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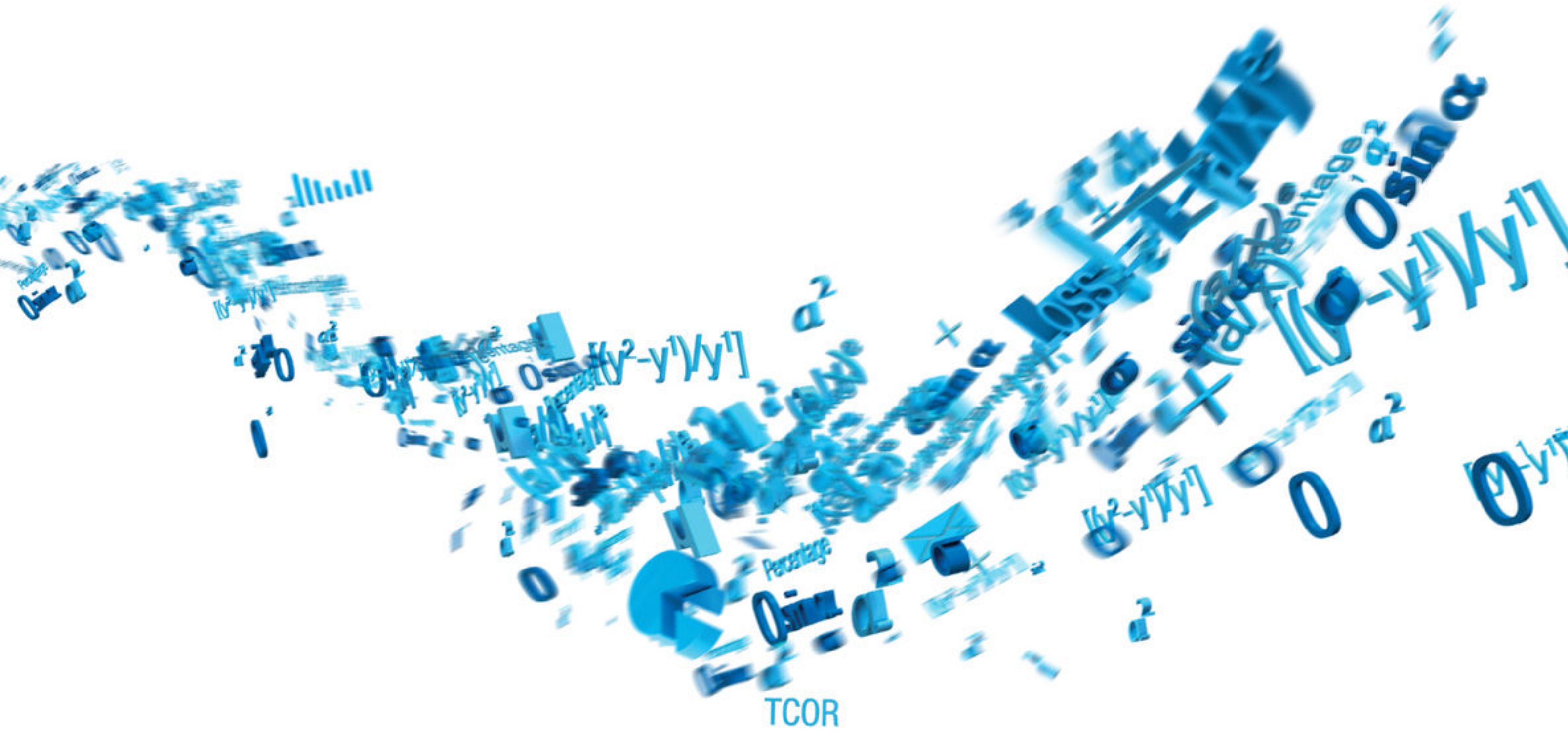

The London Borough of Hackney Council

Review of AVC Arrangements

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Table of Contents

Executive Summary

Introduction

Aon Hewitt has undertaken a review of the AVC arrangements held within the London Borough of Hackney Pension Fund ('the Fund') in line with our scope document "Proposal for Review of AVC Arrangements", dated 4 July 2016.

