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DERBYSHIRE COUNTY COUNCIL

PENSIONS AND INVESTMENTS COMMITTEE

1 August 2018

Report of the Director of Finance and ICT

REVIEW OF DERBYSHIRE PENSION FUND'S ADDITIONAL VOLUNTARY CONTRIBUTION (AVC) ARRANGEMENTS

1 Purpose of the Report

To present the findings of the review of the Fund's AVC arrangements carried out by Hymans Robertson LLP (Appendix A), and to request Committee's approval to develop the Fund's AVC arrangements broadly in line with the review's recommendations.

2 Background

Under the Local Government Pension Scheme (LGPS) Regulations, each LGPS Fund is required to provide access to an AVC arrangement where Fund members can elect to pay additional contributions in order to further boost retirement savings and/or to provide additional life insurance. Although this is an individual choice, the administering authority is the policyholder for the group arrangement in place and, therefore, has certain responsibilities.

The Pension Regulator's Codes of Practice state that Defined Contribution schemes, including AVC arrangements for Defined Benefit schemes such as the LGPS, should meet certain aims. They should be efficient, effective and give members "value for money". These aims should be regularly evaluated to ensure this continues to be the case.

The last review took place in 2012 when Prudential were designated as the Fund's sole provider for new AVC business.

Further to an 'Invitation to Tender' procurement exercise, Hymans Robertson LLP were contracted to perform a review of Derbyshire Pension Fund's ("the Fund") AVC provision, with specific focus on the:

- Range of investment vehicles and coverage of risk profiles
- Performance of investment funds
- Administration performance, including communication with administration authorities, employing authorities, other financial organisations (eg re the transfer of pension pots), and with Fund members

- Costs for Fund members in terms of administration fees, exit charges etc.

3 The Review's Conclusions

In summary, the conclusions from the review were as follows:

- Prudential should remain the Fund's principal AVC provider
- The investment choices offered by Prudential, particularly around the Lifestyle Options, should be updated
- Transferring AVC pots from the legacy providers to Prudential should be given serious consideration
- The Fund could take a more pro-active approach to the governance of its AVC arrangements

These conclusions are reflected in the recommendations proposed to the Committee in section 5 below.

It is not being proposed at this stage to either stop AVC payments to the legacy providers, or to move AVC members from their existing providers without consent. However, once Equitable Life 'With Profits' policy holders have received their windfall in 2019, and work has been completed on the implementation of the replacement pensions administration system, that may be an appropriate time to take a more robust approach to running down the Fund's arrangements with its legacy AVC providers.

4 Considerations

In preparing this report the relevance of the following factors has been considered – equality and diversity, financial, legal, health, environmental, transport, property and human rights considerations.

5 Officer's Recommendation

That the Committee approves:

- that Prudential remain as the Fund's principle AVC provider,
- that the Fund works with Prudential to develop improved investment options that reflect better members' requirements of their AVC funds,
- that the options available to AVC members, particularly those currently saving with the legacy providers, are better communicated with a longer term view towards moving all AVC members to Prudential, and
- that a review of the suitability of the Fund's AVC requirements, incorporating an assessment of the value for Fund members, is carried out every three years.

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HYMANS ROBERTSON

Derbyshire Pension Fund

AVC Review

July 2018

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For and on behalf of Hymans Robertson LLP

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1 Introduction

Addressee

This paper is addressed to the Officers of the Derbyshire Pension Fund ("the Fund") and is provided solely for the purpose of considering the additional voluntary contribution ("AVC") arrangements of the Fund. Our analysis has been based on the information provided to us by the Pensions Team and the Fund's AVC providers.

The paper should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation or without our prior written consent. We accept no liability where the paper is used by, or released or otherwise disclosed to a third party unless we have expressly accepted such liability in writing.

Background

We have been asked to carry out a review of the Fund's current AVC arrangements.

This paper summarises the present AVC arrangements and makes recommendations for changes, which are summarised in Section 2.

2 Executive Summary

After analysing the current AVC arrangements our findings and recommendations are as follows.

Findings

Structure

There are 4 AVC providers: Clerical Medical, Equitable Life, Prudential and Standard Life; of whom Prudential are the principal AVC provider.

Demographics – section 4

There are currently 1,125 active and 237 deferred AVC members.

In late 2017 the total value of members' AVC assets was c. £9.9m.

The average age of the AVC members is 54.

Investment options – section 5

Our main concern is with the lifestyle options (with Prudential and Clerical Medical):

- These target members who are expected to use their AVC fund to buy an annuity at retirement, whereas most Fund members take their AVCs entirely as cash when they retire. As a result, the lifestyle options do not fully meet members' needs and, for members approaching retirement, may give rise to undue interest rate risks.
- The lifestyle options also use a traditional two-stage asset allocation "glide-path", which may not manage the risks members face as effectively as a more contemporary three-stage glide-path.

While the self-select fund ranges vary considerably among the 4 providers, there are some common themes:

- Most offer several similar equity funds which could be rationalised;
- The funds giving an intermediate level of risk are no longer competitive; and
- There are few lower risk funds suitable for members wanting to use the 2015 pension freedoms.

Prudential – section 6

Prudential are the leading provider in the AVC and LGPS AVC markets. While not the cheapest, the overall package of bespoke services for LGPS has given good value for members.

Prudential updated its fund range a few years ago and reduced its charges for most funds in 2018. Prudential is also upgrading its on-line facilities, while it has successfully implemented shared cost AVCs for several LGPS Funds.

The move of its outsourced administration from Capita to Diligenta, which will affect AVCs in 2019, is expected to lead to enhanced on-line functionality. The demerger of M&G Prudential and Prudential plc should not affect the AVC services.

However, the closure of the experienced presenter team in May 2018 and cutbacks in its relationship management team in June 2018 have weakened the Prudential's service versus cost proposition.

Clerical Medical – section 7

Clerical Medical have been closed to new business for some years. While charges are competitive, their overall AVC service has gradually fallen behind the market leaders and is of indifferent value.

It would not be possible to rectify most of our concerns with the investment options and there is no on-line access for members to AVC information, fund values/performance and fund switching. The reporting material provided is insufficient to support regular AVC governance.

Also, bonus pay-outs from the With Profits Fund appear disappointing given its exposure to growth assets.

Equitable - section 8

The Equitable is at an advanced stage of running down its business. Charges for the unit linked funds were increased by 50% in 2016, whilst the services provided to members and employers are very limited.

The unit linked fund range is limited and has not changed since 2000. The With Profits Fund is predominantly invested in bonds and so bonus pay-outs are modest.

Equitable is distributing these and other cost savings to With Profits policyholders by means of a capital distribution, which currently increases transfer values by 35%. On 15 June 2018 Equitable announced plans to transfer its business to Reliance Life in late 2019. Equitable currently expect that this transfer will enable the capital distribution to be increased to 60 to 70%, at which point the With Profits Fund and its guarantees would close.

Standard Life - section 9

Standard Life are a major player in the AVC/DC market. However, the merger with Aberdeen Asset Management has led to an increased focus on investment management services. The recently announced plans to transfer its life and pensions business to Phoenix have introduced an element of uncertainty about the level of commitment to the AVC/DC market.

Standard Life's charges for a small AVC arrangement are not particularly competitive. Whilst AVCs have benefited from developments in their wider DC proposition (such as on-line access), the services are generic and not tailored to AVCs or LGPS.

Recommendations

Structure – section 11

Prudential should remain the principal AVC provider.

The legacy AVC arrangements with Clerical Medical, Equitable and Standard Life have become increasingly uncompetitive and steps should be considered to accelerate the run-down of these arrangements such as:

- Stopping all AVCs to the legacy providers;
- Rationalising the investment options;
- Bringing the changes at Equitable to members' attention; and
- Looking at the options for transferring accumulated AVCs to Prudential.

Fund range – section 10

The current Lifestyle Options should be replaced with two lifestyle strategies: one targeting members taking cash at retirement and the second targeting annuity purchase at retirement as now, which both better manage the investment risks members face over time.

The self-select fund range should be rationalised to avoid unnecessary duplication of equity funds while including funds better suited to the age profile of AVC members and those members wanting to take advantage of the "pension freedoms".

While the Prudential's With-Profits Fund remains in good health, it should no longer be the default investment option, with its place taken by the new lifestyle strategy targeting cash at retirement.

Governance – section 3

While LGPS Funds are not subject to the Pensions Regulator's DC Code, consideration should be given to increased governance of the AVC arrangements reflecting their importance to members. For example:

- The performance of the AVC funds and member usage of AVCs should be monitored annually;
- The continued suitability of the AVC funds and "Value for Members" should be reviewed triennially;
- Periodically reviewing the providers' and fund managers' strategies for and member attitudes to ESG and shareholder engagement; and
- Periodically reviewing the AVC communication strategy.

3 AVC Market

Changing regulatory environment

There is a growing focus on governance, security and "value for members" for all DC benefits including AVCs.

CoP 13

The Pensions Regulator's new DC Code of Practice 13 came into force in July 2016. While the LGPS is not subject to the new code, we understand that the Pensions Regulator would like to see local authority Funds adopt similar standards of AVC governance.

The new DC Code applies to AVC arrangements. The Regulator recognises that a "proportionate" approach is appropriate given the nature of AVCs as a supplement to DB benefits. The Regulator defines proportionate by reference to how important AVCs are to members' overall benefits.

The new DC code covers 6 key areas: The Trustee Board, Scheme Management, Administration, Investment Governance, Value for Members and Communication. Key areas for AVC governance are likely to be:

- **Investment** – including the suitability, performance and security of the investment options.
- **Communication** – member education and communication is effective and timely.
- **Value for members** – the AVC arrangements are, as far as practicable, good value for members.

CoP 14

The Pensions Regulator's April 2015 Code of Practice 14 regarding the governance and administration of public service pension schemes sets out the following expectations with regards to AVCs:

- The Pensions Committee should be familiar with the operation and investment of the AVC arrangements;
- Production of benefit statements.

In addition, the following requirements can also have a bearing on the AVC arrangements:

- Maintaining internal controls to manage risks;
- Data management and record keeping;
- Payment of contributions.

Pension Freedoms

The introduction of the Government's "freedom and choice" reforms in April 2015 has had a profound effect on the design of DC pension arrangements as well as introducing new options for DB scheme members.

The main impact of the pension freedoms has been a dramatic decline in annuity sales – although there is still a case for annuity purchase from around age 75-80. This is leading to a number of providers withdrawing from the annuity market, which may result in less competitive annuity rates.

Income drawdown products aimed at a wider range of retiring members are still, disappointingly, limited or under development. In the meantime, many members are taking pension benefits in cash, despite the tax penalties, perhaps to reinvest in private savings products.

The Scottish LGPS can now offer members Uncrystallised Fund Pension Lump Sums ("UFPLS") into retirement.

Disclosure of charges and costs

AVCs, where they are the only form of "money purchase" benefit a member receives, are exempt from the 0.75% charge cap and the requirement to produce a "Chair's statement" introduced in 2015. Trustees of occupational schemes nevertheless need to conduct an annual assessment of AVCs' "Value for Members".

The FCA has introduced new requirements on the disclosure of transaction and administrative costs:

- Came into force 3 January 2018;
- Fund managers and providers must provide information on request within a "reasonable" period; and
- Transaction costs are to be calculated on the "slippage" basis consistent with MiFID II.

The DWP announced on 26 February further Regulations on the disclosure of AVC/DC charges to members:

- Details of costs and charges for each fund (which many schemes already provide) from scheme years ending on or after 6 April 2018;
- Information to be made readily accessible on-line, with a note of its location on benefit statements;
- Details of each fund's structure including funds' ISIN numbers from 6 April 2019
- .

ESG

In December 2017 the Government published its response to the Law Commission Report on Pension Funds and Social Investment. Regulations and changes to the FCA prudential handbook are expected later in 2018 underscoring best practice (although it is not clear whether these will apply to the LGPS):

- Evaluating long-term risks to sustainability arising from corporate governance, environmental or social impact;
- Considering members' ethical and other concerns; and
- Setting out policies on stewardship, voting rights and engagement in the Statement of Investment Principles.

Activity on environmental, social and governance factors among AVC and DC schemes has been limited in the past to offering members the choice of investing in an ethical fund. This has in part been due to the funds' underlying assets being held at arms-length, while funds which consider the risks and opportunities, such as L&G's Future World Fund, have only recently come onto the DC market.

Determining an appropriate level of engagement with regards to AVC investments needs to balance:

- The size of the AVC assets relative to the main assets; and
- AVCs are members' discretionary savings and some may take greater interest in ESG considerations.

The Pensions Regulator encourages DC schemes in general to become more engaged with members to support Value for Members' assessments. Member surveys etc. including ESG matters may provide useful guidance to Trustees and Pensions Committees.

MiFID II

AVC providers may assume that the Fund is a "Retail" investor for MiFID II purposes. It is worth ascertaining whether an AVC provider regards a Fund as a Retail or Professional investor, what impact this has on administration and what the provider needs for the Fund to be regarded as having Professional investor status.

One legacy provider recently insisted on confirmation from a Fund that risk disclosures had been issued to a retiring member which delayed settlement of benefits. The requirement for LGPS Funds to provide a risk warning is set out in Regulation 19A of the Occupational and Personal Pension Schemes (Disclosure of Information) Regulations 2013 [2013/2734]. The LGPC Secretariat and Communications Working Group are working on a new Freedom and Choice AVC guide containing template letters and a template risk warning to meet these requirements.

GDPR

The arrangements for sending and receiving data vary from provider to provider. To ensure the smooth operation of the AVC arrangements it is important to check that the AVC provider's and the Fund's systems are compatible with each other. In keeping with both CoP13 and CoP14, it would be timely to conduct a review of the member data held by providers.

Value for Members

The 2015 Regulations created a requirement for trust based DC and AVC schemes to carry out an annual Value for Members Assessment and describe in the annual governance statement by the Chair of Trustees what steps were being taken to remedy poor value. The assessment covers all non-optional services for which members bear or share the cost.

The Pension Regulator sees poor value as a major risk and published a guide to value for members in conjunction with the new DC Code in July 2016. Value for Members is not simply about the lowest cost, it should take into account quality of services which help support good member outcomes – investment options, governance, administration and communication.

While the benchmarking of services and charges is still developing, we see Value for Members assessments as a useful member focused governance tool for AVC and DC schemes.

Shared cost AVCs

The payment of members' pension contributions by salary or bonus sacrifice has been popular with contract and trust based private sector schemes for several years. A July 2016 LGA Bulletin advised that the 2013 LGPS Regulations did not prevent AVCs being paid through shared cost/salary sacrifice arrangements.

Particularly following the abolition of contracting-out in 2016, the attractions are reductions in both members' National Insurance Contributions increasing their "take home pay" and reductions in the employers' total National Insurance bill. The benefits of shared costs AVCs do need to be weighed against the costs of setting up and running the arrangements – and so it may not prove viable for small groups of members and/or small AVCs.

AVC providers

The market for AVC providers has contracted markedly in recent years as private sector defined benefit schemes have closed and trustees or employers adopt different vehicles for members' discretionary retirement savings. We are also seeing a period of consolidation among providers with mergers and business transfers.

Few providers are actively developing or promoting their AVC products. Meanwhile, the terms and features of "legacy" products seem likely to fall further behind what is available in other forms of DC arrangement (such as investment options, on-line access and provisions for pensions flexibility). The providers' recently instituted independent governance committees are, for the time being, focusing on schemes where DC is the main source of retirement income.

Charges for AVC arrangements are typically higher than those of other forms of DC provision for schemes with similar numbers of members. The average contribution/fund size per head as well as per scheme are much

lower, meaning that provider's fixed costs are more material; while AVCs tend to be paid for a shorter period and are more likely to be taken as cash at retirement.

As a result, a market review of AVC providers may be of limited value, with any reduction in charges it obtained needing to be balanced against the costs of change (both to members and the authority) and differences in the range of services offered.

4 Member Analysis

For the purposes of this report, the Pensions Team and providers have supplied us with member data and information on policy terms. Clerical Medical, Prudential and Standard Life provide data in spreadsheets enabling us to analyse and present the results graphically. Equitable only provide limited data in hard copy data and so our analysis of Equitable AVC members is restricted.

