Agenda Item No: 7

CAMBRIDGESHIRE PENSION FUND

LGSS

Pension Fund Board

Date:24th July 2014

Report by: Head of Pensions

Subject:	Review of AVC Arrangements.
Purpose of the Report	To present to the Pension Fund Board the principles of Additional Voluntary Contributions and the choices for Fund members on Additional Voluntary Contribution providers.
Recommendations	**The Board is recommended to:-** **1. Approve the continuation with the current providers of AVCs to the Fund;** **2. That the officers of the Fund engage with the current provider(s) to consider their range of investment funds being offered, in terms of diversity;** **3. That the officers of the Fund engage with the current provider(s) on strengthening AVC lifestyle strategy awareness and options.**
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1. Background

1.1 Local Government Pension Scheme ("the Scheme") administering authorities in England and Wales are required by the terms of the Local Government Pension Scheme Regulations to make available to members a facility to which they can make Additional Voluntary Contributions (AVCs) to enhance their pension entitlement. Members are able to make contributions either by paying contributions to a separately managed money purchase arrangement (e.g. with the Prudential) or by buying additional service through Additional Pension Contributions, within the LGPS.

1.2 Members may decide to pay AVCs for any of a number of reasons which include tax-free efficiency in contributions (unlike savings products such as ISAs) and in benefits (i.e. tax free cash) as well as simply increasing their retirement fund (improving benefit adequacy at retirement).

1.3 One of the key attractions of money purchase AVC arrangements has been that members have had the option to take their AVC benefits at retirement as 100% tax free cash (subject to any overall benefit limits), whilst taking their entire pension benefits from the main Scheme as income in retirement. This can help members avoid exchanging income from the Scheme for tax free cash at a fixed rate. However, with effect from 1 April 2014, members starting AVCs may be restricted to taking a maximum of 25% tax free cash from their AVC pot. This may make the appeal of contributing to AVCs less appealing in the future as AVCs become less accessible at the point of retirement and less tax-efficient in payment.

1.4 LGPS Regulations do not currently provide AVC members with the flexibility set out in the Queen's Speech in June for private defined contribution pension schemes post April 2015. It is possible that additional flexibility could be introduced to LGPS in the future, but for the time being, members should assume they will need to exchange their AVC pot (after taking Tax Free Cash) for a regular pension at retirement.

1.5 Prior to changes to the Scheme in 2008, members could elect to buy 'added years' and pay additional contributions into the Funds from a birthday anniversary to their normal retirement age. These added years will then be combined with their actual membership to improve their pension benefits at retirement. This option is no longer available, but has been replaced with a facility for active members to pay Additional Pension Contributions over a selected period of their choice, that provides for extra pension up to a value of £6,500 per annum.

1.6 If a Scheme member wishes to pay additional contributions within the Scheme, the administering authority can only refuse the application if it is satisfied the member is not in reasonably good health following a report from a registered medical practitioner.

2. Issues

2.1 AVCs are an attractive method of tax-efficient saving for retirement, however the changes in April to reduce the ability to take maximum tax free cash to 25% of the AVC Fund may make the arrangement less popular in the future.

2.2 Out of a total 24,854 active members in the Cambridgeshire Pension Fund 397 (1.6%) currently pay AVCs. This is in line with other LGPS funds and corporate pension schemes.

2.3 The Funds are currently compliant in that the Fund has a facility for members to make AVC payments. In terms of compliance with legislation, no further action is required to allow AVC payments to other providers.

2.4 The Fund uses two providers of which only one is currently active (Prudential) andthis provider is the recognised leading AVC provider within the Local Government Pension Scheme.

2.5 There is a very limited market for LGPS AVC providers. Effectively there are three main players, being Prudential, Standard Life and Scottish Widows. However the latter two providers are not particularly proactive, whilst Prudential are very proactive.

2.6 The Cambridgeshire Pension Fund could consider seeking a second open provider such as Standard Life, which, with the exception of administrative and communication implications,is considered to be relatively straight forward as they are active in the Northamptonshire Fund. However it should be noted Standard life have not as actively promoted their product as Prudential.

2.7 It is considered rather than add new AVC providers greater benefit would be to focus on reviewing the underlying investment funds being offered, in particular reviewing their appropriateness and value for money.

