is too short to draw any meaningful conclusions over the quality of these funds, Aon believe the asset allocation of these funds remains capable of achieving the returns required to meet the investment objective over the longer term.

Members have access to only one passively managed fund, the UK FTSE All Share Tracker, and there is no ESG, Shariah or Property Fund.

The range of funds available may not be able to satisfy the needs of all members, and the Investing by Age Strategy is not ideally suited to an AVC arrangement however Aon believe the investment options are adequate considering the closed nature of this arrangement.

2.7 The charging structure for this arrangement remains unchanged from that of the Equitable Life policy. They are not scheme-specific and so there is no scope for the Administering Authority to negotiate lower charges.

The TER is capped at the annual management charge ('AMC') so Utmost Life and Pensions absorb any additional expenses.

In Aon’s experience, charges are higher than current market rates, but in line with the arrangements of other providers.

2.8 In terms of administration, the administration team is relatively small and members are experienced and knowledgeable. Target service standards are 5 to 10 working days for most tasks. Utmost has confirmed that it met all target service standards over 2022. This reflects Aon’s experience, which is that Utmost operates well within these standards, and service has been good, taking account of the challenges of operating an older platform.

. 2.9 With regards to communications and reporting, Utmost provides a standard offering across all schemes, it’s communications and reporting is not tailored to the scheme, whether that be LGPS or any other occupational scheme. Reporting governing bodies of schemes is limited to the annual summary financial statement which provides the information required for the Report & Accounts. The Utmost website includes a lot of useful information and is, in Aon’s opinion, well set out and 'user friendly'. Online access to policy information is not available to AVC members, but it has recently been introduced for personal pension policyholders, and Aon understand it may be offered to members of group schemes at some point in future.

3. Review of Scottish Widows AVC arrangement

3.1 Scottish Widows' reported a solvency coverage ratio of 175% as at 31 December 2022. AKG upgraded Scottish Widows' overall financial strength to A (superior) in August 2021, recognising that Scottish Widows Ltd represents the UK long term life insurance business of Lloyds Banking Group plc and is the key provider of life assurance and pensions in the Group. Furthermore, the purchase of the Zurich's workplace business is demonstrative of a growth and development focus in key customer areas. This is the highest rating available and, as such, Aon have no concerns over Scottish Widows' financial strength.

3.2 Scottish Widows' actively managed funds are now predominantly managed by Schroders. Aon's investment manager research team do not research any of the Scottish Widows funds members invest in, however they do 'Buy' rate a number of Schroders' actively managed strategies and as such Aon have no concerns over its active management capabilities in general.

The funds with a significant allocation to growth assets i.e., the Property, Consensus and Environmental funds, and the Indexed Stock fund provided a positive return over all periods reported.

In regard to the externally managed funds, Aon's investment manager research team does not research any of the external actively managed funds offered through the Scottish Widows arrangement however they do 'Buy' rate a number of BNY Mellon actively managed strategies and as such they have no concerns over its active management capabilities in general.

Aon's investment manager research team rate BlackRock and SSgAs capabilities as passive fund managers highly.

3.3 Aon state the range of funds offered through the Scottish Widows arrangement provides access to the main asset classes (including property), both active and passively managed funds, an environmental fund and a lifestyle strategy. Aon therefore believe the investment options are capable of satisfying most members' investment objectives.

3.4 The lifestyle strategy aligns relatively well with Aon's view that members should invest in growth assets, such as equities, in the early stages as these assets are expected to provide capital growth over the long term, and members are able to withstand the increased volatility associated with such investments, as their fund has time to recover before they take benefits. Aon also believe that the asset allocation of the bespoke lifestyle strategy at selected retirement age targets the format in which members are most likely to take these benefits and is therefore appropriate.