Summary of our views and recommendations

We have no serious concerns following our assessment of the Fund's Prudential AVC arrangement.

We recommend the Administering Authority reviews the structure of the lifestyle strategies available through the AVC arrangement as they are out-dated compared to current investment thinking, and because they do not target the format in which members are likely to take their benefits.

The Global Equity Fund has consistently under-performed and we recommend this Fund is closed to new members.

When considered in isolation, the charges on the AVC arrangement are high, compared to current market rates. We recommend the Administering Authority considers the value provided by the AVC arrangement, in terms of customisation for LGPS, available communications and delegation of what would often be considered employer duties, such as joining members to the arrangement.

Prudential offer a number of services the Administering Authority is not currently making use of, such as governance reporting and member presentations and we recommend the Administering Authority takes advantages of these services wherever possible, as they are included in the annual management charge members pay.

The Fund's website does not appear to provide information regarding the AVC arrangement and we recommend this is addressed.

It would be good practice for the Administering Authority to communicate a summary of the findings of this review to members so as to illustrate the appropriate governance of the AVC arrangement. This is also a useful means to continue to highlight the availability and benefits of AVCs to scheme members. We would be happy to help with drafting this communication, if required.

We note that monthly contributions appear to be submitted to Prudential very close to the statutory deadline. We therefore recommend the Administering Authority raises this matter with the employers to see if contributions can be submitted in a more timely manner.

Introduction

Background

This paper constitutes the Aon Hewitt review of the AVC arrangements held within the Fund as at 31 March 2016.

Summary of AVC arrangements

The Fund currently holds its AVC arrangement with Prudential. The AVC arrangement is open to both new members and further contributions.

Scope of review

The Occupational Pension Schemes (Investment) Regulations 2005 (which focus on trustees' main monitoring responsibilities for direct investments) do not apply to Local Government Pension Schemes ('LGPS'). We have however used these Regulations as a framework by which to assess the Fund's AVC arrangement.

We have also commented on the AVC - related communications available to members and disclosure of fund information as, of all the measures included in the Public Service Pensions Act 2013, we regard these issues to be of particular relevance to AVC funds.

This report considers the following:

- Security – financial strength of the provider;
- The best interests of members and beneficiaries – the suitability of the investment options available to members;
- Performance – fund performance versus benchmark of each unit linked fund option held by members;
- Liquidity and tradability in regulated markets – how readily realisable are the fund options held by members;
- Quality – investment capabilities in relation to the fund options available to members and administration capabilities; and
- Profitability – competitiveness of the fund charges in place, compared to current market rates.

Membership analysis

Membership profile

The table below summarises membership numbers and value of assets held in each fund.

As at 31 March 2016 there were 619 members with c. £5.5m of assets invested across 13 different funds.

A breakdown of members by category of membership and by age is included in Appendix 1.

Fund name	Number of members	Fund value (£)
Cash	4	11,160
Deposit Fund	7	59,397
Discretionary	7	112,941
Ethical	2	23,749
Fixed Interest	5	20,899
Global Equity	8	70,145
Index-Linked	9	76,308
International Equity	4	44,397
Long-Term Gilt Passive	3	29,496
UK Equity	5	21,030
UK Equity Passive	1	21,946
UK Property	6	33,296
With Profits Cash Accumulation Fund	585	4,998,958
Total	**619**[1]	**5,523,721**[2]

1. The 'Total' membership number counts members once where an individual is invested in more than one fund.
2. Numbers may not sum due to rounding.

Lifestyle strategy

Two members invest in a lifestyle strategy, and these are included in the table above.

The AVC arrangement provides access to three lifestyle strategies. All three strategies invest in the UK Equity Passive Fund in the growth phase and switch to the Long-Term Gilt Passive Fund (formerly the Retirement Protection Fund) in the approach to retirement. The strategies differ in the timing of the risk reduction phase, which commences 10, 8 or 6 years prior to the members' selected retirement age.

Death in service cover

Prudential offers AVC members the option to purchase life cover with their AVC contributions, to top-up the death in service cover members receive through the Fund. This facility is very much like the pension term life assurance that was previously available in the private sector, until income tax relief was withdrawn from this benefit.