3. Current arrangements - Cambridgeshire Pension Fund

3.1 The Cambridgeshire Fund allows members to make AVCs to two providers through bundled arrangements (i.e. including administration services). These providers are Prudential and Equitable Life.

3.2 The Prudential choice consists of 13 funds covering a wide range of asset classes. Currently there are 394 members contributing, and with total contributions amount to around £1.0 million per annum.

3.3 The Equitable Life choice consists of 9 Equitable Life funds, however, members are no longer allowed to start making new contributions as Equitable Life is closed to new members. There are 134 members invested with Equitable Life, but only 3 members have made contributions over the last 12 months, representing a small total contribution of £1,600 (to the with-profits fund) over that period. Total assets are currently valued at about £0.6 million, of which 66% is invested in the with-profits fund.

4 AVC Fund Objective

4.1 The Funds AVC objective is to meet the statutory requirements requiring Funds to make AVC provision available to its members.

4.2 The Fund's responsibility is to offer an appropriate choice of funds to cater for a wide range of members' objectives. To have relatively straightforward arrangements for the members to understandis considered beneficial, in particular to reduce the need to make complex investment decisions by providing good easy to understand information on the fund options available to the member.

4.3 The Fund also retains a responsibility for monitoring the appropriateness of the arrangements. Therefore simplicity in the AVC arrangement is desirable as it reduces the overall governance burden, allowing more time to focus on other issues.

4.4 The Fund should also encourage members to take independent advice to assist their understanding of risk and objectives and their decision making about pensions and AVCs. The AVC provider should produce communication material to emphasise to members the risks of investment strategies on their contributions in particular as the member nears retirement.

5 AVC Member Objectives and Requirements

5.1 Members of the Fund will have different objectives for their AVC investments based on their individual needs. For example:-

- Some members may want to take a significant amount of investment risk to achieve a high anticipated investment return, giving them a chance of achieving a much better income in retirement. However, these members must appreciate the volatility of different investments options.
- Some individuals may have a low tolerance to investment risk and may not want to invest in a higher risk investment strategy.
- Some members may have significant pension provision and assets elsewhere, and this may impact their tolerance for investment risk.
- Some members will just want to take advantage of the Tax Benefits of AVCs.
- In all cases AVC providers should make members aware of administration fees and return profiles of the fund options, so consideration of fees against potential return net of fees, can be evaluated, especially if the fees are likely to be greater than the potential return. For example,cash based fund with minimal volatility where the feesare currently greater than the expected return, but the member is happy with the overall benefit deriving from the tax efficiencies of AVCs.

5.2 Members require a provider with multiple investment options that can broadly meet these differing needs. In particular, we should consider offering:

- Appropriate “pre-packaged” solutions which will allow for growing a member’s pot throughout their working life and protecting the value as they approach retirement and;
- A range of self-select funds that will allow members to make their own investment choices.

5.3 In order to allow members to formulate their own investment strategy, the Fund needs to offer them access to an AVC provider with funds that invest in the key ‘building blocks’ of any investment strategy: equities, bonds, property and cash, applying the following principles in designing a self-select fund range;

- A pragmatic range of funds is desirable to help with member understanding and governance.
- Lifestyle and default strategies can be built from these key building blocks.
- A preference to offer members passive funds because:-
    - They provide access to the market return. The choice between investment markets is the most important factor in building an investment strategy and will have a much greater impact on a member’s final pension than the choice of investment manager.
    - They are cost effective, with lower annual management charges than active funds.

- They avoid the need to constantly review investment managers, as most (well managed) passive funds will track the underlying benchmark indices very closely and will not need to be replaced due to personnel changes.
- For the same reasons, they require less active governance.
- Actively managed funds are not strictly necessary, but do add to members' choice of funds.

6. AVC marketplace

6.1 There are only a small number of providers in the LGPSAVC marketplace (being Standard Life, Prudential, Scottish Widows , and Equitable Life However, due to the near collapse of Equitable Life, we do not expect to see commitment from this provider in the future. We also see limited commitment at present from Standard Life and Scottish Widows to grow their market share; this is reflected in our perception that there is no apparent large financial commitment to providing innovative and enhanced supportive services. By contrast, Prudential has shown a much greater commitment to the LGPS and wider public sector AVC market, and is the biggest provider in this area.