3.5 The AVC arrangement benefits from a discount of 0.40% p.a. on Scottish Widows' standard total annual fund charge ('TAFC'). The TAFC is the sum of:

1. the Scottish Widows Annual Management Charge,

2. the External Fund Management Charge, if applicable

3. the Multi-Manager Fund Management Charge, if applicable, and

4. an allowance for any other expenses, if applicable.

The basic level of charges on the Scottish Widows AVC arrangement is higher than current market rates for non-LGPS arrangements, but slightly lower than the charges on the Fund's arrangement with Prudential. As such, Aon consider the level of charges paid by members of this arrangement to be reasonable. However, some externally managed funds are subject to much higher charges and Aon consider it unlikely they provide value for members.

3.5 When it comes to administration, Aon have generally found Scottish Widows to be slow and inflexible when responding to information requests relating to the Fund's AVC arrangement. Service has been particularly poor since Scottish Widows migrated the administration of older policies (including WYPF's AVC arrangements) to Diligenta in August 2022. Aon understand Scottish Widows has been unable to confirm to the Administering Authority when year-end data will be available as it is still working to correct member records, despite initial assurance this work would be complete by 31 December 2022. Aon believe there is a significant risk that payments made to members will be delayed or incorrect whilst this work is ongoing. Aon have been unable to obtain any data from Scottish Widows for this review, despite their request being made over five weeks ago, and our regular follow up calls to Scottish Widows to escalate matters.

Aon has recommended that we continue to monitor the situation. If service standards do not improve, consideration could be given to closing the Scottish Widows arrangement to new members, to reduce the risk of members receiving poor standards of service, however this would remove any choice of provider for members wishing to start paying AVCs, unless an alternative was put in place.

3.6 In terms of communications and reporting, Scottish Widows has invested heavily in its member website in recent years, and one of the key reasons given for migrating legacy policies to the Diligenta platform is improvement in members' digital experience.

Scottish Widows provides a microsite for the Fund, which is accessible via the WYPF microsite, or via an internet search engine. In Aon's opinion, communication materials available through the microsite are of reasonably good quality and where provided, relevant information is set out in a clear manner but it is not particularly well tailored to LGPS, or occupational pension schemes in general. Furthermore, the microsite is not well maintained by Scottish Widows and Aon believe this represents a risk that members will receive incorrect or insufficient information to be able to make decisions about their AVC funds. Aon generally consider the quality of Scottish Widows' reporting to be behind peers.

Aon consider it poor governance practice that Scottish Widows does not specify a benchmark for the SSgA 50:50 Global Equity Index Fund and that it has not updated the names of the externally managed funds (from Newton to BNY Mellon and from ASI to abrdn) as this can make it difficult for members to find further information about the underlying funds. Communication regarding fund closures has also been poor, with Scottish Widows announcing its intention to close funds but not providing any follow up information.

Historically, Scottish Widows has provided governance reports for LGPS AVC arrangements on a quarterly basis. However, these were very basic in terms of the management information provided and lacked structure. As last year, Aon have been unable to obtain copies of any recent governance reports and Scottish Widows has not confirmed whether they longer provides governance reports, or if production has been temporarily impacted by the platform migration

4. **Review of Prudential AVC Arrangement**

4.1 Since the insurance business was de-merged from Prudential plc, M&G plc has been permitted by the Prudential Regulation Authority to prepare a single Group Solvency and Financial Condition Report covering M&G plc, Prudential Assurance Company Limited and Prudential Pensions Limited. The Solvency II Coverage Ratio reported for M&G plc was 205% as at 31 December 2022. AKG currently rates Prudential's overall financial strength as A (superior).

4.2 The underlying fund manager of Prudential's internally managed funds is M&G Treasury & Investment Office, although many of the underlying component funds of the Dynamic Global Equity Passive, Dynamic Growth IV and Dynamic Growth I Funds are managed by BlackRock.

Aon's global investment manager research team does not currently undertake active research on any of the Prudential funds members invest in. This is because their research process is tailored to occupational pension schemes that wish to invest in 'best of breed' funds in each asset class, rather than the wider universe offered by insurance companies. Our assessment of the quality and suitability of these funds is therefore based upon our more general views of the investment managers' capabilities and past performance analysis, rather than in depth analysis of each fund.