Member profile

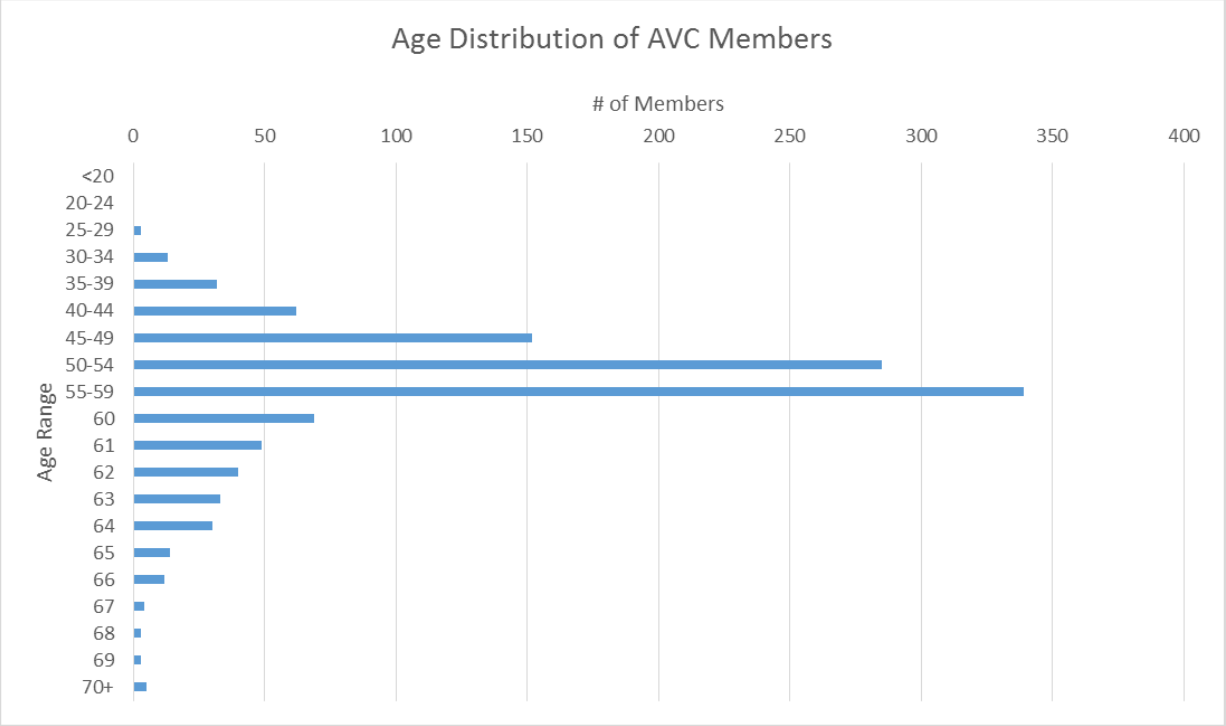
The table below provides a high level summary of the number of members invested in funds with each provider:

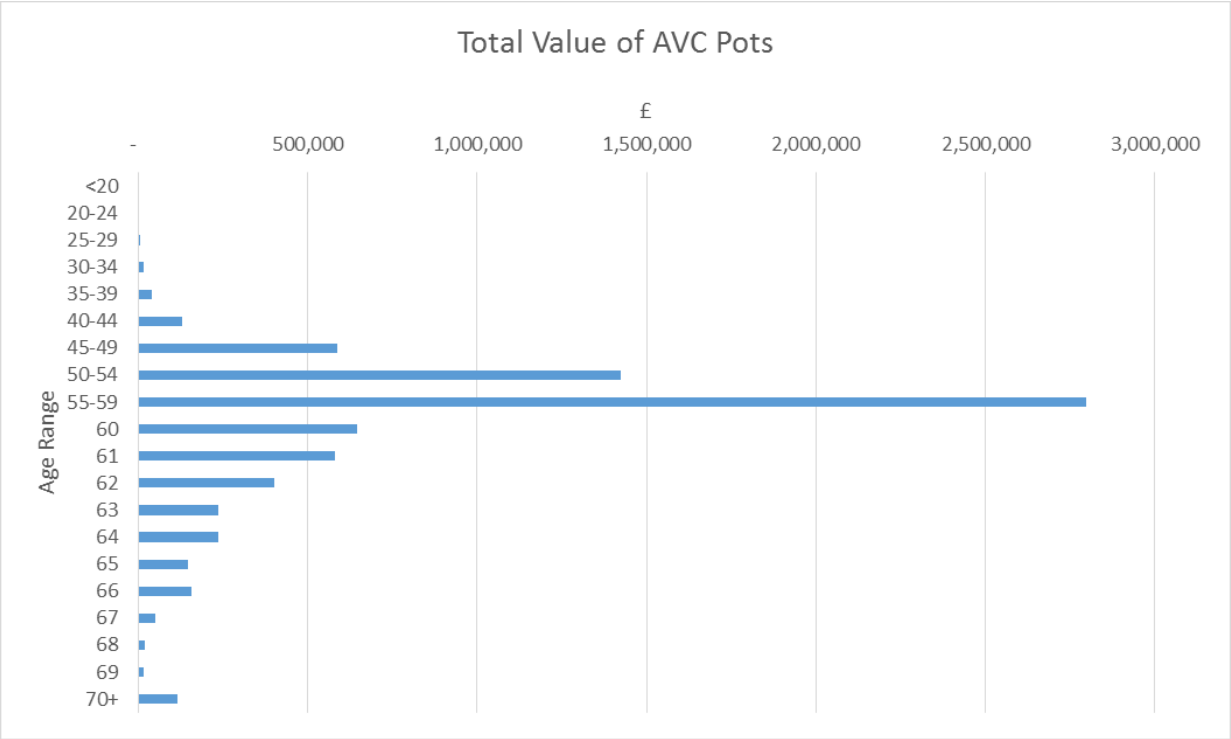
	Clerical Medical	Equitable at 05/04/17	Prudential	Standard	Overall
Active members	7	34	1,069	15	1,125
Deferred members	24	87	79	47	237
Total	**31**	**121**	**1,148**	**62**	**1,362**
Lifestyle members	1	0	46	0	47
Unit linked members *	3	49	620	32	704
With Profits members *	28	101	458	31	618
Deposit members *	0	0	453	0	453
Average age	54.3	-	54.1	53.7	54.1

* Double counting members is possible here.

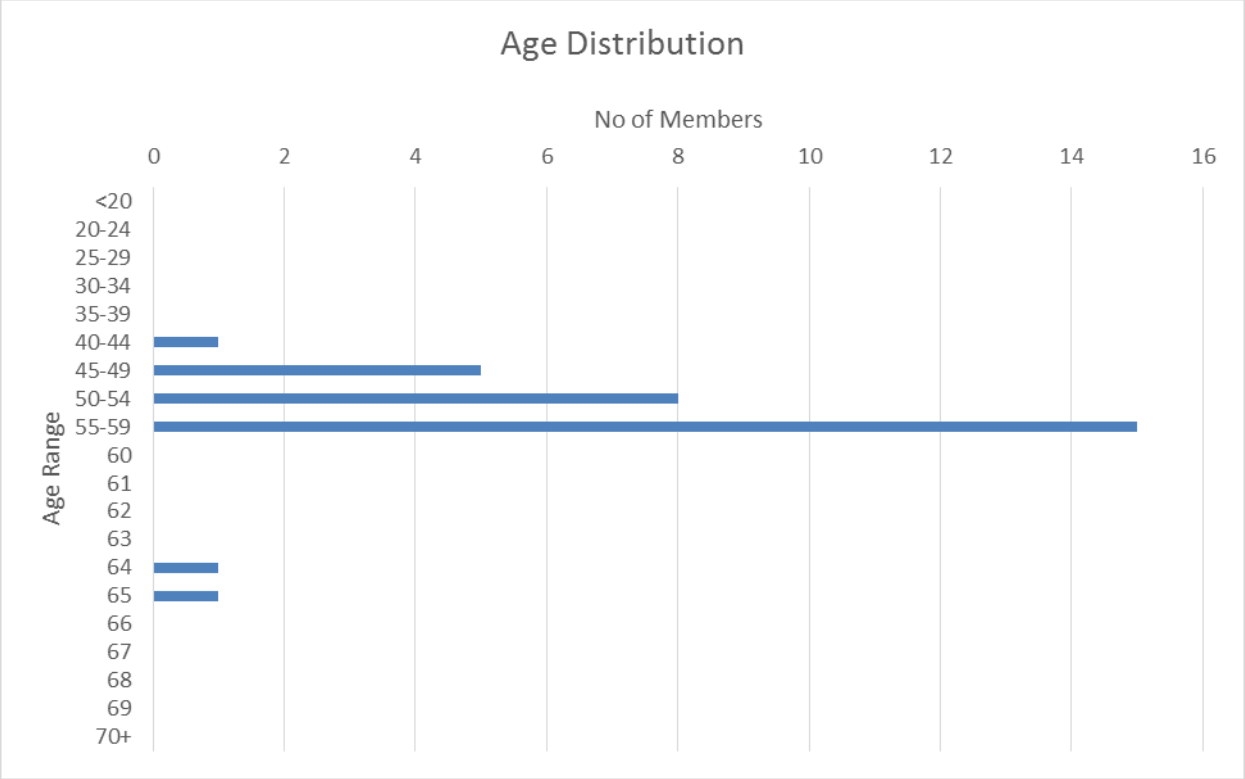
The following charts illustrate the principal demographic ranges for AVC members (except Equitable).

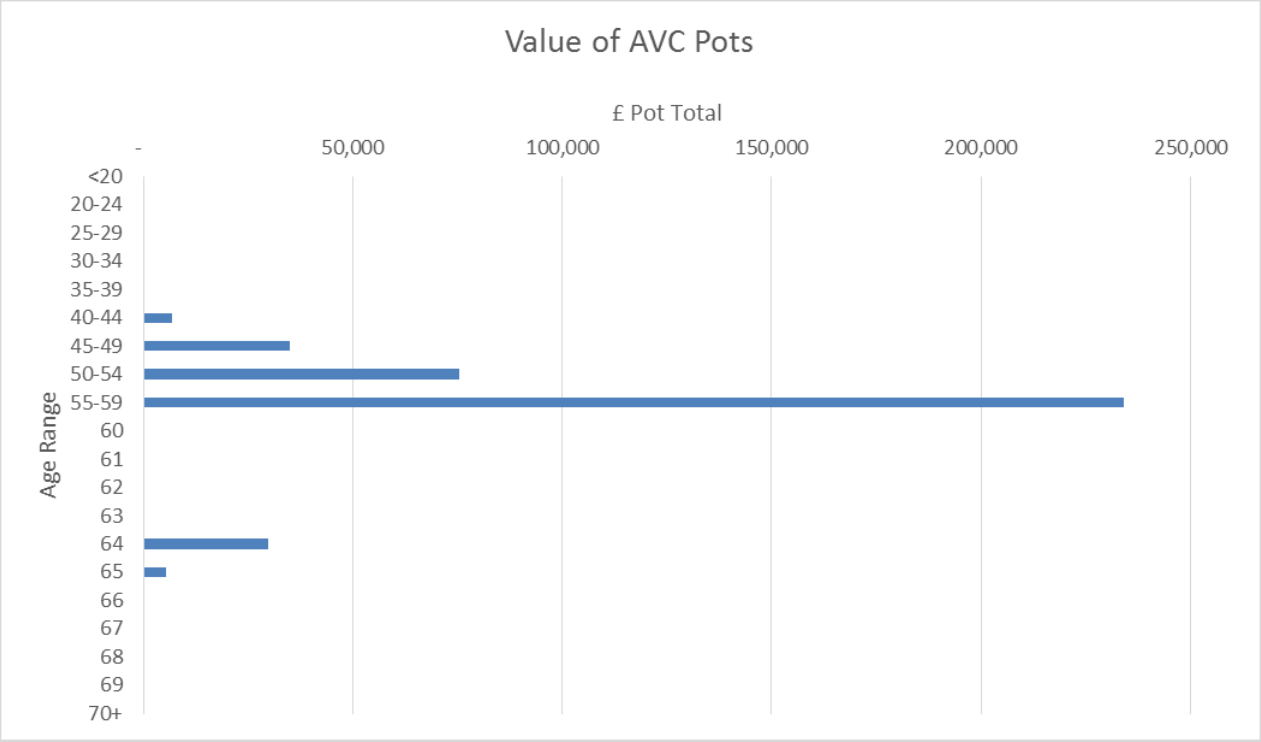
Prudential



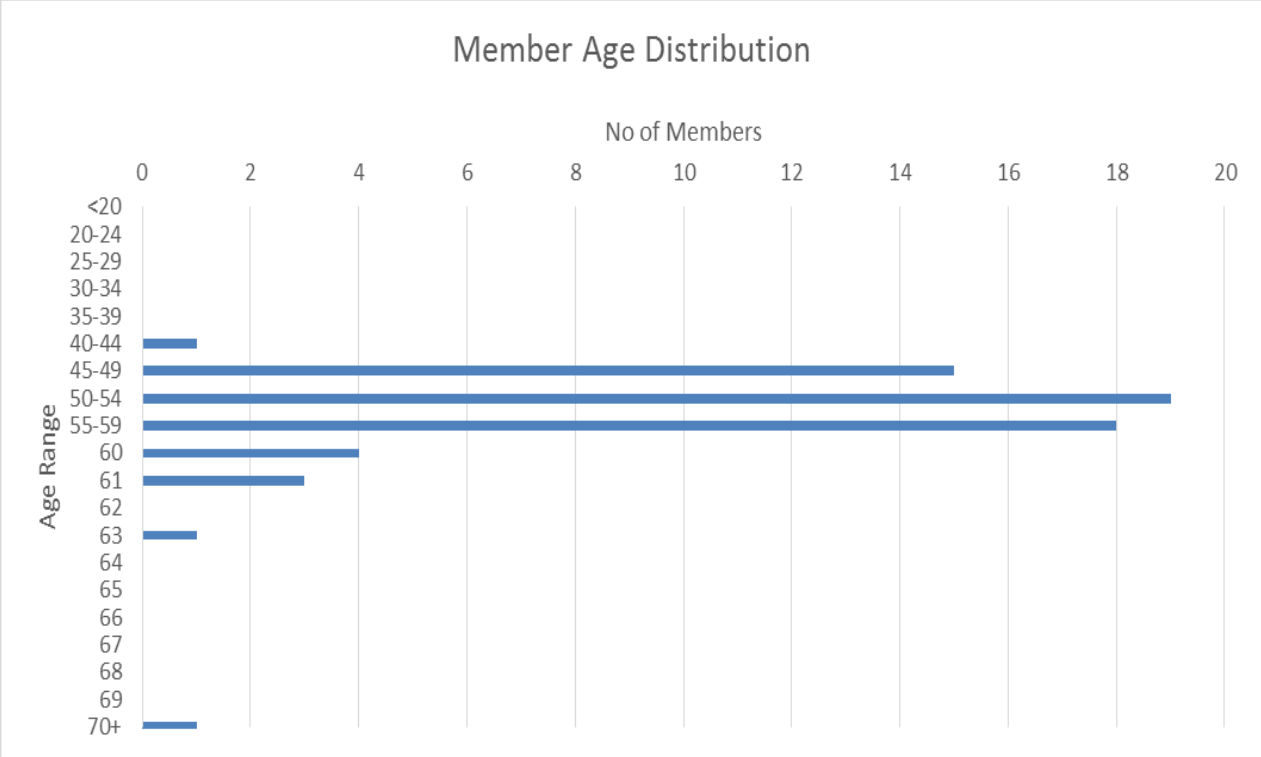


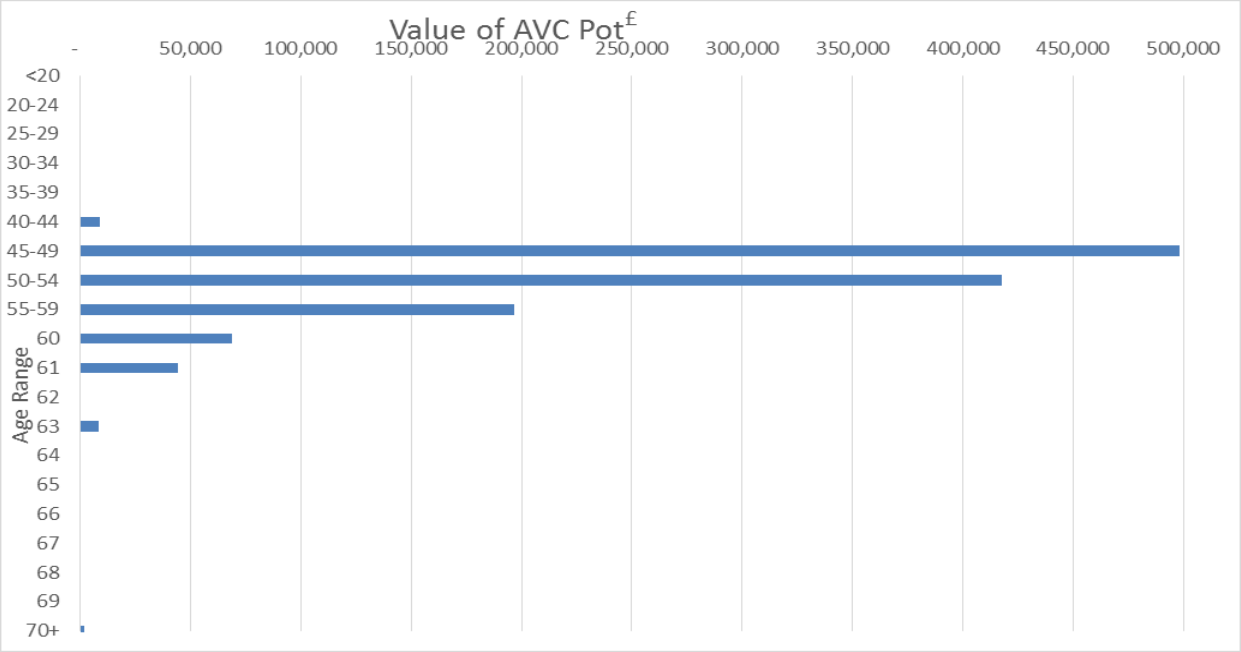
Clerical Medical





Standard Life





Observations:

- As might be expected for AVCs, the age and fund value profiles are tilted towards higher ages.
- Particularly among the Prudential members there are a number of AVC members in their 30s and 40s;
- There are several AVC members in their late 60s and 70s.
- Average ages are quite similar among the providers.

Fund Values

Total values	Clerical Medical £	Equitable at 05/04/17 £	Prudential £	Standard £
Unit linked funds	157,952	370,302	2,174,908	1,049,608
With Profits	228,833	363,948 *	2,380,019	195,032
Deposit	-	-	3,036,042	-
Total	**386,785**	**734,249**	**7,590,969**	**1,244,640**

* £247,188 in Equitable's With Profits Fund and £116,760 in Clerical Medical's With Profits Fund.

The heat maps in the appendix shows the usage of the most popular funds across age groups (except for Equitable where there is insufficient data).