6.2 The Fund currently provides members with options to make contributions to the leading LGPS AVC provider and we do not believe the Fund could be justifiably criticised about the limited current arrangements. Indeed, we see limited benefits of offering an additional bundled provider.

6.3 One benefit could be to allow the introduction of additional fund options from the current providers. However, both Prudential and Standard Life do offer additional funds on their platforms, some of which are managed by external managers. On this basis, it is suggested that the Fund focuses on reviewing the current fund choices, as this will help determine whether they remain appropriate and provide value for money. We would also encourage consideration of offering members a lifestyle strategy, which would automatically de-risk assets as members approach retirement rather than relying on members doing this themselves. We would point out that if a member wishes to invest with a manager or fund that is not offered within the current AVC arrangements, they are able to arrange this themselves via a personal pension plan (although of course these contributions would not be deducted from their pay).

6.4 Introducing a new provider would require a formal selection process, increase the Funds' ongoing governance burden and require initial changes to existing member documentation and website information. If the fund wishes to consider adding an alternative provider we would suggest having an initial discussion with Scottish Widows. There is potential for the Standard Life arrangement in the Northamptonshire Fund being opened up to the Cambridgeshire Fund and this would present little or no additional due diligence and governance across the Funds, due to the existing monitoring and manager relationship with Northamptonshire. Adding Standard Life would provide consistency between Cambridgeshire and Northamptonshire and would only have administrative and communication implications for the Cambridgeshire Fund.

7. Prudential

7.1 Prudential is the biggest provider in the AVC marketplace and has around 70 local authority clients. For example locally these include Lincolnshire, Leicestershire, Bedfordshire, Essex, Buckinghamshire, Oxfordshire and Northamptonshire.

7.2 Prudential also manage arrangements for a number of other public sector clients,such as the Teachers' Pension Scheme, the Judicial Pension Scheme, the NHS Pension Scheme and the Universities Superannuation Scheme. Prudential experienced significant growth in its AVC business following the collapse of Equitable Life and has continued to grow over recent years.

7.3 Prudential aims to add value to its clients through its AVC offering; it sets itself out as focusing on quality rather volume. It has an ongoing commitment to this area and is developing its processes and systems and future developments include a new administration platform and improved online capabilities, both of which will benefit members.

7.4 Our research shows that Prudential:

- has developed bespoke literature in relation to the LGPS;
- has a dedicated website for members;
- provides high quality member support; and
- pro-actively promotes the AVC option to potential new members and existing AVC contributors by offering face to face presentations to groups of members.

7.5 We believe that the services set out above provide members with significant help to understand the concept of AVCs and the funds available to them, whilst providing a high level of servicing support. Prudential is also able to demonstrate very strong brand awareness and is the leading provider of AVCs in the LGPS marketplace as well as being a "household" name.

7.6 Two areas that we would highlight about Prudential are as follows:

7.6.1 The standard Annual Management Charge for Prudential's Cash Fund is high at 0.75% per annum. Considering that this fund is seeking cash returns of currently less than 1.0% per annum, most if not all of these returns will be taken as charges.

7.6.2 Prudential is still applying early exit charges to its LGPS AVC arrangements for contributions made after 18 August 2012. These apply to the first 5 years after a contribution is made as follows:

Prudential Early Exit Charges Schedule.						
Year of Withdrawal	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
% Charge	15%	10%	8%	6%	5%	0%

7.6.3 This may be particularly relevant for new AVC members close to retirement, communications to members should be clear about these charges in order for them to make informed decisions.

8. Standard Life

8.1 Although Standard Life is probably the second largest LGPS AVC provider, it doesnot demonstrate the same level of commitment to this market as Prudential and this is reflected in the quality of their service offering. They do provide limited telephone support and web accessed information, but these services are not as flexible as similar services provided by Prudential.

8.2 However, Standard Life offers a reasonable range of funds, including allowing someexternal investment managers on their platform.