Although Aon have no major concerns over the investment capabilities of Prudential's underlying managers. Generally, Aon believe Prudential lags its peers on taking risks associated with Environmental, Social and Governance (ESG) factors into account in its overall investment strategy.

All externally managed funds available to members are now passively managed, as Prudential has gradually withdrawn access to external actively managed funds on its platform in recent years.

The fund performance reported by Prudential for the external passive funds indicates a far higher tracking difference than that reported for the underlying funds, particularly over the shorter term for some funds. However, Aon are satisfied with the explanation that Prudential provides for this discrepancy (i.e., the Prudential funds may hold an element of cash due to the short delay between new investments being received by the Prudential fund and being placed in the underlying investment). Aon also believe differences in the time of day the

Prudential funds are priced, relative to the benchmark index is a factor here. This is a common issue for external passively managed funds and it does not give Aon cause for concern as long as a 'look through' to the underlying funds shows they are closely tracking their benchmark.

4.3 Investment options include two lifestyle strategies, an active and a passive. Aon's view remains that members investing through a lifestyle strategy should invest in growth assets, such as equities, in the early stages. The rationale for this is that these assets are expected to provide better capital growth over the long term, and members are able to withstand the increased volatility associated with such investments, as their fund has time to recover before they take benefits. Aon believe better member outcomes could be achieved by the introduction of a multi-asset transition phase to the passive lifestyle option, which might also allow the switch to cash to take place closer to retirement and therefore minimise the drag on investment returns caused by investing in cash further from retirement.

The active lifestyle option uses the Dynamic Growth IV Fund in the growth phase and this Fund targets an equity allocation of between 40 and 80%. Furthermore, this Fund only invests in traditional asset classes, though it has scope to invest in other assets if deemed appropriate by the manager and regulations. Aon believe the lower allocation to growth assets, combined with lack of exposure to alternative assets in this Fund is sub-optimal. However, Aon acknowledge that members with a lower appetite for investment risk may be more comfortable investing in this strategy.

Aon understand members of the Fund can use their AVCs as the first source of tax-free cash entitlement from the LGPS and/or use AVCs to provide additional pension from the LGPS. Aon therefore 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.

The names of the lifestyle options may now be considered misleading, as a result of the fund changes made by Prudential since they were designed:

- The passive lifestyle option invests in the actively managed Cash Fund in the risk reduction phase, and
- The Dynamic Growth IV Fund invests in a number passively managed funds, as well as active funds, to achieve its target asset allocation.

Aon has suggested we consider whether the lifestyle options should be re-named to avoid any confusion. For example, the passive lifestyle option could be re-named the growth-focused lifestyle option and the active lifestyle option could be re-named the multi-asset lifestyle option. Alternatively, that we consider adopting Prudential's 'off the shelf' lifestyle strategies, now that Prudential offers a cash-targeting option.

4.4 Prudential offers LGPS-specific pricing for unit-linked funds, which is more competitive than its standard rates. In Aon's experience, charges for unit-linked funds are in line with LGPS arrangements offered by other providers and with other providers' legacy arrangements, though they are higher than current market rates for non-LGPS arrangements (Prudential has a reputation for relatively high charges compared to other insurers for non-LGPS AVC arrangements).

This reflects the fact that within LGPS, the AVC provider deals with multiple employers and payrolls and carries out a number of tasks carried out by employers or the scheme administrators in non-LGPS schemes, such as joining new members. This makes LGPS AVC arrangements more expensive to administer, and less commercially attractive to providers. In view of this, Aon regard the charges on the arrangement to be reasonable, given the complexity of LGPS arrangements and the additional tasks carried out by Prudential.