Observations

- As is often the case with LGPS AVCs, there are significant holdings across the With Profits Funds;
- The Prudential's Deposit Fund is the largest fund across all the AVC providers, of which a large proportion is held by members between 5 and 20 years from retirement;
- As might be expected for by far the largest provider, there is a fair dispersion of members across the Prudential's unit linked funds.

5 Investment options

5.1 Prudential

Lifestyle options

Members are offered a choice of 3 standard Prudential lifestyle strategies.

The key aspects of these lifestyle strategies are:

- All use a conventional two stage approach moving straight from growth to protection phases;
- All three move from a passively managed UK Equity fund tracking the FTSE All-Share Index to a passively managed long-dated Gilt fund;
- Different levels of risk are provided by start de-risking 6, 8 or 10 years from retirement;
- All three effectively target a member expecting to use their entire AVC savings to buy an annuity at retirement.

Observations

- Most LGPS members take AVCs entirely as cash at retirement, so the closing asset allocation of all three lifestyle strategies is a poor match with members likely retirement plans for their AVCs;
- A two stage lifestyle strategy will not effectively manage the value at risk for AVC members who have built up appreciable AVC values by around 10 years from retirement;
- The UK Equity Fund used in the growth phase gives limited diversification across regions and sectors;
- A 100% allocation to long-dated bonds at retirement means that members planning to take their AVCs as cash are bearing significant interest rate risk (particularly at the present time); and
- We would question the merits of offering AVC members three lifestyle options targeting the same benefits at retirement and with little differentiation in the level of investment risk over the medium-term.

Self-select fund range

Prudential Fund	Asset Class	Active/Passive	Charges (p.a.)*
Ethical	Equities	Active	0.65%
UK Equity	Equities	Active	0.65%
UK Equity Passive	Equities	Passive	0.55%
Global Equity	Equities	Active	0.65%
International Equity	Equities	Active	0.65%
Discretionary	Multi-Asset	Active	0.65%
Fixed Interest	Government Bond	Active	0.65%
Index-Linked	Government Bond	Active	0.65%
Property	Property	Active	0.65%
Long Term Gilt Passive	Government Bond	Passive	0.65%
Deposit **	Deposits	Active	***
Cash **	Deposits	Active	0.55%
With-Profits *(default option)*	Multi-Asset	Active	****

* The Prudential's funds are "clean-priced" such that the Annual Management Charge is equal to the funds' Total Expense Ratio. Charges are collected by monthly cancellation of units for the unit-linked funds. Most of these charges were reduced by 0.1% in 2018.

** Prudential closed the Deposit Fund to new contributors in May 2017 and redirected AVCs to the Cash Fund while reducing its charge from 0.75% to 0.55% (reducing the impact of charges on net returns while interest rates are low, but real returns may still be negative).

*** The Deposit Fund is backed by assets of the With Profits Fund. The current practice is to declare a monthly interest rate equal to the Bank of England base rate. As a result, there is no explicit charge.

**** Prudential's Principles and Practices of Financial Management indicates that the charges for the With Profits Fund are expected to average 1% across all policyholders. However, Prudential have indicated that the charge for group pension contracts, such as AVCs, would average around 0.8%.

Observations

- The choice of self-select funds is quite common to LGPS Funds with Prudential;
- There are a few gaps in the lower to medium risk categories (such as corporate bonds and cautious multi-asset);
- The charges for the unit linked funds are, in isolation, slightly above average, but are broadly competitive when the overall package of services is taken into account;
- The charges for the With Profits Fund are competitive;
- The use of the With-Profits Fund as the default option remains quite common among AVC schemes, but is uncommon nowadays among DC schemes in general.

Fund Performance

Performance gross of fees of Prudential's unit-linked funds to 30 June 2018 (UK Property to 31 March 2018):

Prudential Fund	12 months %		3 year % p.a.	
	return	benchmark	return	benchmark
Ethical	7.7	9.3	8.5	9.3
UK Equity	10.4	9.0	10.1	9.6
UK Equity Passive	9.3	9.0	9.5	9.6
Global Equity	9.2	8.6	11.5	10.3
International Equity	6.7	7.6	14.9	14.8
Discretionary	6.5	6.5	11.3	8.7
Fixed Interest	2.4	1.9	5.1	4.7
Index-Linked	2.7	2.0	9.3	8.5
UK Property	9.8	10.0	5.5	8.1
Long Term Gilt Passive	4.1	4.2	8.9	8.9
Cash	0.3	0.3	0.3	0.3

Source: Prudential

These fund returns will reflect any "swing" between the offer and bid trading prices by the underlying funds.

Observations

- All the Prudential funds, except the Ethical, International Equity and UK Property Funds have broadly outperformed their respective benchmarks over the 12 month and 3 year periods to 31 June 2018 (31 March for UK Property where the benchmark will not yet be available to 30 June);
- The UK Property Fund has now underperformed for over 5 years - although this is less marked for the underlying M&G Pooled Fund - while the implicit bid/offer spread (typically around 6%) on sales of units can be significant;
- All these funds are managed by M&G as Prudential's in-house fund manager.

We understand that Prudential do not believe that their unit linked funds are covered by the Financial Services Compensation Scheme (FSCS). There is a reassurance treaty in place between Prudential Assurance and Prudential Pensions Limited in respect of all these funds. Therefore, when considering security of assets as encouraged by the Pensions Regulator's DC Code, it is important to consider the financial strength of Prudential and the structure of the funds it uses.

We focus below on three of the most popular funds where there have been changes of late:

Discretionary Fund

The Discretionary Fund's performance benchmark was the BNY Mellon CAPS Survey Balanced Fund Median and its asset allocation benchmark was the BNY Mellon CAPS Survey Balanced Fund Average. When the CAPS survey was discontinued on 30 June 2016, M&G temporarily used the ABI Mixed Pensions 40-85% Shares Median as a benchmark. Following a review, M&G have moved away from a peer group benchmark and in the first half of 2017 moved to an asset allocation driven by investment fundamentals developed by the Prudential's Portfolio Management Group for the With Profits Fund. This has led to a better diversified fund with equity exposure dropping by around 10% and corresponding increases in allocations to property and a variety of corporate bond sub-funds.

While there are other funds on the Prudential's platform which we rate more highly (such as their slightly cheaper Dynamic Growth Funds), there is not a compelling case for switching members from the Discretionary Fund. Nevertheless, we would not advocate its use in the intermediate consolidation phase of any new lifestyle strategy. Any funds used in a lifestyle strategy need to be replicated in the self-select range to avoid forced sales of funds should members decide to switch out of a lifestyle option.

The International Equity Fund and the overseas element of the Global Equity Fund have also been affected by the change of asset allocation approach.

Recommendations

While the continued use of the Discretionary Fund is not a major issue in itself, if it was decide to introduce a bespoke three phase lifestyle strategy, it would be an opportunity to progressively reduce the use of the Discretionary Fund by:

- Closing the Discretionary Fund to either new AVC payers or all future AVCs;
- Introducing a new multi-asset fund (which also would form part of a new lifestyle strategy); and
- Member communications encouraging members to review their investment choices.

Global Equity Fund

The Prudential's Global Equity Fund is actively managed by M&G. The asset allocation benchmark is 70% UK equities and 30% overseas equities.

While major world equity markets have been quite well correlated in recent years, the Fund is not that well diversified across regions and industrial sectors. The scope for adding value through active management for a Fund with a conservative approach to stock selection is also limited.

Recommendations

- Consideration is given to closing the Global Equity Fund to future AVCs;
- It is replaced by a less UK centric passively managed global equity fund;
- Consideration is given to transferring accumulated assets to the replacement fund – or, failing that, members are encouraged to review their present fund choice.

Deposit Fund

The Deposit Fund is backed by assets in the With Profits Fund. Prudential have maintained for some years the non-guaranteed practice of keeping interest rates in line with the Bank of England base rate. Interest once added is guaranteed (assuming Prudential remains solvent) and withdrawals from this fund are not subject to a Market Value Reduction (MVR).

While Prudential also offer unit-linked funds investing in short-dated securities which offer greater transparency, these have suffered from negative net returns and negative real returns in the present low interest rate environment. .

Prudential closed the Deposit Fund to new contributors in May 2017 and redirected AVCs to the Cash Fund while reducing its charge from 0.75% to 0.55%. This reduced the impact of charges on net returns while interest rates are low, but real returns may still be negative. While the change was made unilaterally by Prudential, we do rate M&G's Cash Fund, whose annual management charge is 0.2% cheaper than the only other cash fund on Prudential's AVC/DC platform, the BlackRock Aquila Sterling Government Liquidity Fund. Any new lifestyle option targeting cash at retirement would need to use unit linked funds offering a high level of liquidity.

Recommendation

We are satisfied that the Cash Fund is an acceptable replacement for future AVCs. While slightly increasing the monitoring requirements going forwards, we would not recommend transferring existing AVCs from the Deposit Fund in the current economic environment.

With Profits Fund

A fuller description of the Prudential's With Profits Fund is given in the Appendix to this paper.

Observations

Prudential's With Profits Fund is in the almost unique position of still being strongly cash-flow positive. This is in contrast to most of its peers who are cash-flow negative and hence, like many private sector DB schemes, have been forced to adopt more cautious investment strategies to protect their solvency.

Our research meetings with Prudential highlighted that a significant proportion of this positive cash-flow comes from the retail IFA market. There is therefore a risk that sentiment towards the Fund among retail market independent financial advisers could change affecting the Fund's cash-flow and in turn, over a period of years, both its investment strategy and, as a result, future bonus rates. Looking at what has happened to other providers as a guide, the investment strategy (and overall returns it generates for investors) might hold up for maybe 10 years, but the prospective returns over the longer term would gradually decline.

So, while the Prudential's With Profits Fund seems likely to continue delivering fair returns for perhaps the next 10 years or so (where the With Profits guarantees are also likely to be most valued by members), there's a risk that returns will start to deteriorate beyond then. Our analysis shows that most AVC payers are within 15 years of retirement and so younger members paying or starting to pay AVCs in the near future could do better elsewhere. Any transfers from a With Profits Fund would, in any event, need to be approached with caution as they could well lead to "winners and losers" amongst the AVC members (which would not become apparent for some years).

Recommendations

The Prudential's With Profits Fund is a popular member choice – not just with your Fund's members, but in other LGPS Funds too. So, we recommend that:

- Consideration is given to introducing a new default option (such as a lifestyle strategy) for new AVC payers while retaining the With Profits Fund as a self-select option, taking care not to alarm existing AVC members in this Fund;
- The Fund's financial health should be monitored annually;
- Member communications regarding the With Profits Fund should be kept under annual review.

Fund usage

The heat maps and charts in the Appendix shows the usage of the funds across age groups:

- Fund usage shows a wide dispersion across all funds at all ages;
- There are a significant number of younger members invested in the Cash and Deposit Funds;
- The Global Equity and International Equity Funds have significant holdings among members approaching retirement;
- The Index Linked Fund is used by several members some years from retirement.

5.2 Clerical Medical

With Profits

Some AVC members are invested in the Clerical Medical With Profits Fund either directly or via the Equitable arrangements.

An outline of the Clerical Medical With Profits Fund's investment strategy and bonus setting are given in the appendix.

Observations

- Despite the With Profits Fund being largely closed to new business (and hence cash-flow negative), the 57% allocation to growth assets as at 31st December 2017 is perhaps higher than we might expect.
- Nevertheless, we might speculate that the 27% allocation to absolute return strategies and "other" investments is needed to maintain liquidity and provide collateral for derivative overlays/hedging strategies.
- The return on the Fund's underlying assets (which gradually feeds through to bonuses) was 7.8% in 2017, suggesting that liability and liquidity management is having an impact on returns.
- This contrasts with Prudential's £100bnbn With Profits Fund, which remains strongly cash-flow positive with a 66.1% allocation to growth assets as at 31 December 2017 giving a return on its underlying assets of 10.3% for 2017.

We would question whether the Clerical Medical With Profits Fund remains a suitable home for younger members' AVCs.

Recommendations

- Any future AVCs (existing or new) to the Clerical Medical With Profits Fund should be stopped;
- AVC members should be encouraged to review whether With Profits remains a suitable investment.

Lifestyle options

One member uses two of Clerical Medical's six standard lifestyle options. The key aspects of these lifestyle strategies are:

- All use a conventional two stage approach moving from straight from growth to protection phases;
- All start de-risking 10 years from retirement;
- The main differentiator is the level of investment risk/diversification in the growth phase;
- All effectively target a member expected to take 25% of their savings as a cash lump sum with the remaining 75% used to buy an annuity.

Observations

- Most LGPS members take AVCs entirely as cash at retirement, so the closing asset allocation of all the lifestyle strategies is a poor match with members likely retirement plans for their AVCs;
- A two stage lifestyle strategy will not effectively manage the value at risk for AVC members who have built up appreciable AVC values by around 10 years from retirement;
- A 75% allocation to bonds at retirement means that older AVC members are bearing significant interest rate risk (particularly at the present time); and
- We would question the merits of offering AVC members several lifestyle options with the same de-risking period and targeting the same mix of benefits at retirement.

Self-select fund range

The funds used by members in the lifestyle options and on a self-select basis are:

Clerical Medical Fund	Asset Class	Active/Passive	Charges % p.a.
International Growth	Equity	Active	0.5
UK Growth	Equity	Active	0.5
Balanced	Multi-asset	Active	0.5
Cautious	Multi-asset	Active	0.5
Non-Equity	Multi-asset	Active	0.5
Retirement Protection	Bond	Active	0.5
Cash	Cash	Active	0.5
Halifax	Cash	Active	0.5

* The funds are "clean-priced" such that the Annual Management Charge is equal to the funds' Total Expense Ratio.

Observations

- The fund charges are, in isolation, competitive with their peers, but less competitive when taking the overall package of services into account;

- The largely flat-rate charging structure means that some funds are cheaper (e.g. Balanced) while some funds are dearer (e.g. Cash) than might be expected with a more granular charging structure;
- Clerical Medical do offer a wider range of funds across the main asset classes, some with active or passive management.

Fund usage

The heat map and charts in the Appendix shows the usage of the funds across age groups.

Observations

- The use of the Cash Fund is, reassuringly, entirely at older ages;
- The lifestyle options result in some exposure to higher risk funds and, potentially, interest rate risk relatively close to retirement;
- The usage of the With Profits Fund grows quite linearly with age, although there are a few members in their 40s.

5.3 Equitable

With Profits

A fuller description of Equitable's With Profits Fund is given in the Appendix to this paper. We summarise the key considerations below.

Some AVC members have investments via Equitable in the Clerical Medical With Profits Fund described in 5.2.

Investment and bonuses

Equitable Life's With Profits investment strategy remains focussed on maximising the returns on policyholders' assets whilst meeting solvency requirements. The With Profits Fund is predominantly invested in bonds and cash (97% in 2017), which closely match the With Profits' liabilities (guarantees and past bonus additions).

Equitable Life do not expect to make further guaranteed bonus additions which would increase its liabilities. Non-guaranteed values (on which early surrender and transfer values are based) have been increased by a discretionary bonus which could be withdrawn if the With Profits Fund's financial position deteriorated.

Guarantees

In addition to the usual With Profits capital guarantee (assuming the provider remains solvent), the Fund's Equitable Life With Profits policy includes a 3.5% minimum return guarantee.

This guarantee only bites at the retirement age specified in the policy when the higher of the guaranteed or non-guaranteed value is payable. If a member retires or transfers before the specified age, they would only receive the non-guaranteed value (together with the capital distribution if still available).

This guarantee may be valuable for members approaching retirement in present market conditions and should be borne in mind when considering a transfer to another fund or provider.

Capital distribution

As Equitable's financial position improved since 2000, it has gradually moved from imposing a penalty on early surrenders to distributing surplus capital. For 2018 this capital distribution remains at 35% of a member's non-guaranteed value at 31 December 2014.

There is a risk that this uplift, which is not guaranteed, could be reduced if Equitable's financial position were to deteriorate. Equitable's Annual Report and Accounts for the year ending 31 December 2017 warns of the pressure on its capital available for distribution caused by members with the 3.5% guaranteed return (which accounts for 80% of policies) deferring retirement.

In June 2018 Equitable announced that it was transferring its business to Reliance Life (see section 8 for further details). The transfer is expected to result in the capital distribution to With Profits policyholders increasing in late 2019 from the present 35% to in the region of 60% to 70%. The main risks appear to be that the Equitable's financial position could deteriorate in the interim and funds and policy terms offered by Reliance going forwards are uncompetitive or restrictive.

Consideration will need to be given in due course as to whether these AVCs should remain with Reliance or be transferred to the Fund's principal AVC provider (members could individually choose to draw or transfer their Equitable AVCs). Equitable do not communicate directly with members and so, at this stage, it would seem appropriate to inform members of what is happening in case it has a bearing on their investment choices or retirement plans.

Self-select funds

Equitable have not provided details of the unit linked funds used by 49 members with a total value of £247,188. There is no mention of any lifestyle options.

We have therefore set out the entire Equitable unit-linked fund range below.

Fund name	Annual fund charge	Fund name	Annual fund charge
Ethical **	1.00%*	North American	0.75%*
European	0.75%*	Pelican	0.75%*
Far Eastern	0.75%*	Property	1.00%*
FTSE 100 Tracker **	0.50%*	Smaller Companies **	1.00%*
FTSE All Share Tracker	0.50%	Special Situations **	1.00%*
Fund of Investment	0.75%*	Clerical Medical Non-Equity	0.50%
Gilt & Fixed Interest	0.50%	Clerical Medical Adventurous	0.50%
High Income **	1.00%*	Clerical Medical Ethical	0.50%
Index-Linked Gilt	0.50%	Clerical Medical Balanced	0.50%
International Growth	0.75%*	Clerical Medical Cautious	0.50%
Japanese [1]	0.75%*	Clerical Medical With-Profits	0.50%
Managed	0.75%*	Clerical Medical UK Growth	0.50%
Money	0.50%	Deposit Account	0.00%

The Annual Management Charge is equal to the funds' Total Expense Ratio.