9. Equitable Life

9.1 Although members are invested across 9 Equitable Life funds, members are no longer allowed to start making new contributions as Equitable Life is closed to new members

9.2 The Equitable Life with profits fund was forced to substantially reduce the level ofinvestment risk in the fund several years ago; following from this it expected to maintain a bond exposure of 75%-90% of the fund. This hurt its performance relative to peers over the period leading up to 2008 due to lower equity market exposure, although we expect this to have benefited the fund’s performance from 2008 to early 2009. The Annual Report and Summary Financial Statements 2013 states that the investment strategy remains focussed on maximising the returns on policyholder assets whilst meeting solvency requirements. The fund is invested largely in fixed-interest investments with an increased proportion in cash. During 2013, the fund withdrew completely from its investment in commercial property. As at 31 December 2013 77% of the assets were invested in gilts and corporate bonds with a further 21% invested in short-term gilts and cash. Consideration will be given over the coming year as to whether the allocation to corporate bonds will be reduced in order to reduce the amount of capital put aside for potential defaults.

9.3 In May of 2011, the Government published details of its compensation arrangements for policyholders and its proposals to enhance payments to with profits holders who “leave” the firm. In its January 2014 update, Equitable confirmed that they had made considerable progress on its compensation payment process.

9.4 Equitable Life Payment Scheme is set out in more detail in Appendix 3.

10. Relevant Pension Fund Objectives

Perspective	Outcome
Communications	• Promote the Scheme as a valuable benefit. • Provide clear information about the Scheme, including changes to the Scheme, and educate and engage with members so that they can make informed decisions about their benefits.
Governance	• To have robust governance arrangements in place, to facilitate informed decision making, supported by appropriate advice, policies and strategies.

11. Finance & Resources Implications

11.1 Additional Voluntary Contribution products are provided by external providers with minimal finance and resource implications to the Fund. However there would be resource and financial costs to the Fund should a procurement exercise be required.

12. Risk Implications

a) Risk(s) associated with the proposal

Risk	Mitigation	Residual Risk
The Fund has not reviewed alternative providers to ensure best choices are available to members.	Monitor performance of investment options.	Green (Hymans Robertson's feedback is that we have the best AVC providers available.

b) Risk(s) associated with not undertaking the proposal

Risk	Risk Rating
The costs associated will a full or partial review of the Fund's AVC providers may not be considered good value for money when considered with the advice provided from the Fund's actuary that a full review is not needed at this time.	Amber

13. Communication Implications

Direct Communications	Contained within the Annual Benefit Statements..
Website	Information held on the Pensions Website.

14. Legal Implications

14.1 Not applicable.

15 Consultationwith Key Advisors

15.1 Advice has been sought from the Fund's Benefit Consultancy and Actuary, HymansRobertson.

16. Alternative Options Considered

16.1 This report considers the options available.

17. Background Papers

17.1 Not applicable

18. Appendices

18.1 Appendix 1 –Examples of Investment Choices.

18.2 Appendix 2- Annual Management Charges, Indicative Risk Ratings and Historic Fund Returns

18.3 Appendix 3 – Equitable Life Payment Scheme.

Checklist of Key Approvals	
Is this decision included in the Business Plan?	No
Will further decisions be required? If so, please outline the timetable here	N/A
Is this report proposing an amendment to the budget and/or policy framework?	No
Has this report been cleared by Section 151 Officer?	Yes – 09/07/2014
Has this report been cleared by Head of Pensions?	Yes - 08/07/2014
Has the Chairman of the Pension Fund Board been consulted?	Copy of report sent to Cllr Count 09/07/2014
Has this report been cleared by Legal Services?	No – not required for this report.

Appendix 1 – Examples of Investment Fund Choices

PrudentialExample C

Fund name	Asset Class	Fund Value (£)
Prudential UK Equity	UK Equity	202,412
Prudential UK Equity Passive	UK Equity	448,659
Prudential Socially Responsible	Ethically screened UK equities	142,459
Prudential International Equity	Overseas Equity	226,466
Prudential Global Equity	70% UK Equity, 30% Overseas Equity	97,191
Prudential Discretionary	Global Equity, Bonds, Property and Cash	540,319
Prudential Property	UK Commercial Property	192,527
Prudential With Profits	Multi-Asset	3,660,161
Prudential Fixed Interest	Gilts and UK corporate bonds (and Overseas government bonds)	110,636
Prudential Index-Linked	UK Index-Linked Gilts	220,888
Prudential Retirement Protection	Long dated UK Gilts	289,843
Prudential Cash	Deposits and Treasury bills	129,481
Prudential Deposit	Deposits and Treasury bills (With Profits)	592,529
Total Value		**6,853,572**