4.6 In terms of administration, Prudential's outsourcing model of operation is relatively mature (it initially outsourced policy administration to Capita in 2008), including increasing volumes of administration offshored to India. In 2018, it announced it was replacing Capita as its outsource partner with Diligenta (the Financial Conduct Authority-regulated business of TATA Consultancy Services). This move was a key part of Prudential's ambition to become a lower-cost digital organisation, with Diligenta also becoming responsible for some of Prudential's IT infrastructure.

Migration to the Diligenta BANCS platform took place in Q4 2020. This project resulted in significant disruption to policy administration and customer service. It took over two years for Prudential to resolve issues resulting from the migration, including clearing the backlog of work and reconciling policy details. Prudential reported itself to the Pensions Regulator and was proactive paying financial redress to members dis-advantaged by poor service and delays, however it was very difficult to engage with during this time, as it had previously removed the majority of its client relationship managers and wait times on the telephone helpline for clients and members were very long.

Prudential has since focused on clearing the backlog and returning to its usual service standards and Aon's recent experience indicates this has now been achieved for the vast majority of schemes however we understand its wider support for LGPS has not yet been re-established.

4.7 With regards to communications and reporting, the Fund's members benefit from Prudential's customisation to the LGPS. Aon believe the suite of communications tailored to LGPS clients is of good quality, with relevant information set out in a clear manner. For example, the total charges on unit-linked funds are very clearly disclosed in the Fund-specific investment guide.

Prudential stopped offering worksite marketing services to participating employers a number of years ago and has since significantly reduced the number of account managers available to support employers and Administering Authorities, with the majority of queries directed to its AVC administration team.

Prudential has given no indication that its level of commitment to LGPS AVCs has fallen, though it is likely its offering will remain pared back compared to what has been provided historically, as it focuses on reducing costs. Aon are yet to be convinced that the improvement in member experience cited as one of the key reasons for moving to the Diligenta platform has been achieved.

5. ALTERNATIVE LGPS AVC PROVIDERS

In addition to the annual review we asked Aon to comment on whether their view had changed on whether they were any alternative AVC providers available. Aon has said Legal & General has now formally entered the LGPS AVC market and is running arrangements for three Funds and having discussions with a number of others.

Legal & General is pricing each potential LGPS arrangement individually and is keen to fully understand how each Fund is operated before considering whether its proposition is right for the Fund in question, so it may not offer terms for all Funds.

Aon believe Legal & General has numerous strengths that makes its proposition attractive including its range of ESG funds, its in-house administration platform, market share of (DB and DC) pension assets and strong commitment to UK DC pensions.

Given the size of our Fund's arrangements, Aon believe Legal & General may be interested in providing terms for these arrangements and they recommend we consider at least an initial conversation with Legal & General, or progress discussions with alternative providers as soon as the planned National framework for AVCs comes into effect.

6. OTHER CONSIDERATIONS

None

7. FINANCIAL & RESOURCE APPRAISAL

None

8. RISK MANAGEMENT AND GOVERNANCE ISSUES

None

9. LEGAL APPRAISAL

None

10. OTHER IMPLICATIONS

10.1 SUSTAINABILITY IMPLICATIONS

None

10.2 TACKLING THE CLIMATE EMERGENCY IMPLICATIONS

None

10.3 COMMUNITY SAFETY IMPLICATIONS

None

10.4 HUMAN RIGHTS ACT

None

10.5 TRADE UNION

None

10.6 WARD IMPLICATIONS

None

10.7 AREA COMMITTEE ACTION PLAN IMPLICATIONS (for reports to Area Committees only)

None

10.8 IMPLICATIONS FOR CORPORATE PARENTING

None

10.9 ISSUES ARISING FROM PRIVACY IMPACT ASSESEMENT

None

11. NOT FOR PUBLICATION DOCUMENTS

None

12. OPTIONS

None

13. RECOMMENDATION

It is recommended that the Joint Advisory Group note the report

14. APPENDICES

Appendix 1 - Aon AVC Review Report.