The cost of life cover is age-related and members have to undergo a certain level of underwriting when they apply for life cover. The sum assured provided by the premium is reviewed every 3 years and members are given the option to maintain the sum assured and pay a higher premium, or maintain the premium and have the sum assured reduce.

34 members currently purchase life cover with the average premium being £200 per annum and the average sum assured £30,500.

Analysis of Prudential AVC arrangement

Introduction

In this section we provide our views and recommendations in relation to the Prudential arrangement.

Our views take into account the financial strength of Prudential, quality and suitability of fund options, quality of administration, charges, and communications.

Provider financial strength (AKG rating)

When reviewing the financial strength of AVC providers and with-profits funds, we subscribe to the services of AKG Financial Analytics Limited (AKG). AKG is an actuarially based consultancy specialising in the provision of ratings, information and market assistance to the financial services industry.

Prudential is one of the UK's most financially strong insurers and AKG currently rate Prudential's financial strength as A (superior).

Quality of fund options

The performance of the funds used by members, compared to the benchmark or sector average is detailed in Appendix 2.

Members are invested in funds managed by M&G Investments (Prudential's in-house fund manager). Our manager research team do not research any of the funds held by members. This is because our research process is extremely in-depth and focuses on institutional funds offered by investment houses, rather than traditional life office funds.

We have no serious concerns over the performance of the majority of funds used by members, which have performed broadly in line with their benchmark or sector over the five year period to 30 June 2016.

The exception to this is the Global Equity Fund which has consistently under-performed its sector average before charges, and we recommend the Administering Authority considers removing this Fund, or at least closing it to new members.

The UK Equity Fund has under-performed the FTSE All Share Index over the year and 3 years to 30 June 2016, but 3 year under-performance is not significant and many actively managed UK equity funds have under-performed the index over the year to 30 June 2016, as they were seeking growth opportunities outside the FTSE 100 which has performed better than the All Share Index over the period.

Prudential has suspended new investments into and switches from the UK Property Fund following the outcome of the EU referendum, and the resulting illiquidity in the property market. This is in line with many other property funds and we have no concerns over the Fund itself.

The Deposit Fund is part of the Prudential With Profits Fund. It aims to provide a return in line with the Bank of England base rate, net of charges (there are no explicit charges on this Fund). There is no contractual guarantee that returns will continue to track the Bank of England base rate in future, though the capital of investment in this Fund is guaranteed not to fall. The Deposit Fund has provided superior returns to money market funds, such as the Cash Fund, which are subject to an annual management charge and are therefore likely to show marginal losses in net performance in the current environment. Both the Cash Fund and the Deposit Fund are likely to continue to produce low returns in the current low interest rate environment. Whilst we have no concerns over the quality of these funds, the Administering Authority may wish to make members who invest in these funds aware of this fact.

As at December 2015, AKG applied an 'excellent' financial strength and future performance prospects rating to the With Profits Cash Accumulation Fund and we have no concerns about this Fund.

Suitability of fund options

The arrangement offers access to the main asset classes we would expect for an AVC arrangement, as well as an ethical fund, and we therefore regard the fund options to be likely to meet most members' investment needs and objectives.

Members also have access to three lifestyle strategies. We discuss the suitability of the lifestyle options in the next section.

Lifestyle strategies

We regard the structure of the lifestyle strategies to be relatively out of date and not particularly well suited to the format in which members are likely to take their benefits.

The final asset allocation of the lifestyle strategies assumes the member will use their entire AVC fund to purchase an annuity. Fund members can use their AVCs to provide their tax-free cash entitlement from the LGPS, and/or use AVCs to provide additional pension from the LGPS, therefore a lifestyle strategy that targets cash or cash and pension may be more appropriate.

Our view is that members investing through a lifestyle strategy should invest in equities in the early stages, as these assets are expected to provide good levels of growth over the long term, and members are able to withstand the increased volatility associated with equity investments. We favour investment in a global equity fund in preference to a UK equity fund in order to improve diversification and spread risk and because of the concentration of the UK stock market.

We also believe better member outcomes can be achieved by including a 'transition' phase between the growth phase and the pre-retirement phase of the lifestyle strategy, to reduce risk but retain some capital growth potential in the intervening period.