* The Equitable increased the charges for these funds in April 2016.

** Equitable Life have reduced the number of unit-linked funds that they offer. The fund closures and resulting fund switches were:

Fund closing	Switch if no instruction	Date of closure
Ethical	International Growth	July 2016
Japanese		
Special Situations	Pelican	August 2016
Smaller Companies		
High Income		
FTSE 100 Tracker	FTSE All Share Tracker	

Equitable Life's unit linked funds have undergone several changes of investment manager since 2000 and are now managed by Aberdeen Standard.

Equitable Life's unit-linked funds have been subject to three explicit charges:

1 Contribution charge – 5% is deducted from new contributions, so only £95 has been invested of each £100 contributed.

2 Bid/offer spread – funds are "dual priced" with a fixed 4.5% spread, so that the bid price is 95.5% of the offer price.

3 Annual management charge (AMC) – was 0.5% p.a. for all the unit-linked pension funds until 2016.

As shown above, Equitable Life significantly increased the charges for most of its unit linked funds from April 2016 and closed some funds in mid-2016, with a view to rationalising its unit linked fund range. This was prompted by the desire to run-down the business and contain costs. Equitable Life's literature now makes no reference to a 5% contribution charge, which appears to have been absorbed into the bid/offer differential.

Equitable Life's literature does not make reference to whether implicit costs are included in the explicit charges above or are additionally deducted before unit prices are set. Equitable Life have confirmed separately that for all their unit linked funds except Property, the charges above include implicit costs which means that the funds' Total Expense Ratios ("TERs") are the same as their AMCs (except Property where the TER is greater).

The practice of using a fixed bid/offer differential (4.5% in Equitable Life's case) has long fallen from favour among the providers active in the UK AVC/DC market. It is now common practice that the members potentially incur no more than the funds' true bid/offer differential – in the region of 1% for a conventional UK Equity Fund. However, it seems that Equitable Life's charges have not fallen foul of the cap on exit fees.

Observations

The number of funds available is very limited, with no externally managed funds or more contemporary funds which have come onto the market since 2000.

The funds' 0.5% AMC was, in isolation, competitive in the AVC market while the revised charge of 0.75% is above average. These charges are poor value when the very limited supporting services are taken into account. The fixed 4.5% bid/offer spread is very high by current standards. This suggests that the continuation of any existing contributions to Equitable Life's unit linked funds should cease.

5.4 Standard Life

With Profits

The Fund has a small amount of AVCs invested in variants of Standard Life's With Profits One and With Profits One 2006 sub-funds. An outline of the With Profits One Fund's investment strategy and bonus setting are given in the Appendix.

Observations

- While the With Profits One Fund is gradually closing to new business (and hence cash-flow is declining), the Fund had an above average 66% allocation to growth assets as at 31st December 2017.
- The return on the Fund's underlying assets (which gradually feeds through to bonuses) was 12.2% in 2016 and 7.9% in 2017.
- This compares reasonably with Prudential's £90.1bn With Profits Fund, which remains strongly cash-flow positive with a 62.6% and 66.1% allocation to growth assets as at 31 December 2016 and 2017 respectively, giving a return on its underlying assets of 14.5% for 2016 and 10.3% for 2017;

- Recent overall bonus returns appear modest compared to the return on the underlying assets.

We would question whether the Standard Life With Profits Fund remains suitable for younger members' AVCs.

Lifestyle Option

13 members are invested in the Standard Life's "Balanced Universal" lifestyle option. This has until recently been designed for members expecting to take a mix of cash and annuity at retirement. However, following changes to the At Retirement Fund used in the lifestyle strategy's closing stages, this lifestyle strategy is now aimed at wider range of benefit choices at retirement.

Self-select funds

Standard Life's generic literature can result in members having access to a very large range of funds which are too numerous to describe. We note here that members have only paid AVCs to 4 unit linked funds:

Standard Life Fund	Asset Class	Active/Passive	Charges p.a. *
Ethical	Equity	Active	1.65%
Managed	Multi-asset	Active	0.82%
Multi-Asset Managed 20-60	Cautious multi-asset	Active	0.82%
At Retirement (Multi-Asset Universal) **	Long Government Bonds	Active	0.81%

* The table uses the 0.2% discount (see below), although this does not currently apply to all AVC members.
** This Fund was previously known as the At Retirement Multi-Asset (Annuity Purchase) Fund, but its asset mix has now changed to accommodate members making a wider range of benefit choices at retirement.

Charges

We note that all current members with Standard Life commenced their AVCs after 22 February 2002 and so the charges they bear depend on the size of their unit linked funds.

For members prior to 22 February 2002, a repricing discount created, on average, an additional 0.40% of units into their plans on their fund value from contributions paid prior to 23/02/2002 and on all ongoing regular contributions up to the level being paid prior to 23/02/02 (any increases are excluded).

For members from 23/02/2002, Standard Life introduced "Value For Money" discounts. Additional units are created when the overall fund value for an individual plan (i.e. repriced fund and ongoing regular contributions) reach certain levels:

Size of Member's Fund	Total Fund Discount
Over £10,000	0.1%
Over £20,000	0.2%

Additional units are created on a monthly basis to create the effect of reducing the amount deducted from the member's fund each year.

Observations

- Standard Life's charging structure is not as easy for members to follow as its peers' flat rate charges;
- The Ethical Fund appears quite expensive, while charges for the multi-asset and long bond funds are not particularly competitive;

- Standard Life's fund naming convention (where several funds can share the same base fund) could be confusing to members.

Fund usage

The heat map and charts in the Appendix shows the usage of the funds across age groups.

- The distribution of members' AVC values in some funds across the age bands is quite wide;
- There is a spread of members from ages 40s to 60s in the equity biased funds;
- Use of the Managed Fund (which has a meaningful equity allocation) is concentrated on members 5 to 20 years from retirement;
- As might be expected, use of the Ethical Fund is spread quite evenly across all ages, although this again means that older members in this fund are carrying equity market risks.

5.5 Overall recommendations

Investment choices

In our view, a compact and robust choice of investment options under the AVC arrangement is desirable. It helps make the arrangements simpler for members to use and reduces the overall governance burden on the Pensions Committee.

As described in section 10, we believe that a default option is desirable for AVCs to make it as easy as possible for members to save more for their retirement and benefit from the tax reliefs. However, the default needs to be appropriate for a majority of members.

Lifestyle options

Our main concern is that Clerical Medical and Prudential lifestyle strategies targeting 75% or 100% annuity purchase respectively are unlikely to be appropriate for the majority of LGPS AVC members, who typically take their AVCs as a lump sum at retirement.

We also believe that several similar lifestyle options is excessive, while two stage lifestyle strategies (with growth and pre-retirement phases) do not effectively manage the investment risks members face over time.

We would recommend that **two new lifestyle options should replace the existing lifestyle options:**

1) **Targeting members expecting to take their AVCs as cash at retirement; and**
2) **Targeting those members planning to buy an annuity at retirement**.

Self-select funds

The choice of self-select funds currently offered to members through Prudential covers a range risk/return options. The self-select fund choices with the three "legacy" providers are less balanced with differing levels of fund choices, charges and support services as well as the limited scope for making changes.

AVCs to Clerical Medical, Equitable and Standard Life unit-linked funds should be discontinued with these members having the opportunity to redirect future AVCs and transfer accumulated AVC funds to Prudential.

There is scope for rationalising the fund choices with Prudential, particularly among the equity funds. This would create room for a few new funds aimed at members wanting an intermediate to lower level of risk, perhaps to take advantage of the pension freedoms.

Consideration should also be given as to whether one ethical fund fulfils both the Fund's ESG approach and the views of its members.

With Profits

Prudential's With Profits Fund appears to be in good health and delivering acceptable returns. Clerical Medical's and Standard Life's With Profits Funds have become less effective, whilst Equitable's With Profits Fund is at an advanced stage of run-off with meaningful inducements to transfer AVCs elsewhere.

We would therefore recommend:

- While AVCs to the Prudential's With Profits Fund can continue, it should no longer be the default choice;
- AVCs to the Clerical Medical, Equitable and Standard Life With Profits Funds should cease;
- Members in the Equitable's With Profits Fund should be appraised of the current 35% capital distribution and prospects of a further increase in the distribution following the transfer to Reliance; while
- Members in the Clerical Medical and Standard Life With Profits Funds could be encouraged to consider whether these funds remain suitable for their needs.

Overall

We propose that Prudential becomes the sole provider for members' future AVCs, albeit with a revamped choice of investment options, while steps are undertaken to accelerate the run-off of the other three providers.

Potential changes to the lifestyle options and self-select funds are considered in more detail in Section 10 "Future investment options".

6 Prudential

Summary & Recommendations

- Prudential announced in January 2018 that their outsourced administration services are to be transferred from Capita to Diligenta/Tata to take advantage of their stronger digital capabilities.
- In March 2018 Prudential announced plans to demerge its UK/European and Far Eastern/US businesses.
- In May 2018 Prudential announced the closure of its presenter team and a restructure of its relationship management team (of which further details are awaited).
- Prudential remains one of the leading AVC providers with a strong commitment to the AVC market (in some senses providing a degree of pooling).
- Prudential are continuing to enhance their on-line facilities, have experience of operating shared cost AVCs and reduced charges in 2018.
- Prudential's fund range is competitive, covering a range of low, medium and high risk/return options with a choice of internal and external managers.
- While Prudential's charges are slightly above average, they represent good value for members when taking into account the package of services bespoke to LGPS – although the closure of the presenter team will affect Funds that used them as part of member communications.
- The direct and indirect costs associated with any change of AVC provider are likely to outweigh any fee savings.

We recommend Prudential is retained as the Fund's main AVC provider, although the effects of the recent restructure and growing on-line focus on the quality of service should be monitored.

Prudential as a provider

Demerger

On 14 March 2018 Prudential announced that M&G Prudential and Prudential plc are to be demerged into two separate listed companies. M&G Prudential will focus on the UK and European investment and savings markets, while Prudential will focus on the Far East and US. The demerger is subject to regulatory approval and is not expected to be completed until late 2019. At the same time, Prudential will transfer £12bn of its annuity business to Rothesay Life.

While information is limited at present, it seem unlikely that the demerger will have an impact on the pensions business in the short-term, while in the longer term it will not have to compete with the Far East of the allocation of capital. However, while Prudential estimate that the Solvency II ratio for the UK regulated business will be diluted slightly, we would like to see the effect on M&G Prudential's future level of indebtedness.

Outsourcing

Prudential's life and pensions administration has been outsourced to Capita for 10 years and these arrangements have worked satisfactorily. In January 2018 Prudential announced that their outsourced administration services are to be transferred from Capita to Diligenta, which is the FCA Regulated subsidiary of Tata Consulting Services ("TCS"), to take advantage of Diligenta's stronger digital capabilities. Diligenta already provide administration services to several major UK insurers and TCS, provides support to NEST.

While TUPE transfers of Capita and some Prudential staff to Diligenta will begin in 2018, we understand that schemes including LGPS AVCs administered on the "Hartlink" platform will not be transferred to Diligenta until 2019.

AVCs

Prudential continue to be the leading provider of AVC arrangements. They have been active in the public sector while continuing to manage a large book of AVC business for many private sector schemes. Prudential have a reputation, particularly in the public sector, for providing a well-rounded service with effective administration of multi-site payrolls and good member education/communication where required.

In May 2018 Prudential announced the closure of its experienced and sizeable presenter team, which was used extensively by some LGPS Funds. In conjunction with this and the growing digital focus of its business, changes to the size and structure of its relationship management team will take place in July 2018.

Prudential have continued to improve their competitiveness in other areas:

- The fund range was updated in 2015 and offers a good choice of in-house and externally managed funds across the risk/reward spectrum as well as more specialist investment approaches;
- The charges for most funds have been reduced in 2018;
- The on-line functionality for members was updated in 2017 and further improvements are in prospect;
- The administration is compatible with shared cost/salary sacrifice AVCs (giving savings to both members and employers).

Set against this, Prudential are closing some funds in August 2018 including two external funds which we rate. The overall effect is to introduce a slight bias towards Prudential's internal funds.

In our view Prudential's charges are slightly above average, although not materially so. This should be balanced against the range of LGPS bespoke ancillary services Prudential offer (where these are of value to the members and/or the Pensions Committee).

It is disappointing that Prudential have closed the presenter team and seem set to scale back the level of client support, potentially eroding the differentiation of its AVC offering compared to their competitors.

Whilst it may be possible to obtain better terms elsewhere, any saving needs to be balanced against:

- The costs to the Authority of appointing a new provider;
- The potential transaction costs that would be incurred by members (approaching 1% for equity assets);
- Potential issues for members associated with disinvesting from the With-Profits Fund; and
- The member communications change would necessitate.

The direct and indirect costs associated with a change of provider are likely to outweigh any fee savings. Consequently, based on charges alone, we do not believe there is any merit in seeking to change from Prudential for unit-linked AVC funds. We would not, in any event, recommend moving AVCs in the With Profits Fund.

Exit charge

Prudential introduced and are now phasing out an exit charge:

- The key date is when the member started paying AVCs - subsequent increments are not subject to the exit charge;
- The exit charges was 3% in year 1, 2% in year 2 and 1% in year 3 from when AVCs commenced;
- From 19 March 2017 the exit charge was removed for new AVC payers and reduced to 1% for existing recent AVC payers;

- It will disappear completely by 19 March 2020.

The exit charge only applied to Local Government and USS AVC Schemes, not other public sector nor private sector schemes. We understand that Prudential had encountered a much higher incidence of short-term AVCs in the LGPS and USS which impact upon Prudential's administration and reserving costs. This penalty is out of line with the spirit of the FCA requirement to curtail excessive exit penalties and so we are pleased that it is being phased out.

Overall

Prudential remain the leading provider in the AVC and LGPS AVC market, offering a well-rounded proposition which they continue to develop.

We recommend that Prudential are retained as the lead AVC provider, while the impact on the quality of service of the changes to the relationship management team and growing digital focus of its business should be monitored.

7 Clerical Medical

Summary

Clerical Medical has been closed to new business for some years and their AVC offering has gradually become uncompetitive: investment options as well as supporting services for both members and authorities/employers.

Clerical Medical had a significant presence in the LGPS AVC market and now fall under the wing of Scottish Widows who are also active in the LGPS AVC market. While Scottish Widows provide a degree of support to LGPS Funds, this does not appear to be fully "joined-up" with Clerical Medical's administration.

The unit linked fund range has seen some development since Clerical Medical closed to new business with the addition of external managers' funds. However, there are gaps in the fund range and the lifestyle strategies are now largely unsuitable for AVCs.

While it is possible to make limited improvements to the unit linked funds with Clerical Medical, there is no scope for changes to the lifestyle options or improvements to the services available to members and the authority/employers. We therefore recommend accelerating Clerical Medical's replacement by Prudential.

Structure

Clerical Medical became part of the Lloyds Banking Group in December 2009. Clerical Medical's operations and client support have become integrated with that of Scottish Widows, although administration is separate.

Administration is being outsourced to Diligenta (a subsidiary of Tata Consultancy Services). Scottish Widows administrative staff were TUPE'd to Diligenta in March 2018.

Scottish Widows are in the process of acquiring Zurich's group pensions business (subject to regulatory approval). This is consistent with the consolidation among DC providers we are seeing (e.g. AEGON and BlackRock's platform, Mobius and Old Mutual's platform, Phoenix and AXA Wealth's platform and most recently Phoenix and Standard Life).

Zurich are competitive in the DC market and the acquisition has the potential to enhance Scottish Widow's offering at the institutional end of this market as well as gaining access to Zurich's Master Trust. However, it is not clear as yet to what extent the acquisition will have in time on Clerical Medical's and Scottish Widows' existing AVC clients – although early indications are that the criteria for moving to the Zurich platform will be out of reach of some LGPS Funds.

With Profits

Some AVC members are invested either directly in Clerical Medical's With Profits Fund or via the Equitable arrangements.

Unit linked funds

Clerical Medical's "in-house/own-branded" unit linked funds have undergone several changes of investment manager over the years and are currently managed by Aberdeen Standard Investments. Lloyds Banking Group announced in February 2018 that they will be transferring its £109bn of mandates from Aberdeen Standard in 2019.

Range

Despite being closed to new business, the fund range has been expanded on the back of Clerical's links to Scottish Widows and now includes funds from several external managers: BlackRock, Fidelity, Insight, Invesco Perpetual, Newton, Schroder and UBS. The fund range does, to an extent, have something of a retail savings market flavour. In particular, the choices of passively managed and multi-asset funds are limited.

Charges

The funds' 0.5% AMC is, in isolation, competitive in the AVC market. However, taking into account the limited range of services Clerical Medical provide, this charge is less competitive value for money.

Clerical Medical as a provider

Clerical Medical has been closed to new scheme business for some years, although they continue to accept new members and increments for existing members. Their AVC product has gradually fallen behind their main competitors:

- Client servicing and governance reporting is limited;
- The fund range has some gaps and a retail bias;
- The lifestyle strategies are no longer suitable for AVC or DC schemes;
- There are no on-line facilities for members (or the Authority) to: view fund values, switch funds, access educational/communication material or access benefit modelling tools.

From our discussions with Scottish Widows, it appears that the links between the Scottish Widows relationship management team and the Clerical Medical administration operations are limited meaning that information is not always readily to hand.