Prudential Example N

Fund name	Asset Class	Fund Value (£)
Prudential UK Equity	UK Equity	20,384
Prudential UK Equity Passive	UK Equity	164,900
Prudential Socially Responsible	Ethically screened UK equities	22,145
Prudential International Equity	Overseas Equity	29,480
Prudential Global Equity	70% UK Equity, 30% Overseas Equity	17,948
Prudential Discretionary	Global Equity, Bonds, Property and Cash	160,985
Prudential Property	UK Commercial Property	33,031
Prudential With Profits	Multi-Asset	309,875
Prudential Fixed Interest	Gilts and UK corporate bonds (and Overseas government bonds)	24,790
Prudential Index-Linked	UK Index-Linked Gilts	44,139
Prudential Retirement Protection	Long dated UK Gilts	49,066
Prudential Cash	Deposits and Treasury bills	159,507
Prudential Deposit	Deposits and Treasury bills (With Profits)	1,722,576

Equitable LifeExample C

Fund name	Asset Class	Fund Value (£)

Equitable With-Profits	Multi-Asset	384,657
Equitable Managed	Multi-Asset	137,913
Equitable UK FTSE 100	UK Equity	2,955
Equitable FTSE All Share	UK Equity	9,763
Equitable Property	UK Commercial Property	31
Equitable Far Eastern	Overseas Equity	24
Equitable Ethical	SRI Equity	4,129
Equitable High Income	Multi-Asset	20
Equitable Deposit Account	Deposits and Treasury bills	38,474
Total Value		**577,966**

Standard Life Example N

Fund name	Asset Class	Fund Value (£)
Pension Millennium With Profits Fund	Multi-Asset	228,343
Pension With Profits Fund	Multi-Asset	17,190
SL Henderson European Growth Pension Fund	Overseas Equity	1,895
Standard Life Global Equity Pension Fund	Global Equity	18,448
Standard Life Managed Pension Fund	Multi-Asset	288,749
Standard Life Multi Asset (40-85% Shares) Pension Fund	Multi-Asset	11,104
Standard Life Multi Asset (20-60% Shares) Pension Fund	Multi-Asset	82,962
Standard Life Stock Exchange Pension Fund	Global Equity	19,981
Standard Life UK Equity Pension Fund	UK Equity	6,828
Total		**675,501**

Appendix 2 – Annual Management Charges, Indicative Risk Ratings and Historic Fund Returns

Annual Management Charges

Please note that these are the managers' standard annual management charges paid to the manager for the management of the funds and administration of member's policies (including benefit statements etc.). There may be modest additional charges incurred within each fund, for example for safe custody of assets and accounting functions.

Prudential – C and N

Fund name	Indicative risk rating [1]	Annual Management Charge % p.a.
Prudential UK Equity	High	0.75
Prudential UK Equity Passive	High	0.65
Prudential Socially Responsible	High	0.75
Prudential International Equity	High	0.75
Prudential Global Equity	High	0.75
Prudential Discretionary	Medium	0.75
Prudential Property	Medium	0.75
Prudential With Profits	Medium	1.00
Prudential Fixed Interest	Medium	0.75
Prudential Index-Linked	Medium	0.75
Prudential Retirement Protection	Medium	0.65
Prudential Cash	Low	0.75
Prudential Deposit	Low	No explicit charge

Standard Life – N

Fund name	Indicative risk rating [1]	Annual Management Charge % p.a.
Pension Millennium With Profits Fund	Medium	1.15

Pension With Profits Fund	Medium	1.75
SL Henderson European Growth Pension Fund	High	1.75
Standard Life Global Equity Pension Fund	High	1.00
Standard Life Managed Pension Fund	High	1.00
Standard Life Multi Asset (40-85% Shares) Pension Fund	High	1.00
Standard Life Multi Asset (20-60% Shares) Pension Fund	Medium	1.00
Standard Life Stock Exchange Pension Fund	High	1.00
Standard Life UK Equity Pension Fund	High	1.00

[1] The risk rating provides an indication of the extent of risk that a fund could fall in value in any one year