Prudential can construct lifestyle strategies from any funds available on its AVC platform and we therefore recommend the Administering Authority reviews the lifestyle strategies available through the AVC arrangement. We would obviously be happy to provide assistance in ensuring the final lifestyle strategies are appropriate.

Liquidity

All AVC assets are invested in regulated markets and, with the exception of investments in the UK Property Fund, are held in liquid assets that are readily realisable. Funds may use derivatives for the purposes of efficient portfolio management, reduction of risk or to meet the fund's investment objective if this is permitted and appropriate.

Investments in the UK Property Fund can be illiquid. Currently new investments into and switches from this Fund are temporarily suspended following the result of the EU Referendum and the ensuing illiquidity in the property market.

Dis-investment from With Profits Cash Accumulation Fund at any time other than selected retirement age may incur a market value reduction.

Charges

The annual management charges ('AMCs') that apply to funds available to members under the AVC arrangement are shown in the table below.

Fund	AMC (% p.a.)
Cash	0.75
Discretionary	0.75
Ethical	0.75
Fixed Interest	0.75
Global Equity	0.75
Index-Linked	0.75
International Equity	0.75
Long-Term Gilt Passive	0.65
UK Equity	0.75
UK Equity Passive	0.65
UK Property	0.75

Total Expense Ratios are capped at the AMC for unit-linked funds, with the exception of the UK Property Fund which has property expenses of 0.75% p.a. making the total charge 1.5% p.a.

Charges on the With Profits Cash Accumulation Fund are not explicit but are accounted for in the annual bonus declarations. This is standard market practice for with profits funds. Prudential estimates the charge on the With-Profits Cash Accumulation Fund to be 0.8% p.a. Charges on with-profits business depend on the performance of the With-Profits Fund and, in particular, the investment returns achieved and expenses incurred. (Source: Prudential Principles and Practices of Financial Management).

There are no explicit charges on the Deposit Fund, and it aims to provide net returns in line with the Bank of England base rate.

Prudential applies the same charging structure to all LGPS AVC arrangements, rather than pricing each scheme on an individual basis. It has a reputation for relatively high charges, compared to other insurers. We believe this is at least partly due to the fact that the administration systems it uses have not benefitted from the advances in technology that many other insurers' systems have, such as straight-through processing. Prudential has acknowledged that some LGPS employers are unlikely to be able to adopt these advances (such as online submission and verification of contribution schedules) but it is considering the introduction of divergent terms (different charges) for LGPS arrangements who are able to do so. Prudential's level of charges for LGPS arrangements also take account of the fact that Prudential deals with multiple payrolls and employers and it carries out a number of the duties typically undertaken by employers, such as joining new members.

Benchmarking charges

In order to benchmark the charges on the Fund's AVC arrangement, compared to current market rates, we have obtained indicative terms from the market. Providers who meet Aon Hewitt's quality criteria for new business and offer a group AVC arrangement, were approached to offer an indication of the terms they would offer if the Fund replaced Prudential as its AVC provider. When requesting indicative terms, we have asked that providers assume 50% of holdings in the With Profits Cash Accumulation Fund would transfer from Prudential, based upon our recent experience of similar bulk exercises.

AEGON, Aviva, BlackRock, Fidelity, Legal and General, Standard Life and Zurich were approached in this indicative review, however, only Aviva provided terms for new business. It offered indicative terms for its Group AVC contract with a Total Expense Ratio of 0.73% for Aviva's off-the-shelf “My Future" Default Solution.

The indicative terms we have obtained are slightly more competitive than those offered by Prudential however Aviva does not offer a bespoke service for LGPS. Those providers that have previously been active in the AVC market for LGPS (such as Scottish Widows, Clerical Medical and Standard Life) either no longer offer a group AVC contract, or have minimum financial requirements in excess of the Fund's AVC assets under management. Although the indicative terms offered by Aviva are slightly lower than those on the existing Prudential AVC arrangement, and Aviva's group AVC contract offers straight through processing, Aviva is likely to have less knowledge of LGPS requirements and how they operate, and is unlikely to offer the level of LGPS customisation that Prudential offers, such as their LGPS website. Aviva would also require the employer or the Administering Authority to join new members online and submit contribution schedules online.