Redirecting future AVCs and perhaps transferring accumulated unit linked funds from Clerical Medical to Prudential would give better "value for members":

- A more institutional market orientated fund range better suited to the members' needs;
- The availability of lifestyle strategies better suited to members' likely benefit choices at retirement;
- Better administration services for members and employers including on-line functionality; and
- Better support for the Pensions Committee on the governance of the AVC arrangements.

The benefits of change do need to be balanced against:

- The work involved in moving members;
- Members may incur additional transaction costs (depending upon their choice of fund and market conditions) going in and out of unit linked funds twice.

Recommendations

Consideration is given to taking steps to accelerate the run-down the arrangements with Clerical Medical:

- Any future AVCs to Clerical Medical are stopped;
- Members are encouraged to review whether their present investment choices still meet their needs and given the option of transferring their AVCs to Prudential;
- The lifestyle options drawbacks are brought to members' attention.

These steps, over time, should both give better value for members as well as simplifying the governance work in keeping with the spirit of the Pensions Regulator's 2016 DC Code.

8 Equitable Life

Please note that our comments on Equitable Life are constrained by the limited member data available.

Our paper reflects Equitable Life's results for the year ending 31 December 2017 which were published in April 2018.

Summary

Equitable has been closed to new business since 2000 and its AVC offering has become uncompetitive.

In the last few years Equitable have passed on savings made around their business as a capital distribution – currently a 35% uplift in non-guaranteed With Profits values (see section 5 and Appendix 4). .

In June 2018 Equitable announced the transfer of its business to Reliance Life. This is expected to take place in late 2019 and lead to an increase in the capital distribution from 35% to 60-70% (assuming Equitable's solvency does not deteriorate in the meantime).

The unit linked fund range has been rationalised and charges increased. Members investing in the unit-linked funds do not benefit from the Equitable's improved financial position.

We recommend taking steps to accelerate the run-down of Equitable Life's unit-linked funds, bring the transfer to Reliance and potentially increased capital distribution to the attention of members in the Equitable With Profits Fund and encourage members in the Clerical Medical With Profits Fund to seek financial advice on the its continued suitability.

Structure

After closing to new business in 2000, Equitable Life's business is now at an advanced stage of being run down. There has been a sustained effort to reduce liabilities (for instance, selling parts of its annuity business and restructuring their unit-linked funds) and reducing costs (cutting back services) with the aim of passing as much money as possible back to With Profits (but not unit-linked) policyholders.

On 15 June 2018 Equitable announced that it was transferring its business to Reliance Life. While details are limited at present, the key aspects are:

- The transfer is expected to take place in the latter part of 2019 (although experience of other "Part VII" transfers suggest this may be optimistic);
- The transfer is expected to result in the capital distribution to With Profits policyholders increasing from 35% to in the region of 60% to 70% (subject to Equitable's solvency not deteriorating in the interim);
- The With Profits Fund would close (with members transferred to an as yet unspecified unit-linked fund) and its guarantees would come to an end; and
- Members in the Equitable's unit-linked funds would not receive any capital distribution.

Life cover

Equitable are unusual in providing a facility for members AVCs to buy added life assurance cover. £427.92 of the AVCs paid were used in this way during the year ended 5 April 2017.

Prudential also offer a facility for AVCs to buy term/temporary life assurance cover. It may be that the costs and terms of cover with Prudential would be better value.

Equitable Life as a provider

Equitable Life has been closed to new business since 2000 with the whole business in managed decline and their AVC product has become increasingly uncompetitive:

- Client servicing is extremely limited as they cut costs during the run-off of their business in recent times;
- The overall fund range is limited;
- Charges are generally above average;
- Cost savings are be distributed to With Profits investors only.

There is a case for transferring unit linked funds from Equitable Life to Prudential:

- Lower charges for continuing contributions on most equivalent funds;
- A wider and more contemporary choice of funds which may be better suited to the member's needs;
- Better administration services and support for members and employers including on-line; and
- Reduced governance for the Fund's Pensions Board.

The benefits do need to be balanced against:

- The work involved in moving members;
- Members would need to remain invested with Prudential for a few years (depending upon the choice of fund) to recoup the potential costs of their AVCs going in and out of unit linked funds twice; and
- Limited benefits could be obtained by rationalising the range of Equitable unit linked funds.

Equitable Life will now consider making a "partial surrender" (moving unit linked funds while leaving with profits). So, the merits and demerits of moving the unit linked and With Profits funds can be considered independently of each other.

Recommendations

We recommend that:

- Any future AVCs to the Equitable Life are stopped;
- The forthcoming transfer to Reliance and potential increase in the capital distribution are brought to the attention of members in the Equitable With Profits Fund;
- Any members in the Clerical Medical With Profits Fund (which has been open to Equitable AVC members) are encouraged to seek advice on its suitability;
- Members are are encouraged to review whether the Equitable Life unit linked funds still meet their needs and given the option of transferring their AVCs to Prudential;
- and
- The terms for life cover with Equitable are compared against those offered by Prudential with a view to asking members to transfer cover.

These steps, over time, should both give better value for members as well as simplifying the governance work in keeping with the spirit of the Pensions Regulator's 2016 DC Code.

9 Standard Life

Summary

Standard Life have long been a major player in the AVC/DC market. However, following the merger in 2017 Aberdeen Standard is increasingly focusing on its investment business, creating uncertainty around the future of its traditional life and pensions business.

The AVC/DC fund range is extensive, albeit with a strong in-house bias. Charges, which may include a scheme specific discount, are broadly competitive both in isolation and taking into account the overall range of standardised supporting services. The AVC offering is based upon Standard's general DC proposition. While AVC schemes benefit from system developments for the wider proposition, there is little tailoring to suit the specific requirements of the AVC and LGPS AVC markets.

We recommend that the situation at Standard Life is monitored and steps are taken to run-down the use of Standard Life.

Structure

Standard Life's business is changing focus:

- The 2017 merger with Aberdeen Investment Management to form Aberdeen Standard Investments marks a change towards an investment management focused business model;
- The announcement on 23 February 2018 that the administration of Standard Life's life and pensions business is to be transferred to Phoenix who have, until recently, focused on running closed books of life and pensions business.

Whereas providers, such as Prudential, outsource back office administration, Standard Life are going further:

- Ownership of Standard Life Assurance Limited will be transferred to Phoenix;
- Standard Life's administrative staff and systems will be transferred to Phoenix, with only distribution/relationship management and product development/marketing remaining with Standard;
- The use of the Standard Life brand will be licensed by Phoenix;
- Existing service standard commitments will continue;
- Standard Life will in return take a 19.99% stake in Phoenix, whose head office will move to Edinburgh.

It is anticipated that the transfer will be completed by the third quarter 2018. However, experience of similar transfers (e.g. AEGON's acquisition of BlackRock's DC platform) suggests this timetable may be optimistic.

Full details are not yet available and it is too early to ascertain the longer-term impact of these changes on policyholders. However, it seems likely that there will be a period of uncertainty in the near-term.

Unit linked funds

Fund range

Standard Life's AVC product shares its fund range with other defined contribution products including contract-based group personal pension plans:

- The fund range is large and perhaps unwieldy with numerous similar funds in each asset class;
- The fund range covers the main asset classes and investment styles, although lacking funds using some of the latest investment ideas;

- There is a strong bias to in-house funds including the flagship Global Absolute Return Strategies ("GARS") Fund; and
- Externally managed funds tend to be expensive.

The unit linked fund range needs to be used selectively to avoid both confusing members and creating an undue governance burden. While Standard Life's administration systems can accommodate limiting the choice of funds used by a scheme, their generic literature does not. So, the Fund would need to issue communications to members.

Charges

Standard Life's literature quotes their standard charge across all schemes, to which a scheme specific discount is applied by purchasing additional units. Charges are above average.

Standard Life as an AVC provider

Standard Life have been one of the largest players in the UK DC market for a number of years and, as a result, have been active in the Public Sector AVC market. The range of DC products are highly homogenised, which has both advantages and disadvantages for AVC schemes:

- The fund range benefits from the general developments aimed at leading product lines;
- Administration and communication benefit from enhancements to on-line access;
- Communication material is generic and not tailored to AVCs or LGPS.

Compared to their main rivals in the AVC market, Standard Life's commitment to the AVC market can at times appear somewhat half-hearted and we wonder if this will become more pronounced following the transfer to Phoenix?

Standard Life have a team able to deliver presentations at staff meetings. Standard Life do generally charge for member presentations and have less experience of LGPS.

Administration has been handled on in-house systems and normally works smoothly. However, we are aware of a couple of spells in recent years where a surge in the volume of work has caused service standards to slip temporarily. It is too early to assess the impact of the transfer of administration to Phoenix, who normally use systems developed by Diligenta/Tata Consulting Services, but will be taking over Standard Life staff and systems.

Standard Life are able to produce regular scheme reports to assist in the governance of the AVC arrangements.

Recommendations

The transfer of pensions business from Aberdeen Standard to Phoenix should be monitored, paying particular regard to charges, service standards, product/system development and security of assets.

Consideration is given to taking steps to accelerate the run-down the arrangements with Standard Life such as:

- Any future AVCs to Standard Life are stopped;
- The scope for rationalising/restricting the wide choice of Standard Life funds is examined;
- Members are encouraged to review whether their present investment choices still meet their needs and given the option of transferring their AVCs to Prudential.

These steps, over time, should again both give better value for members as well as simplifying the governance work in keeping with the spirit of the Pensions Regulator's 2016 DC Code.

10 Future investment options

Objectives

We suggest that the future investment options for AVCs are set with the following objectives in mind:

- A range of funds should be offered across the risk/reward spectrum;
- The choice of funds should reflect the age profile of the AVC members and the pattern of AVC values;
- The range of funds should cover the benefit choices members are likely to make at retirement;
- There should be provision as appropriate for specialist funds meeting more specific investment requirements (such as ethical funds);
- Lifestyle options should target the most common benefit choices at retirement and manage the risks AVC members face over time, principally: inflation, value at risk, volatility and conversion.

This is in keeping with the Pensions Regulator's guidance in the 2016 DC Code of Practice 13.

Investment options

Behavioural economics studies and experience suggest that offering a large number of investment options can be counter-productive:

- Most members do not feel comfortable making investment choices;
- Many members are not well-placed to make asset allocation decisions which are the main driver of good outcomes;
- Offering too many choices can deter members from taking any action to save more for their retirement (and in turn forego valuable tax relief);
- Members do not tend to review their past investment choices in the light of changing circumstances and market conditions or as they approach retirement, when their tolerance to investment risks may change.

We therefore believe that:

A default option, which manages investment risks and asset allocation over time (such as a lifestyle strategy), should be offered to make it easy for members to save;

The choice of self-select funds for members who want to take a more active role in investing their AVCs should be compact (say 10-15 funds), while covering the main asset classes and key specialist fund types.

Lifestyle options

The present lifestyle options targeting annuity purchase are inappropriate where most members are likely to take cash at or a short way into retirement.

In addition, the present "two-stage" lifestyle options moving from a growth phase to a pre-retirement phase, do not, in our opinion, adequately manage the value at risk aspect:

- Some strategies invest too cautiously further from retirement, when inflation is the biggest risk;
- Some strategies carry too much risk around 10 years from retirement, when there is insufficient time left to recover from a major market downturn by paying extra AVCs; and
- Not catering for short-notice changes in members' retirement plans.

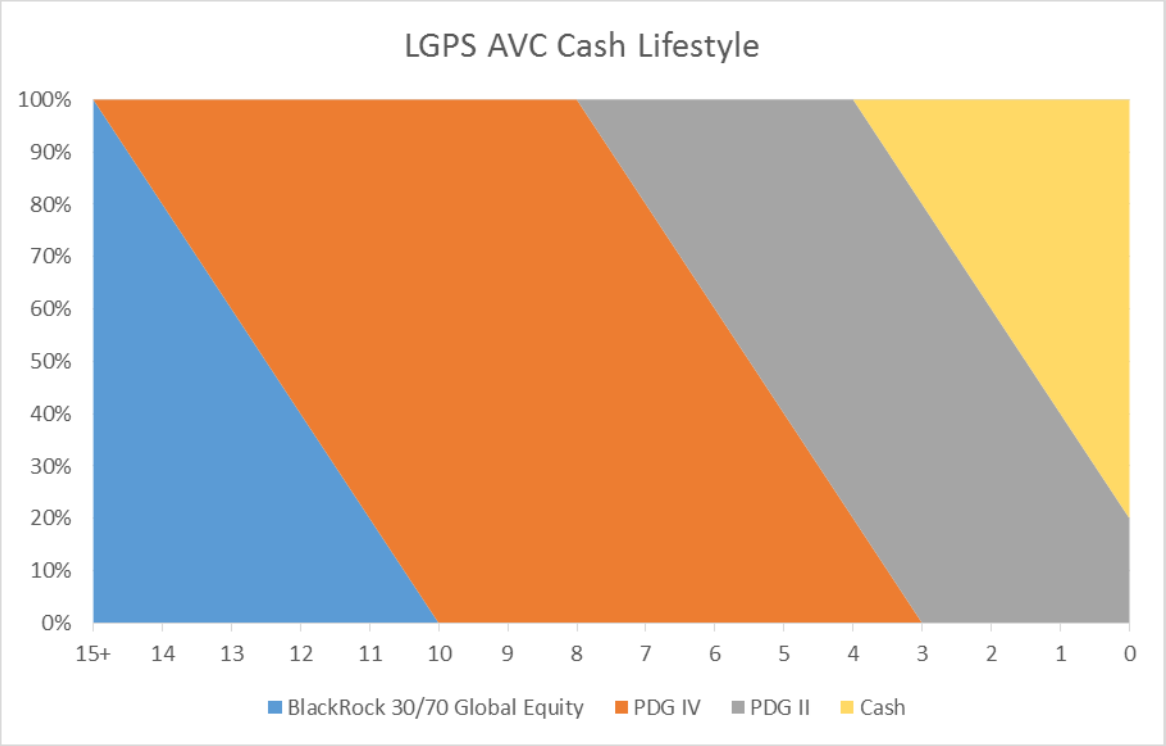
Nevertheless, it may be felt that ceasing to have a lifestyle option targeting annuity purchase would unduly reduce the investment options available to AVC members.

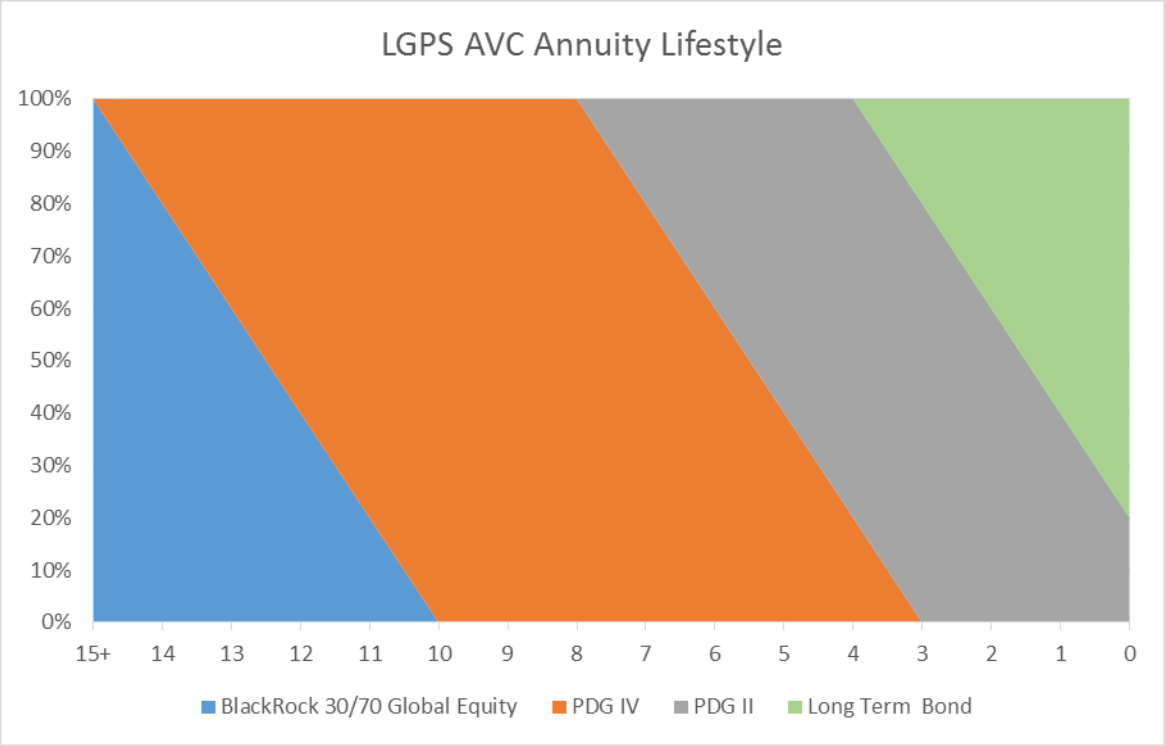
We would recommend:

A new lifestyle option targeting members expecting to take their AVCs in cash at retirement is introduced and becomes the new default option for members who want to pay AVCs, but do not want to make investment choices; and

A new lifestyle strategy targeting members planning annuity purchase is also introduced.

Both new lifestyle options should use a “three-stage” lifestyle strategy, which can be more closely tailored to the risks members face with growth, consolidation and pre-retirement phases. We have asked Prudential to confirm that they can operate the following AVC lifestyle strategies for our LGPS clients:





Growth phase

Equities should provide the best long-term match against inflation. We also advocate the inclusion of "smart beta" factor based funds in the growth phase, giving better risk adjusted returns from equity markets over the longer-term. However, the availability of these funds for AVCs is in its infancy.