Historic Fund Returns to 31 March 2014

All fund returns are before the deduction of AMCs

Prudential – C and N

Fund name	1 year %	3 years % p.a.	5 years % p.a.
Prudential UK Equity	11.3	10.3	17.2
Prudential UK Equity Passive	9.2	8.8	16.5
Prudential Socially Responsible	13.4	11.0	17.6
Prudential International Equity	8.2	7.3	15.0
Prudential Global Equity	9.5	9.2	16.6
Prudential Discretionary	7.9	7.6	13.9
Prudential Property	8.2	2.9	6.0
Prudential With Profits**	6.7	6.5	7.9
Prudential Fixed Interest	-1.9	6.1	6.3
Prudential Index-Linked	-4.0	10.1	10.8
Prudential Retirement Protection	-3.1	8.7	6.5
Prudential Cash	0.4	0.4	1.6
Prudential Deposit	0.5	0.5	0.5

Standard Life – N

Fund name	1 year %	3 years % p.a.	5 years % p.a.
Pension Millennium With Profits Fund	7.6	10.1	9.2
Pension With Profits Fund	1.1	3.0	5.6
SL Henderson European Growth Pension Fund	12.6	9.6	17.8
Standard Life Global Equity Pension Fund	12.9	11.9	18.9
Standard Life Managed Pension Fund	8.4	8.0	13.4
Standard Life Multi Asset (40-85% Shares) Pension Fund	7.0	8.2	13.2
Standard Life Multi Asset (20-60% Shares) Pension Fund	5.6	7.7	10.9
Standard Life Stock Exchange Pension Fund	12.4	8.7	15.9
Standard Life UK Equity Pension Fund	14.1	10.4	17.7

Appendix 3 – Equitable Life Payment Scheme.

The Equitable Life Payment Scheme ("ELPS") was set up by the Government to make "fair and transparent" payments to those policyholders that suffered financial losses as a result of Government maladministration, which was found to have occurred in the regulation of Equitable. These payments are being funded by HM Treasury. Policyholders' eligibility for the ELPS was dependent upon their policy and the date that it was purchased (see table below). Eligibility was not affected if policyholders, who have suffered relative losses, had subsequently exited from Equitable.

Eligibility criteria

Contract	Relevant purchase period
With Profits Annuity ("WPA") or Conventional With Profits policy ("CWP")[1]	1 September 1992 and 31 December 2000
Accumulating With Profits ("AWP") policy (both individual and Group scheme policies)[2]	1 September 1992 and 31 December 2000 or had a premium payment made into it between 1 January 1993 and 31 December 2000

Based on the Government's "Scheme Design for Parliamentary Review" ("SDPR"), which set out the design of the compensation scheme, it was agreed that:

- £775m would be shared among around 945,000 CWP and AWP policyholders. This is equivalent to c.22.4% of these policyholders' losses[3]. Payments would be in the form of a single lump sum.
- £620m would be shared among 37,000 With Profits Annuitants. This was equivalent to 100% of their losses (WPA holders are to be compensated in full as they were unable to surrender or withdraw and so were locked into policies that provided a declining income in their retirement). Compensation payments for WPA would be in the form of annual payments.
- Around 100,000 CWP and AWP policyholders would not receive any money, as their loss was less than £10 each and payment of compensation would be inefficient.
- Around 435,000 policyholders were judged not to have suffered any losses and therefore would not receive any compensation.

In its January 2014 update, Equitable confirmed that the ELPS has made considerable progress on its compensation payment process. As of 31 December 2013, the ELPS has made payments totalling £816m to 717,600 policyholders. The figures are broken down as follows:

- 375,672 payments to Individual investors have been issued totalling £511m.
- 33,547 first payments to With-Profits Annuitants (WPAs) have been issued by the Scheme, totalling £64m. Subsequent annual payments totalling £116m have also

[1] CWPs are with profits policies that are not unitised. Such policies usually have a fixed premium amount and defined sum assured.

[2] AWPs are where the with-profits fund is subdivided into units for the purposes of determining benefits. The units are entitled to a share in some or the entire surplus distributed, usually by some form(s) of bonus additions.

[3] Losses are determined as being, *"the difference between the actual returns received, or expected to be received from Equitable and the assumed returns the policyholder would have received if they had invested in a similar product in a comparable company."*

been made to annuitants. Additionally payments of £15m have been paid to the estates of 2,425 deceased annuitants.

- 305,956 payments totalling £110m have been paid to those who bought their policy through their company pension scheme.