Value for money

Given the membership profile and assets under management of the Fund's AVC arrangement, we regard the charges paid by members to be in line with current market rates. This is evidenced by the indicative terms we obtained.

Value for money can also be derived from other benefits, as well as low charges, such as engaging communication materials and efficient administration.

We therefore recommend the Administering Authority considers the value it and its members get from Prudential's customised LGPS offering, compared to the likely benefits of a slightly more competitively charged policy that is not tailored to LGPS.

Administration and other services

Prudential outsourced its administration services to Capita in 2008, with all AVC business being transferred to the Capita HartLink platform in April 2013. We have found client experience of the outsourcing to be positive and we have no concerns about the quality of administration of Prudential AVC policies.

We would comment however that Prudential's administration systems have not adopted the straight-through processing many insurers systems have and therefore its processes remain relatively manual. This means the potential for human error is higher than for insurers that use more automated operating systems as well as resulting in policies that are more expensive to operate.

As part of this review, the Administering Authority asked us to investigate a particular case where the member had contacted Prudential to increase their contributions and Prudential notified Hackney Council payroll in line with agreed practice. There was a delay to payroll actioning the increase and we are awaiting confirmation of the contribution received on 22 August, in respect of July payroll from Prudential, but expect that this will include the back-dated increased contribution deducted from the members' salary.

We would comment, from the information Prudential has provided, that contributions appear to be paid to Prudential on or very close to the statutory deadline each month (the 22nd of the month following deduction from payroll). Although this does not breach legislation, this timescale is a deadline not a target date and it is best practice to submit contributions to the pension provider as soon as practically possible after they are deducted from members' salary. We therefore recommend the Administering Authority discuss this matter with employers to see if contributions can be submitted in a more timely manner.

Governance reporting

Prudential can provide governance reports for LGPS AVC arrangements on a regular basis however it is not proactive and Administering Authorities only receive reports if they have requested them. We understand the Administering Authority has not received a governance report in the last 12 months. Prudential has confirmed it would be happy to provide a governance report and meet with the Administering Authority face to face to discuss the report and agree a future contact and reporting strategy. We recommend the Administering Authority arranges to receive the governance report on an annual basis in future.

Communications

Prudential is able to support the Administering Authority with a range of communication materials, such as flyers to include with annual benefit statements, wording for member newsletters, emails and case studies as well as presentations to members. We understand London Borough of Hackney is using the annual benefit statement insert to accompany annual benefit statements this year.

We regard Prudential’s literature as informative and well written, and scheme members benefit from its customisation to the LGPS. Relevant information is set out in a clear manner. For example, the total charges on unit-linked funds are very clearly disclosed in the Fund's AVC fund guide, which is held on Prudential's website.

Prudential does not charge a fee for communication materials and the cost of providing these is included in the annual management charge on the AVC arrangement. Therefore, as members currently pay the same charges irrespective of what communication materials are provided, we recommend the Administering Authority makes as much use as possible of the communication material and presentations on offer.

We have reviewed the content of the London Borough of Hackney pension fund website at http://hackney.xpmemberservices.com/Home and could find no reference to paying AVCs. The links to the LGPS Scheme Guides also appear to not be working.

We therefore recommend that the Administering Authority adds a reference to paying AVCs to the website, and includes a link for members to access the Prudential LGPS website: https://www.pru.co.uk/rz/localgov/

DC Pension Freedoms

Legislative background

From 6 April 2015, individuals have had far more flexibility in terms of how they access DC pension benefits, including AVCs. Individuals over minimum pension age can take funds as cash, annuity or 'income drawdown' subject to payment of tax at their marginal rate of income tax on the element over their tax free cash entitlement.

Schemes do not need to offer direct access to the freedoms. The Occupational Pension Plans (Transfer Values) (Amendment and Revocation) Regulations 2015 introduced the statutory right of a member to transfer separate categories of benefit (such as defined benefits and defined contribution AVCs) to other arrangements, rather than the whole of their scheme benefits. The Regulations also require schemes to provide separate transfer statements for each category of benefits for which a transfer is requested.