Consolidation phase

A multi-asset fund should help mitigate the impact of market volatility when fund values are larger and investment returns have overtaken contributions as the main source of growth in values.

Pre-retirement phase

A combination of cash and cautious multi-asset funds should help avoid giving up too much investment return while maintaining a level of capital stability if retirement is delayed for some months.

The funds used in the lifestyle options need to be included in the self-select fund range (to avoid forced sales of existing fund holdings if a member decides a lifestyle option no longer meets their needs). The multi-asset and cautious multi-asset funds would improve the spread of risk/return options in the self-select range.

Self-select fund range

We would recommend the following structure for the self-select fund range:

Member usage	Fund type	Active/passive	Prudential Fund
Growth	Global Equity	Passive	BlackRock 30/70 currency hedged Global Equity Index *
Growth	UK Equity	Passive	UK Equity Passive
Growth	Property **	Active	UK Property
Consolidated Growth	Multi-asset	Hybrid	Dynamic Growth IV *

De-risking	Corporate Bond	Active	All-stocks Corporate Bond *
De-risking (and annuity)	Index Linked Bond	Active or passive	Index Linked
De-risking (and annuity)	All-Stocks Bond	Active	Fixed Interest
Annuity	Long Bond	Passive	Long Term Gilt
Cash at retirement	Cash	Active	Cash
Drawdown ***	Cautious multi-asset	Hybrid	Dynamic Growth II *
Ethical	Ethical, Shariah compliant	Active or passive	Ethical *, HSBC Amanah *

* New, all funds managed by M&G except Global Equity and Shariah compliant.

** There are arguments for and against including a property fund, but we note this type of fund is currently offered and used by some AVC members. The issues, such as the liquidity of property funds seen a few years ago and the large bid/offer differential on the underlying funds need to be brought to members' attention.

*** While most schemes are not offering in-scheme drawdown, we believe that members planning to use an income drawdown product should be able to invest in similar funds approaching retirement as they are likely to use immediately post-retirement to contain market related risks.

Passively managed funds have the attraction of containing costs to members and the level of governance, but passive management is not available in some asset classes while active management may deliver better returns net of charges in some markets.

Rationalising AVC funds

For trust based occupational pension schemes both Regulations and the Pensions Regulator's guidance require trustees to regularly review AVC/DC investment options and make changes if it is found that funds are no longer suitable for members' needs. Then, in most cases, scheme rules give the trustees power to change the funds without member consent as long as it can be demonstrated to be in the best interests of most members and members are given "reasonable" notice.

The position for LGPS Funds AVC investment options is less certain. While Funds can close existing funds to future AVCs, we are aware of differences of opinion regarding the scope and procedures to be followed for transferring accumulated AVCs to replacement funds without member consent. The Pensions Board and Committee may therefore want to obtain legal advice on this aspect.

11 AVC Providers

LGPS AVC market

The LGPS AVC market divides into three groups of providers.

1 Providers active in the LGPS AVC market: Prudential, Scottish Widows and Standard Life.

2 Other providers open to AVC business, but not familiar with LGPS: Aviva, Legal & General, Zurich.

3 Legacy AVC providers, principally: Clerical Medical, Equitable and Phoenix.

LGPS AVC propositions

Commenting in general on the broad features of the 3 leading LGPS AVC providers' propositions:

Feature	Prudential	Scottish Widows	Standard Life
AVC market position	AVCs principal source of DC business	Active until recently in AVC market, while DC products have retail bias - focus moving towards Zurich platform and larger schemes	Major DC provider, AVCs spun-off DC products
LGPS market position	Leading provider, regular contact with LGA, recently updated proposition, selectively taking new business	Active until recently with moderate market presence	Strong market presence, but not actively pursuing new business or specifically developing AVC proposition
Business	Prudential and M&G merged in 2017 Transferring outsourced administration from Capita to Diligenta	Investment management will be transferred to new managers in 2019 Acquiring Zurich DC business	Merged with Aberdeen, with greater focus on investment management Pensions business being transferred to Phoenix
Fund range	Covers most bases, new funds added including low-cost multi-asset while rationalising older funds, fair balance between internal and external managers	Covers most bases, albeit with some gaps, bias towards internal funds	Huge, unwieldy range, strong bias to in-house funds
Lifestyle strategies	Design of standard lifestyle options basic, but use new multi-asset funds Willing to adopt bespoke lifestyle strategies	Fairly basic design. May consider bespoke lifestyle strategies	Wide range of standard strategies Reluctant to offer bespoke lifestyle strategies

Administration	Not aware of any recent issues Bespoke LGPS teams familiar with multiple pay-centres Actively offering shared cost /salary sacrifice AVCs	Not aware of any recent issues Indifferent service across DC in past	Recent issues with administration for other products Administration systems and staff transferring to Phoenix.
Communication	Written material tailored to LGPS Enhancing on-line functionality	Written material largely standard across DC products	Written material standard across DC products
Member presentations	Presenter team closed in 2018	Free	Usually at extra cost
Client management	LGPS specialist team – wider relationship management team being restructured	Part of wider DC team	Carried out by general DC team
Governance	Comprehensive reporting, LGPS user group	Developing reporting	Standardised reporting
Charges	Reducing charges in 2018 Base costs may be slightly higher than rivals, but charges across range benefits from wide use of institutional funds	Average	Scheme by scheme discount makes comparison difficult, fair value on internal funds, but can be expensive on external funds
Value	Above average, higher base costs, but offer well-rounded LGPS bespoke services	Average, average charges with add-on services including staff presentations	Average
Overall	LGPS AVC market leader, services tailored to LGPS, but focusing on internal changes at present	Competitive, seeking to grow market share through acquisition of Zurich platform	Basic service on back of wider DC business, may be cheaper as a result, but not necessarily good value

Consolidating AVC provider

We would recommend that any rationalisation of the Fund's AVC providers is achieved by using Prudential, who are already by far the Fund's largest AVC provider and have the strongest LGPS AVC proposition.

12 Conclusion and next steps

Summary of advice

Investment options

- The lifestyle options do not reflect members' likely use of AVCs at retirement, do not manage the investment risks faced by members as well as they could and presently give rise to significant interest rate risks for older members – so new lifestyle options should be introduced addressing these concerns;
- The self-select fund range is "top heavy" with growth orientated funds, while lacking funds giving an intermediate to lower level of risk – so the number of investment options should be streamlined to make it easier for members to save more for their retirement.

Lead AVC provider

Prudential are the AVC market leader and have recently updated their AVC proposition. We believe that Prudential remain a sound choice for the Fund's lead AVC provider, although the quality of service should be monitored following changes to their relationship management team and move towards a digital service model.

Future of Clerical Medical, Equitable and Standard Life

While Clerical Medical and Equitable have served the Fund and its members well in the past, we believe that their AVC arrangements are no longer fully fit for purpose. Changes are needed to improve the investment options and level of service, which cannot be achieved with these providers.

The run-down of Equitable is reaching its closing stage with the transfer to Reliance Life in 2019 with a potential windfall for With Profits policyholders. Clerical Medical's AVC book seems to be in limbo at present while Scottish Widows focus on the acquisition of the Zurich platform.

Standard Life are a significant player in the AVC market. However, their AVC offering is rather generic as it draws heavily on their wider DC proposition. At the same time the merger with Aberdeen and transfer of Standard Life Assurance Limited to Phoenix is creating uncertainty as Standard focuses on investment management.

We therefore recommend taking steps to accelerate the run-down of the arrangements with Clerical Medical, Equitable and Standard Life such as:

- Stopping AVCs to these providers asking members to redirect AVCs to Prudential;
- Bringing to members attention the changes taking place at Equitable and drawbacks with Clerical Medical's lifestyle options; and
- Encouraging members to review the suitability of their existing fund choices and possible benefits of transferring accumulated AVCs to Prudential.

Rationalising the AVC providers should deliver better "Value for Members" as well as facilitating ongoing AVC governance.

The Fund and its Officers may wish to take legal advice on the scope for moving AVC members' from their existing providers/funds without consent. Although transaction costs on a bulk transfer of funds to Prudential would be a factor.

Governance

The Fund has a responsibility to ensure that the AVC funds remain appropriate. The Pensions Board and Committee should consider adopting some aspects of good practice for "proportionate" AVC governance (by

reference to the importance of AVCs to members' overall benefits) set out in the Pensions Regulator's 2016 DC Code such as:

- Monitoring annually the investment performance of unit linked funds, financial health of With Profits Funds and member usage of AVCs;
- Conducting a Value for Members assessment at least every three years;
- Conducting a review of the suitability of the AVC arrangements and investment options at least every three years;
- Agreeing and periodically reviewing the member communication strategy.

Next steps

Once the broad direction of future AVC provision has been set by the Committee, next steps might include:

- Finalising investment advice on the design of the lifestyle strategies and choice of funds for use in the self-select option;
- Member communication exercises; and
- Putting in place the long-term governance arrangements.

We suggest that it is decided what actions on the AVC arrangements should be prioritised. We would be happy to assist in implementing the proposals in this paper.

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

With Profits Warning

The performance of a with-profit policy is dependent on the bonuses declared by the insurance company and the manner in which these are distributed. Surrender of a policy during the early years may reflect the higher incidence of charges during this initial period. In addition, surrender or contractual termination may trigger an adjustment ("market value adjustment") to the amount payable in certain market conditions. This adjustment is applied at the discretion of the insurance company to protect the interests of continuing policyholders.

Appendices

1 Investment option usage

1.1 Prudential

Fund distribution

The heat map below (referred to in section 4) shows the members' usage of the most popular funds:

Age Range	# of Members	Value of AVC Pot	Avg Size per Member	PUGE	PUFI	PUEU	PUCS	PUOU	PUSR	PUEP	PUIL	PUDC	PURP	PUPR	WPCA	DEPO	
<20	0	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
20-24	0	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	
25-29	3	1,628	543	-	74	-	-	-	-	-	85	84	81	69	1,236	-	1,628.48
30-34	13	16,843	1,296	1,572	-	-	-	1,691	-	-	-	8,504	-	-	3,010	2,066	16,842.59
35-39	32	40,452	1,264	2,630	-	937	410	810	1,518	2,685	1,737	3,003	1,141	3,504	16,112	5,966	40,452.13
40-44	62	127,359	2,054	4,101	716	15,639	-	6,997	3,093	5,773	2,943	12,344	1,220	793	36,791	36,949	127,358.97
45-49	152	585,220	3,850	31,881	1,685	22,965	9,851	50,249	6,182	34,944	11,917	66,408	5,926	6,108	140,522	196,584	585,220.18
50-54	285	1,423,387	4,994	58,871	2,027	20,923	12,405	66,471	32,210	103,672	43,428	51,673	16,697	33,418	361,584	620,008	1,423,387.44
55-59	339	2,795,999	8,248	114,659	32,677	4,292	18,116	72,485	9,325	79,086	120,898	217,968	36,682	39,223	1,049,663	1,000,925	2,795,999.31
60	69	646,379	9,368	7,836	5,168	1,204	5,896	17,350	-	1,520	8,265	13,144	13,672	30,818	242,527	298,980	646,379.47
61	49	578,549	11,807	27,291	8,395	12,433	-	12,796	-	-	12,490	101,811	4,851	19,521	220,612	158,349	578,549.47
62	40	399,840	9,996	6,376	22,500	1,631	18,785	-	-	6,535	69,861	8,799	21,874	2,619	67,901	172,960	399,840.46
63	33	235,628	7,140	3,009	612	2,675	4,915	-	381	-	3,747	7,344	18,845	-	52,878	141,222	235,627.93
64	30	237,360	7,912	-	19,139	-	9,738	-	-	-	4,508	13,826	-	14,017	58,738	117,394	237,359.93
65	14	145,237	10,374	-	-	-	-	-	-	-	-	12,326	-	-	66,133	66,779	145,237.34
66	12	155,111	12,926	-	-	55,206	-	-	-	-	-	-	-	-	33,554	66,350	155,110.80
67	4	49,540	12,385	-	-	-	-	-	-	-	-	4,595	-	4,077	21,612	19,256	49,540.37
68	3	20,383	6,794	2,135	-	-	-	2,338	-	-	-	4,395	4,165	-	3,775	3,575	20,382.85
69	3	15,205	5,068	-	-	-	-	-	-	-	-	-	-	-	3,373	116,847	120,219.64
70+	5	116,847	23,369	-	-	-	-	-	-	-	-	-	-	-	-	11,832	11,832.04
	1148	7,590,969.41		260,359.82	92,992.16	137,905.69	80,116.03	231,186.60	52,708.69	234,216.39	279,879.64	526,222.09	125,154.00	154,167.42	2,380,019.02	3,036,041.86	

Key:

PUCS Prudential Cash

PUDC Prudential Discretionary

PUEP Prudential UK Equity Passive

PUEU Prudential UK Equity

PUFI Prudential Fixed Interest

PUGE Prudential Global Equity

PUIL Prudential Index-Linked

PUOU Prudential International Equity

PUPR Prudential UK Property

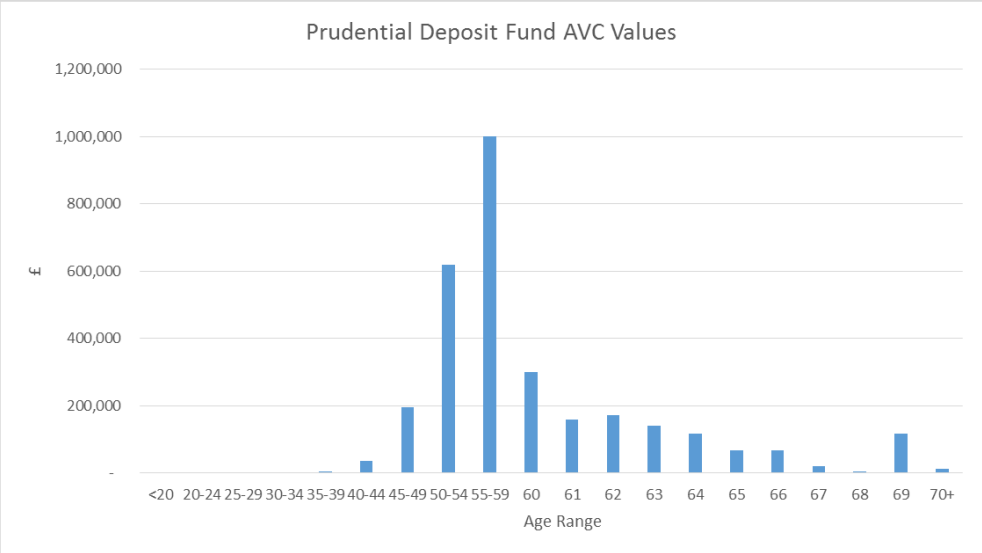
PURP Prudential Long-Term Gilt Passive

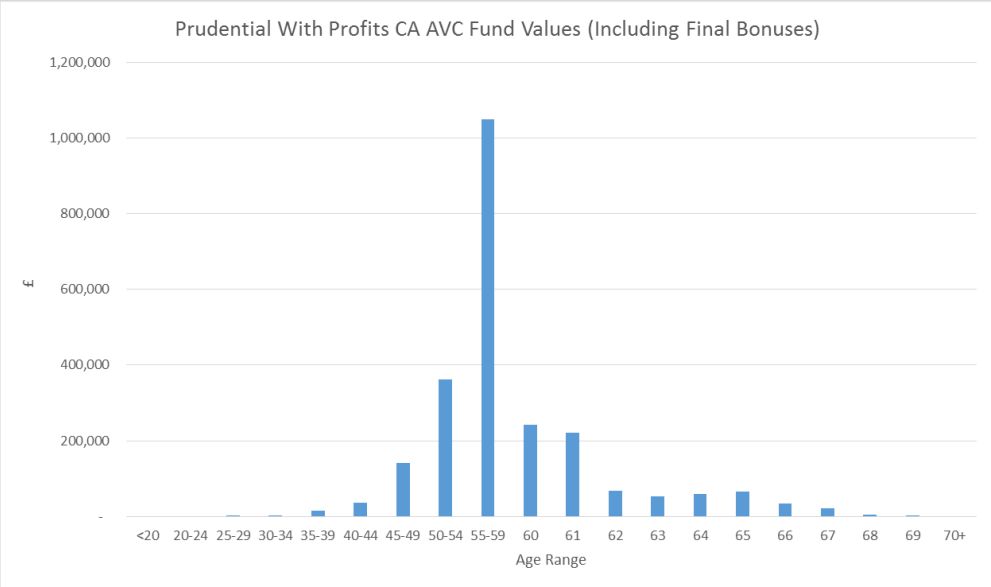
PUSR Prudential Ethical

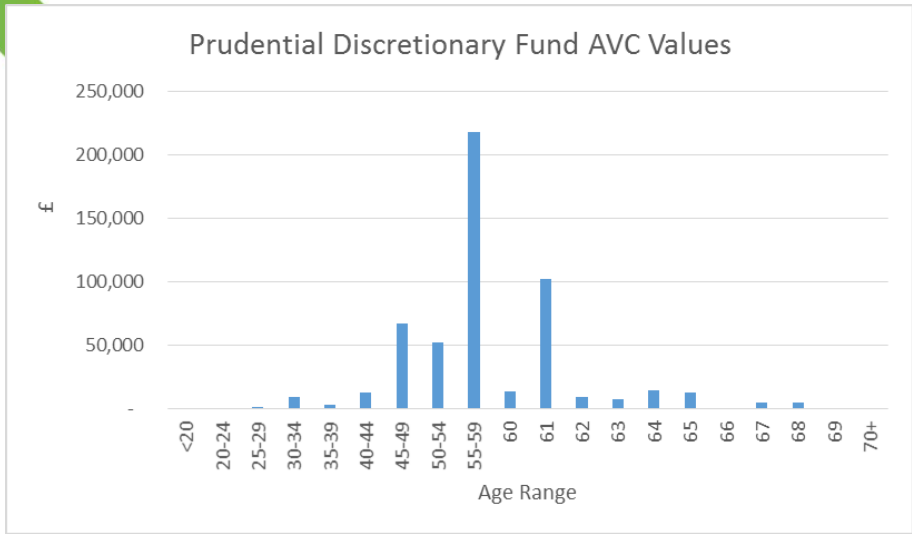
WPCA Prudential With Profits Fund

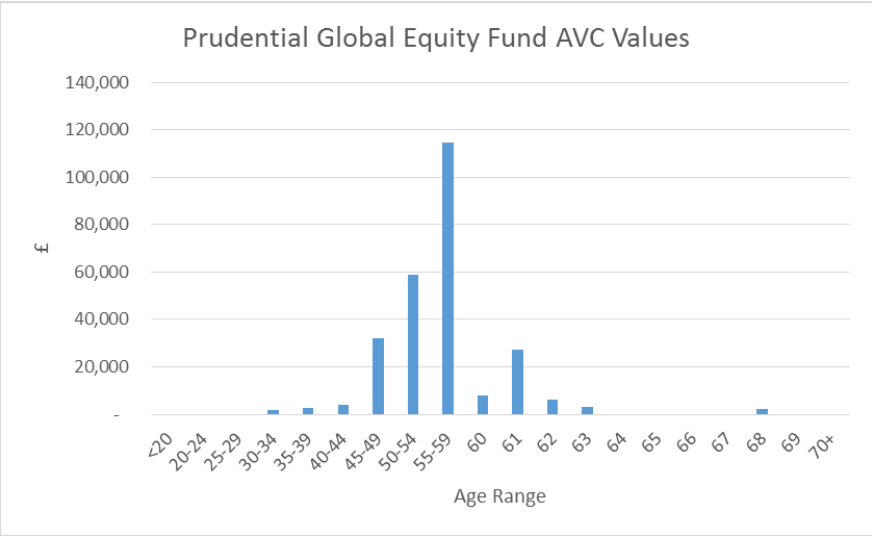
Demographic profile of most popular funds