The Department for Communities and Local Government consultation, which closed on 20 August, proposes to amend the Local Government Pension Scheme Regulations 2013 to set out new options for accessing benefits accrued through LGPS AVC arrangements. The proposed regulations will allow a member who has accrued AVC benefits to take them as one or more lump sums, to purchase additional pension, to purchase an annuity, or transfer the benefits into another appropriate pension arrangement.

Recommendations

Based upon the average value of members' AVC funds (currently approximately £8,000), we consider it likely most members will use their AVCs to provide their entitlement to tax free cash from the Fund.

If members have AVC funds in excess of their tax free lump sum, they currently have the option of securing additional pension within LGPS or purchasing an annuity. Members could use the statutory over-ride described above to access the flexibilities outside of the Fund, though this would mean they could no longer use their AVCs to provide their tax free cash entitlement in respect of their defined benefits.

The changes to the Regulations described above could potentially mean members must be allowed to take as many uncrystallised pension fund lump sums as they choose and there must be no de-minimus applying to the fund left behind, or imposed on each tranche. We envisage some AVC providers will not allow this degree of flexibility as it could make LGPS AVC policies very costly to administer,

The final Regulations may provide discretion to each LGPS Fund as to how many uncrystallised pension fund lump sums they allow and to impose a de-minimus residual fund value. In this instance it is likely a framework that works for the AVC provider could be established.

Prudential has stated it will facilitate any changes made to the Regulations for members of LGPS AVC schemes.

Appendix 1– Membership Data

Introduction

The tables below show a breakdown of membership by category of membership and by age. All data is effective as at 31 March 2016.

The following data features are present:

- Active members make up 89% of the total AVC membership and preserved members 11%.
- More than half of members are in the 50 – 59 age group and members in the age group 55 – 59 have the highest average fund value.
- The 30 – 39 age group has the lowest number of members with only five members and a total fund value of £7,984. This could be due to a number of reasons, a few of which are cited below:
    - Different priorities with age or economic circumstances: Other demands on cash that make saving for retirement a lower priority.
    - Other benefits: More reliance on accruing main scheme benefits and seeing little need to build up additional pension
    - Marketing and communications: these members may not realise they can pay AVCs.

Total AVC membership

	Number of members	Total fund value £	Average £
	619	5,523,721	8,924

Membership by age

	Number of members	Total fund value £	Average £
30 - 34	3	4,926	1,642
35 - 39	2	12,684	6,342
40 – 44	12	92,371	7,698
45 – 49	78	607,940	7,794
50 – 54	196	1,472,913	7,515
55 – 59	199	2,160,935	10,859
60 – 64	79	774,171	9,800
65+	50	397,781	7,956

Appendix 2 – Fund performance and commentary

Introduction

The tables below show performance of the unit linked funds held by members against benchmarks/comparators. Performance is shown before charges.

Fund Performance to 30 June 2016

Fund	1 Year (%)	3 Years (% p.a.)	5 Years (% p.a.)
Cash	0.5	0.4	0.5
LIBID 7 Day Deposit Rate	0.4	0.4	0.4
Relative performance	*0.1*	*0.0*	*0.1*
Deposit Fund	0.5	0.5	0.5
Bank of England Base Rate	0.5	0.5	0.5
Relative performance	*0.0*	*0.0*	*0.0*
Discretionary	6.0	7.6	7.1
BNYM CAPS Balanced Pooled Fund Net Median	10.5	8.6	8.0
Relative performance	*-4.5*	*-1.0*	*-0.9*
Ethical	0.7	6.8	7.9
FTSE4Good UK Equity Index	1.7	6.0	6.8
Relative performance	*-1.0*	*0.8*	*1.1*
Fixed Interest	13.7	8.5	7.9
FTSE Actuaries UK Conventional Gilts All Stocks Index	13.5	8.1	7.4
Relative performance	*0.2*	*0.4*	*0.5*
Global Equity	2.4	6.6	7.0
ABI Global Equities	6.5	8.2	7.6
Relative performance	*-4.1*	*-1.6*	*-0.6*
Index Linked	18.4	13.0	12.2
FTSE Actuaries UK Index-Linked Gilts Over 5 Years Index	17.0	12.2	11.1
Relative performance	*1.4*	*0.8*	*1.1*
International Equity	10.7	10.2	8.7
Mix of FTSE and MSCI Regional Indices	11.6	10.1	8.5
Relative performance	*-0.9*	*0.1*	*0.2*