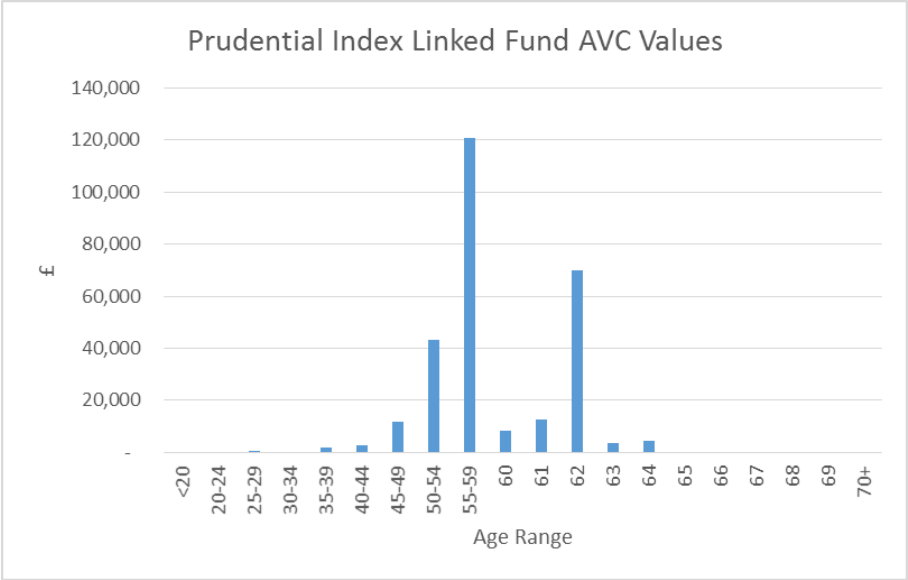
The demographic profile of the most popular funds (referred to in sections 4 and 5) are as follows.

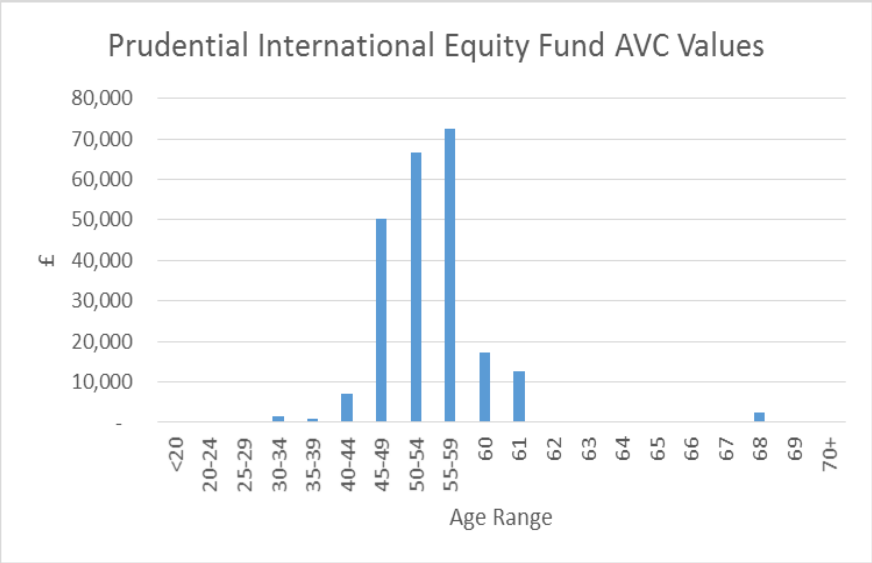





Prudential Discretionary Fund AVC Values
250,000
200,000
150,000
100,000
50,000
-
£
<20
20-24
25-29
30-34
35-39
40-44
45-49
50-54
55-59
60
61
62
63
64
65
66
67
68
69
70+
Age Range


Prudential Global Equity Fund AVC Values
140,000
120,000
100,000
80,000
60,000
40,000
20,000
-
£
<20
20-24
25-29
30-34
35-39
40-44
45-49
50-54
55-59
60
61
62
63
64
65
66
67
68
69
70+
Age Range


Prudential Index Linked Fund AVC Values
140,000
120,000
100,000
80,000
60,000
40,000
20,000
-
£
<20
20-24
25-29
30-34
35-39
40-44
45-49
50-54
55-59
60
61
62
63
64
65
66
67
68
69
70+
Age Range


Prudential International Equity Fund AVC Values
80,000
70,000
60,000
50,000
40,000
30,000
20,000
10,000
-
£
<20
20-24
25-29
30-34
35-39
40-44
45-49
50-54
55-59
60
61
62
63
64
65
66
67
68
69
70+
Age Range

1.2 Clerical Medical

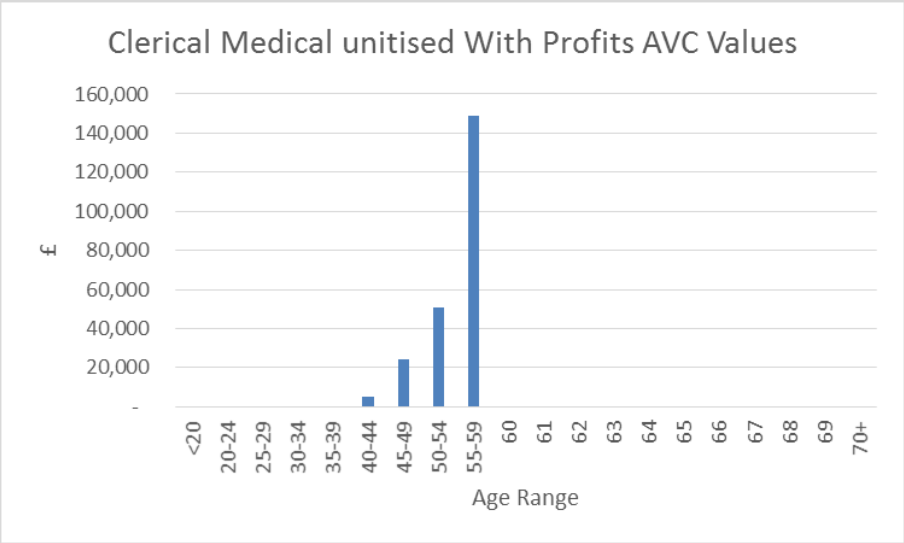
Fund distribution

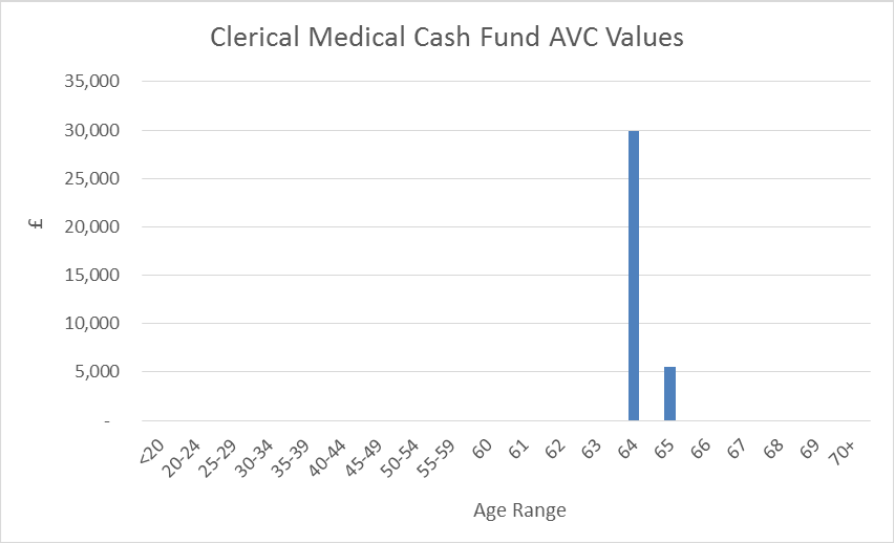
The heat map below (referred to in section 4) shows the members' usage of the most popular funds:

Age Range	# of Members	Value of AVC Pot	Avg Size per Member	Value of Conts	Member AVC	With Profits Regular	With Profits Terminal	Lifestyle UK Growth	Lifestyle Balanced	Cash	
<20	0	-	-	-	-	-	-	-	-	-	-
20-24	0	-	-	-	-	-	-	-	-	-	-
25-29	0	-	-	-	-	-	-	-	-	-	-
30-34	0	-	-	-	-	-	-	-	-	-	-
35-39	0	-	-	-	-	-	-	-	-	-	-
40-44	1	6,953	6,953	20	20	5,061	1,893	-	-	-	6,953
45-49	5	34,955	6,991	2,000	400	24,094	10,861	-	-	-	34,955
50-54	8	75,369	9,421	8,821	1,103	51,079	24,290	-	-	-	75,369
55-59	15	234,069	15,605	20,002	1,333	148,600	66,152	2,892	16,425	-	234,069
60	0	-	-	-	-	-	-	-	-	-	-
61	0	-	-	-	-	-	-	-	-	-	-
62	0	-	-	-	-	-	-	-	-	-	-
63	0	-	-	-	-	-	-	-	-	-	-
64	1	29,923	29,923	250	250	-	-	-	-	29,923	29,923
65	1	5,516	5,516	3,604	3,604	-	-	-	-	5,516	5,516
66	0	-	-	-	-	-	-	-	-	-	-
67	0	-	-	-	-	-	-	-	-	-	-
68	0	-	-	-	-	-	-	-	-	-	-
69	0	-	-	-	-	-	-	-	-	-	-
70+	0	-	-	-	-	-	-	-	-	-	-
	Total Sum	386,784.84				228,833	103,196	2,892	16,425	35,439	

Demographic profile of most popular funds

The demographic profile of the most popular funds (referred to in sections 4 and 5) are as follows.





Standard Life

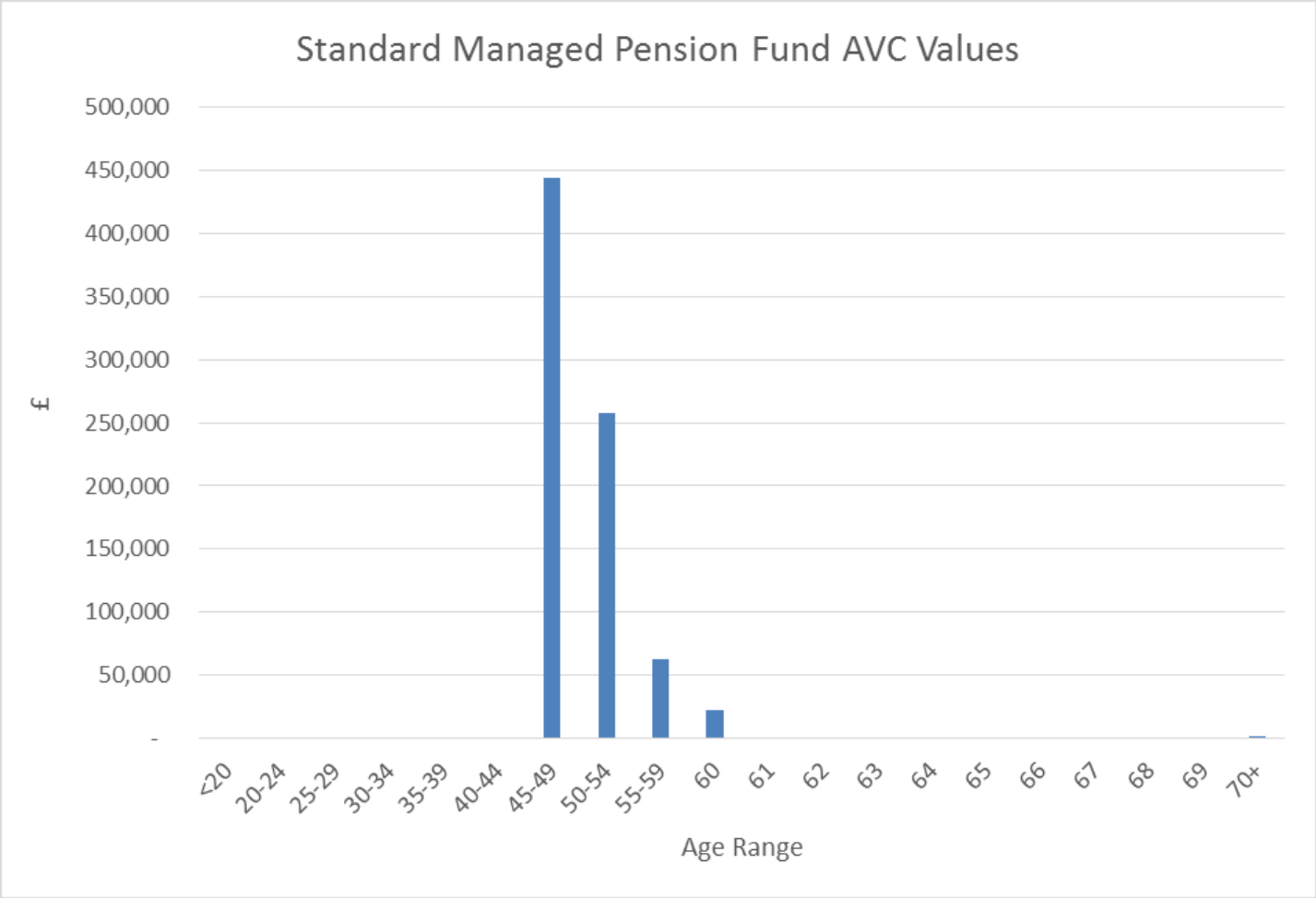
Fund distribution

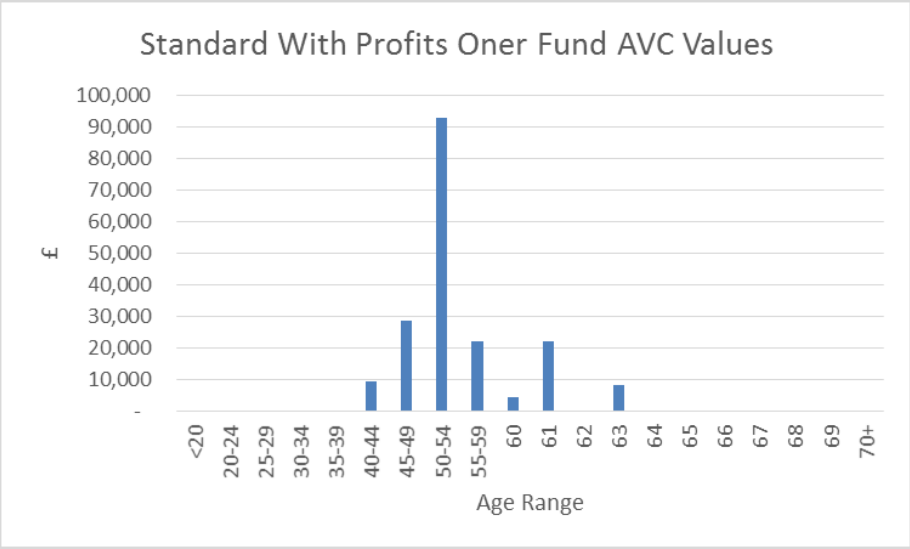
The heat map below (referred to in section 4) shows the members' usage of the most popular funds:

Age Range	# of Members	Value of AVC Pot	Avg Size per Member	With Profits One	Managed Pen	Ethical	With Profits One 2006	At Retirement Multi Asset	Multi-asset Managed 20-60	Totals
<20	0	-	-	-	-	-	-	-	-	
20-24	0	-	-	-	-	-	-	-	-	
25-29	0	-	-	-	-	-	-	-	-	
30-34	0	-	-	-	-	-	-	-	-	
35-39	0	-	-	-	-	-	-	-	-	
40-44	1	9,105	9,105	9,105	-	-	-	-	-	9,105
45-49	15	497,942	33,196	28,435	444,082	23,992	1,432	-	-	497,942
50-54	19	417,578	21,978	92,785	257,483	25,762	4,974	513	36,061	417,578
55-59	18	196,834	10,935	21,910	62,668	24,475	1,750	61,266	24,765	196,834
60	4	68,572	17,143	4,285	22,129	12,124	-	30,034	-	68,572
61	3	44,482	14,827	22,156	-	22,327	-	-	-	44,482
62	0	-	-	-	-	-	-	-	-	
63	1	8,201	8,201	8,201	-	-	-	-	-	8,201
64	0	-	-	-	-	-	-	-	-	
65	0	-	-	-	-	-	-	-	-	
66	0	-	-	-	-	-	-	-	-	
67	0	-	-	-	-	-	-	-	-	
68	0	-	-	-	-	-	-	-	-	
69	0	-	-	-	-	-	-	-	-	
70+	1	1,926	1,926	-	1,926	-	-	-	-	1,926
Totals	62	1,244,640		186,876	788,289	108,679	8,156	91,813	60,827	

Demographic profile of most popular funds

The demographic profile of the most popular funds (referred to in sections 4 and 5) are as follows.




Standard With Profits Oner Fund AVC Values
100,000
90,000
80,000
70,000
60,000
50,000
40,000
30,000
20,000
10,000
-
£
<20
20-24
25-29
30-34
35-39
40-44
45-49
50-54
55-59
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62
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66
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68
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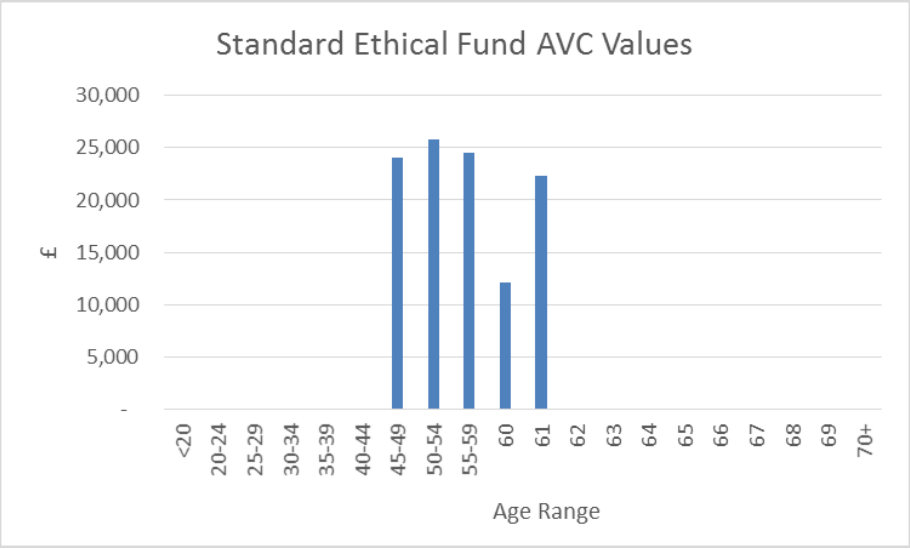
70+
Age Range


Standard Ethical Fund AVC Values
30,000
25,000
20,000
15,000
10,000
5,000
-
£
<20
20-24
25-29
30-34
35-39
40-44
45-49
50-54
55-59
60
61
62
63
64
65
66
67
68
69
70+
Age Range

2 Prudential With Profits Fund

The With Profits Fund's total value rose from £91.0bn at 31 December 2016 to £103.0bn at 31 December 2017.

The Fund remains financially sound with strong cash-flows and so should be able to sustain an investment strategy with a significant allocation to growth assets for some years.

Investment strategy

Investments are well-diversified including holdings of infrastructure and private equity. While the Fund's holdings of equities and property fell towards 50% in the aftermath of the "credit crunch", since 2014 holdings have reverted to the longer-term 60% plus level:

At 31 December	2017	2016	2015	2014	2013	2012
UK Equities	18.2	16.1	18.0	18.7	18.7	16.8
Overseas equities	33.8	31.3	28.4	23.8	16.8	17.0
Other equities	-	-	2.2	2.2	2.4	-
Property	14.1	15.2	16.1	16.0	13.9	12.1
Alternative assets	5.5	6.6	3.7	3.9	3.7	5.9
Fixed Interest	26.3	26.4	29.1	33.8	41.8	44.0
Cash	2.1	4.4	2.5	1.6	2.7	4.2

Source: Prudential

The asset allocation is also notable, compared to several of its peers, for the levels of exposure to overseas equities and property.

The gross investment returns (which drives long-term bonus returns) was 14.5% in the year to 31 December 2016 were:

Year to 31 December	2017	2016	2015	2014	2013	2012
Gross return %	10.3	14.5	3.6	8.3	10.3	10.5

Prudential has one of the few With Profits Funds which is open to new business and cash-flow positive. This gives Prudential greater flexibility in setting the Fund's investment strategy and contrasts with other With Profits Funds which have become cash-flow negative and are progressively adopting more cautious investment strategies. Prudential have commented to us that a significant proportion of the With Profits Fund's cash-flow in recent years has come from individual savers (for example, investing money from the pension freedoms).

Bonus setting

The FCA requires With Profits providers to state the pay-out values relative to the "fair asset share return" for 90% of policyholders. Prudential's "Principles and Practices of Financial Management" state that this is in the range of 80% to 120% of the fair asset share.

The bonus setting and market value reduction process give returns to policyholders which fairly reflect the return on the underlying assets.

Annual/reversionary bonus rates were trimmed by 0.25% at both the 2016 and 2017 bonus declarations, but remain unchanged for the 2018 declaration. Overall returns including final/terminal bonuses (which more closely reflect investment conditions) over 5, 10 and 15 years rose slightly in 2017, but are largely unchanged for 2018:

Duration years	1	3	5	10
Average Overall yield % p.a.	2.50	6.40	6.40	7.35

Source: Prudential

As with all With Profits Funds, the lack of transparency surrounding the Fund's operation is a concern. This has been highlighted by the difficulty private sector schemes have experienced in obtaining details of charges and assessing "value for members" under the 2015 Pension Regulations. This should be resolved by the FCA's January 2018 cost disclosure requirements for providers.

3 Clerical Medical With Profits Fund

The comments below are based on Clerical Medical's reports for the year ending 31 December 2017.

Investment strategy

As at 31 December 2017 the assets of the With Profits Fund was £6.1bn, £0.3bn down from 2016. This does suggest that the With Profits Fund's cash-flow is declining.

The With Profits Fund's asset allocation for the asset share section of the Fund which backs policy values at years ending 31 December is as follows:

Asset class	2014 %	2015 %	2016 %	2017 %
UK Equities	18	17	18	18.3
Overseas Equities	24	20	24	25.5
Property	13	14	12	12.7
Corporate Bonds	13	14	12	9.7
UK Gilts	6	3	6	3.8
Asset backed securities	0	2	3	3.3
Absolute return funds	9	12	13	14.1
Cash and Other	17	18	12	12.6

Source: Clerical Medical

The investment returns achieved by the underlying assets of the With Profits Funds were:

	2011	2012	2013	2014	2015	2016	2017
Gross return %	3.1	7.2	9.9	7.1	2.3	8.5	7.8

Source: Clerical Medical

Estate

The Estate is the Fund's "working capital" enabling the Fund to maintain an adequate solvency level as required by the regulatory authorities, which in turn enables the asset share section of the Fund to be invested to improve policy values.

Clerical Medical commenced distribution of its excess estate in February 2010. The scope for distributions is reviewed at 6 monthly intervals. While distributions were reduced in 2016 due to falls in Government bond yields, Clerical Medical aim to distribute 0.5% per annum from the Estate.

Expenses

Clerical Medical did not disclose the expenses for traditional With Profits business in 2016. This may change as a result of the FCA's new requirements on administration and transaction costs introduced in January 2018.

The expenses to meet With Profits guarantees were 0.3% of asset shares in 2016. Clerical Medical's aim is that costs of these guarantees should be less than 1% per annum.

Smoothing

Clerical Medical's target range for overall bonus pay-outs (reversionary plus terminal) is that 90% of surrender values should be within +/- 20% of the underlying "fair asset share value".

Bonuses

The regular or reversionary bonus rates added to policy values each year are:

Year from 1 January	2017	2018
Reversionary bonus rate %	0.12	-
Interim bonus rate %	-	0.12

Source: Clerical Medical

The overall policy return including both regular/reversionary and final/terminal bonuses are:

5 years to 1 February	2016	2017
Overall bonus return % p.a.	5.7	5.6

Source: Clerical Medical

Guarantees

Clerical Medical's With Profits Fund only provides the usual With Profits capital guarantee (assuming the provider remains solvent). Nevertheless, this security of capital on discretionary savings may well be valued by members approaching retirement.

4 Equitable Life With Profits

After closing to new business in 2000, Equitable Life's business is now at an advanced stage of being run down. There has been a sustained effort to reduce liabilities (for instance, selling parts of its annuity business and restructuring their unit-linked funds) and reducing costs (cutting back services) with the aim of passing as much money as possible back to With Profits (but not unit-linked) policyholders.

Equitable Life's With Profits investment strategy remains focussed on maximising the returns on policyholders' assets whilst meeting solvency requirements. However, it seems clear that maintaining the fund's solvency to meet its appreciable past liabilities is the principal focus.

Investment strategy

The With Profits Fund is now predominantly invested in gilts, corporate bonds and cash (97% in 2017). These assets closely match the With Profits' liabilities (guarantees and past bonus additions) and Equitable Life do not expect to make further bonus additions which would increase its liabilities.

The With Profits Fund's asset allocation has developed as follows:

Asset class	2011	2012	2013	2014	2015	2016	2017
Gilts	56%	60%	47%	57%	55%	56%	51%
Corporate Bonds	28%	29%	30%	23%	24%	22%	26%
Cash	8%	6%	21%	17%	19%	20%	20%
Property	4%	2%	2%	3%	2%	2%	Other 3%
Equity	4%	3%					

Source: Equitable Life

The investment returns achieved by the underlying assets of the With Profits Funds were:

Year to 31 December	2009	2010	2011	2012	2013	2014	2015	2016	2017
Gross return %	6.0	8.4	9.6	5.6	-2.0	13.7	0.2	10.6	1.0

Source: Equitable Life

The return net of charges and provisions for movements in the value of liabilities was 0.6% in 2016 and 0.3% in 2017.

Expenses

The overall expenses charge for Equitable Life's With Profits Fund was again 1.0% in 2017. There is also an additional charge of 0.5% to cover the cost of guarantees.

Bonus setting

Equitable Life has not for some years added any reversionary bonuses which would increase its liabilities. However, non-guaranteed values (on which early surrender and transfer values are based) have been increased by non-guaranteed interim bonuses - which could be withdrawn if the With Profits Fund's financial position deteriorated:

Year from 1 April	2009	2010	2011	2012	2013	2014	2015	2016	2017
Reversionary bonus rate	0	0	0	0	0	0	0	0	0
Interim bonus rate	5.5%	3.5%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%

Source: Equitable Life

Capital distribution

As its solvency has gradually strengthened since 2009, Equitable Life has progressively reduced and then removed the financial adjustment it applied to surrender values (but this penalty could be re-applied if its solvency were to deteriorate again):

Year from 1 April *	2009	2010	2011	2012	2013	2014	2015	2016	2017
Financial Adjustment	5%	5%	5%	5%	5%	0	0	0	0

Source: Equitable Life

Equitable Life has made savings around their business which they have passed on to With Profits policy holders as a one-off uplift in non-guaranteed policy values.

Year from 1 April *	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Capital distribution	0	0	12.5%	12.5%	12.5%	25%	35%	35%	35%	35%

Source: Equitable Life

* The distribution is a single, flat rate percentage, uplift on the non-guaranteed policy value as at 31st December 2014. Between 2016 and 2018 the total non-guaranteed value payable including the capital distribution will have only changed by the 2% interim bonus increasing the base policy value.

It seems unlikely that Equitable Life can make further economies in future of the scale seen in recent years. So, the value of this one-off distribution which had risen to 35% by 2015 may be eroded by inflation over time.

Equitable anticipated that the capital distribution should gradually increase over the next 10 years under its existing "run-off" plan, there is the risk that this uplift, which is not guaranteed, could be reduced if Equitable's financial position were to deteriorate. Equitable's Annual Report and Accounts for the year ending 31 December 2017 warns of the material risk to its capital available for distribution caused by the growing trend for members with the 3.5% guaranteed return (which accounts for 80% of policies) deferring retirement.

On 15 June 2018 Equitable announced plans to transfer its business to Reliance Life. This would result in the closure of the With Profits Fund (and with it loss of guarantees) together with a further and final capital distribution (currently estimated to increase the present 35% distribution to 60-70%).

Guarantees

In addition to the usual With Profits capital guarantee (assuming the provider remains solvent), the Fund's Equitable Life With Profits policy includes a 3.5% minimum return guarantee which is valuable for members approaching retirement in present market conditions.

This guarantee only bites at the retirement age specified in the policy when the higher of the guaranteed or non-guaranteed value is payable. If a member retires or transfers before the specified age, they would only receive the non-guaranteed value (together with the capital distribution if still available).

Any comparison between the guaranteed and current uplifted non-guaranteed values needs to be undertaken on a member by member basis and take into account their likely retirement plans. We would expect members in the Equitable Life With Profits Fund to fall into three groups:

1. Those where a transfer away (most likely to Prudential) is clearly in their interests;
2. Those where the financial case is less compelling, but are attracted by the greater flexibility on when they retire a transfer would give; and
3. Those where transferring elsewhere is clearly not in their financial interests.

Our experience of exercises for other schemes suggests that there is no easily discernible pattern as to which groups members would fall into.

5 Standard Life With Profits

Information is based on material produced in 2017 and early 2018. Full details of the Fund's management in 2017 are not expected until mid-2018.

Structure

Standard Life's With Profits Fund is divided into several sub-funds, with each sub-fund using a discreet "asset mix" which reflect the liabilities for that group of policyholders. The Fund's members invest in two of Standard Life's With Profits sub-funds: the With Profits One Fund and the With Profits One 2006 Fund. Both funds come under Standard Life's asset mix 3 (details below). Standard Life's With Profits fund is closed to new business.

Investment strategy

While the strategic asset allocation of the sub-funds is set by the With Profits Actuary, Aberdeen Standard's Multi-Asset Macro team are able to make limited shorter term tactical asset allocation moves. This tactical asset allocation has added value in recent years.

The asset allocation for asset mix 3 in recent calendar years is shown below:

Asset class	2017	2016	2015	2014	2013	2012	2011
UK equity	35%	32%	31%	32%	36%	31%	30%
Overseas equity	16%	14%	14%	15%	15%	11%	12%
Emerging / unquoted equities	2%	2%	3%	3%	3%	5%	4%
Property	13%	15%	16%	16%	15%	15%	16%
Bonds and cash	34%	37%	36%	34%	31%	38%	38%

Source: Standard Life

The investment returns for asset mix 3 (i.e. before smoothing, expenses and bonus rate declaration) in recent calendar years is shown below:

	2017	2016	2015	2014	2013	2012	2011
Return (net)	7.9%	12.2%	3.2%	8.3%	13.0%	9.8%	2.9%

Source: Standard Life

The exposure to real assets (equities and property) of asset mix 3 remains moderately high relative to other with profits funds that we monitor. However, the asset allocation does show a strong UK bias.

The performance shown over the period has been acceptable for a diversified portfolio of this nature.

All the UK sub-funds are in run-off with assets under management declining. Other sub-funds have shrunk markedly over the last 10 years and will contract further in the near future. As a result, the With Profits Fund's overall policyholder profile is maturing and maintaining liquidity is a growing focus. Fund is progressively reducing its holdings of property and private equity, while the duration of the bond portfolios is being shortened.

Expenses

Standard Life's "Principles and Practices of Financial Management" and annual" Report to UK With Profits Policyholders" do not give an indication of the average level of expenses the Fund expects to incur. We would hope that more information will become available in due course in the light of the FCA's changes to the COBS rule-book in January 2018.

Charges for unitised With Profits are specified in the contract. However, any surplus is passed to shareholders if the actual charges are less than those set out in the contract. Unexpected out of course expenses would be met from the Inherited Estate.

Inherited estate

Contributions prior to demutualisation on 9th July 2006 to what has become the Heritage With Profits Fund are eligible for distributions of surplus assets from the sub-funds' Estate. These "enhancements" increase pay out values in the event of a claim, but do not increase the guaranteed values. During 2016 there was a modest 1.7% enhancement.

Bonus setting

The FCA requires With Profits providers to state the pay-out values relative to the "fair asset share return" for 90% of policyholders. Standard Life's "Principles and Practices of Financial Management" state that this is in the range of 80% to 125% of the fair asset share.

The bonus rates and any guarantees differ between the sub-funds. These two sub-funds do not have any attaching guaranteed minimum investment returns. Bonus rates/returns for the With Profits One and With Profits One 2006 sub-funds are as:

Period	Bonus rate %	Overall bonus return%
1 February 2018 until further notice	0.5	0.5
01/02/17 to 31/01/18	0.75	0.75
01/02/16 to 31/01/17	0.5	0.5
01/02/15 to 31/01/16	0.75	0.75