Long-Term Gilt Passive	24.0	14.9	13.1
FTSE Actuaries UK Conventional Gilts All Stocks Index	24.1	15.0	13.1
Relative performance	*-0.1*	*-0.1*	*0.0*
UK Equity	-0.8	5.5	6.5
FTSE All-Share Index	2.2	5.9	6.3
Relative performance	*-3.0*	*-0.4*	*0.2*
UK Equity Passive	1.5	5.7	6.1
FTSE All-Share Index	2.2	5.9	6.3
Relative performance	*-0.7*	*-0.2*	*-0.2*
UK Property	10.1	14.6	8.3
All Balanced Property Fund component of the AREF / IPD UK Quarterly Property Fund	7.2	12.5	8.4
Relative performance	*2.9*	*2.1*	*-0.1*

Appendix 3 - Wider relevant DC developments

The following requirements, consultations and developments in the DC market may be relevant to AVC arrangements, albeit many will not apply to LGPS arrangements. These points may, however, be of general interest when considering this report.

Issue	Details
Britain Leaving the European Union	On 23 June 2016, the UK voted to leave the EU in a national referendum. We expect market volatility to continue as the talks about how and when the UK will officially leave the union progress. As markets and members continue to react to the news, we recommend that the Trustees keep up to date on any regulation or legislative changes that may affect AVCs or their members. This upcoming change should be communicated to members as more information becomes available, and the Administering Authority should ensure a frequent review of funds is undertaken.
Member-Borne Commissions Ban	From 6 April 2016 service providers will be prevented from levying a charge on members to recover the cost of any commission payments to advisers for certain advice or services in respect of any new commission arrangements or variations or renewals of existing commission arrangements – including AVC arrangements. The safest route to ensure compliance is for every scheme that is being used to meet Auto-Enrolment requirements to have written confirmation from their providers confirming there is no commission charge.
Exit Charges Consultation	The Department of Work and Pensions has recently consulted on "Capping early exit charges for members of occupational pension schemes". While this is inherently a good direction, the reaction by providers should be looked at carefully as there may be a wider impact if exit charges must be reduced. Administering authorities should continue to monitor this as it may impact on LGPS AVCs.
Quality Features Assessment	The Pensions Regulator's DC Code of Practice in 2013 introduced 31 quality features the Regulator expects to see evidenced in well-governed DC schemes. The Pensions Regulator's revised Code of Practice was published on 28 July 2016. The revised Code is shorter, simpler and less prescriptive than the previous Code. It is better aligned with the Chair's statement and moves reference of the 31 quality features, though it covers the same aspects of governance. Although this doesn't apply directly to public sector schemes, many of the elements are worth considering to ensure ongoing governance of your AVC arrangements complies with best practice.
Charge Cap	The charge cap introduced by the DC Charges and Governance Regulations does not apply to AVCs where they are the only money purchase benefits in a scheme.

Appendix 4 – Indicative terms for replacement AVC arrangement

The table below shows the indicative terms received from Aviva in the market to implement a replacement Additional Voluntary Contribution (AVC) Arrangement.

The following providers declined to offer terms due to the proposed profile of the new pension arrangement not satisfying their minimum financial requirements in terms of total size of assets under management and/or total annual contributions: AEGON, Blackrock, Fidelity, Legal & General, Standard Life and Zurich.

The Administering Authority's incumbent providers, Prudential were not invited to offer terms.

Please note only charges are shown in the table below. Provider's propositions have not been analysed, scored (which also takes into consideration provider's investment processes and administration capabilities) or ranked. Subsequent analysis may prove the most competitive provider is not ranked in first place.

AVC Terms

	Aviva
Total Expense Ratio[1]	0.73%

Data and Assumptions

Aviva	Active Members	Deferred Members
Number of Members	84	550
Annual Premium	£210,108	n/a
Funds Under Management	£1,090,153	£1,980,737
Average Age	57	57

Notes:

1. Current fund options were provided to the market in order to quote on a like for like basis.

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