PRINCIPLES AND PRACTICES
OF FINANCIAL MANAGEMENT.

LEGAL & GENERAL ASSURANCE
SOCIETY LIMITED.
REPORT TO WITH PROFITS POLICYHOLDERS ON
COMPLIANCE FOR 2012.
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1. INTRODUCTION AND SUMMARY

The Board of Legal & General Assurance Society (the Society Board) published its Principles and Practices of Financial Management (PPFM) for its with profits business on 30 April 2004. Revised PPFMs were published on 29 June 2005, 29 June 2007, 31 December 2007 and 30 June 2012.

Each year, the Society Board must report to with profits policyholders on compliance with its obligations relating to the PPFM. These obligations require companies to establish governance arrangements designed to ensure that they comply with and maintain PPFMs for their with profits business.

In the opinion of the Society Board it has complied with the obligations in relation to its PPFM over the period 1 January 2012 to 31 December 2012, including the bonus declaration for the year ending 31 December 2012, announced on 21 February 2013.

The reasons for reaching this conclusion are presented in this report, which covers:

- Governance arrangements for with profits business;
- The Society Board’s compliance with its PPFM in the exercise of discretion in the management of its with profits business;
- Competing or conflicting rights, interests and expectations;
- PPFM changes and communications with policyholders.

The With Profits Actuary advised the Society Board on the operation of the with profits business, including the exercise of discretion and potential conflicts of interest. The Independent Reviewer provided independent judgement relating to the management of the with profits business and compliance with the PPFM. This report includes statements from both the Independent Reviewer and the With Profits Actuary.

Defined terms in this report have the meaning set out in the current version of the PPFM which can be found on our website at www.legalandgeneral.com

2. GOVERNANCE ARRANGEMENTS FOR WITH PROFITS BUSINESS

The Society Board is responsible for the key decisions relating to the management of with profits business, including the bonus declaration. These decisions were subject to ratification by the Legal & General Group Board, as stated in the PPFM.

An Independent Reviewer, Nick Dumbreck of Milliman, appointed by the Society Board provides independent judgement on the exercise of discretion in relation to the Society’s with profits business, on compliance with its PPFM and on how competing or conflicting rights and interests of policyholders and shareholders have been addressed. The Independent Reviewer met regularly during 2012 with the Society’s senior management team responsible for the with profits business and reviewed all the key decisions affecting with profits policyholders, including the bonus declaration for the year ending 31 December 2012.

The Society also has a With Profits Actuary, who is authorised by the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA), to provide advice to the Society Board on the exercise of discretion in relation to with profits business, on compliance with the PPFM and on the interests of the with profits policyholders.

3. COMPLIANCE WITH THE PPFM IN THE EXERCISE OF DISCRETION

The main areas in which discretion is exercised in the operation of with profits business are:

- Declaration of bonus rates;
- Investment policy and the arrangements for investment management;
- Setting surrender values (and transfer values for pension business) and market value reduction factors (MVRFs);
- New business terms and volumes;
- Apportionment of expenses and charges;
- Management of the Inherited Estate.

3.1 Bonus rates

Decisions regarding bonus rates were taken by the Society Board, having received advice from the With Profits Actuary, and were ratified by the Legal & General Group Board. The main bonus declaration was guided, for most with profits business, by the annual bonus and final bonus smoothing formulae used in recent years and designed to achieve the aims stated in the PPFM.
The reports on bonus rates presented to the Society Board provided evidence that the bonus methodology was based around the stated aims and followed the approach set out in the PPFM. The material assumptions used in determining bonus rates were presented to the Society Board for approval. The bonus rates declared demonstrated clear differentiation between product types and generations, in accordance with the PPFM.

While investment returns are usually the most important factor in determining bonus rates, allowance is made for operating experience within the With Profits Sub Fund, such as surrender, expense and mortality profits or losses. The work carried out to investigate operating experience grouped together similar policies.

Payout ratios for maturing business are regularly monitored throughout the year so that bonus rates can be adjusted if necessary. It was not deemed necessary to implement an additional bonus declaration during the year.

The Society’s PPFM contains target ranges for payout ratios on with profits policies. For the majority of policies the target range for benefits at contractual points is 80% to 120% of asset share and for benefits not at contractual points is 75% to 120% of asset share. The Society manages its with profits business with the aim that at least 90% of payouts fall within the relevant target range. Analysis of maturity and surrender claims has confirmed that the Society complied with its policy on target ranges during 2012.

The Contractual Minimum Addition (CMA) applicable to certain of the Society’s contracts was calculated and applied in line with the formulae set out in the PPFM.

### 3.2 Investment policy

The Society Board and its committees regularly monitor investment policy and are required to approve any proposed changes in policy. Asset allocation, counter-party exposure, liquidity (including forecasts) and performance, together with deviations from benchmarks, are monitored monthly. There are separate guidelines for assets backing asset shares (whose returns directly influence bonus rates) and assets backing the cost of guarantees on with profits business, the Inherited Estate and other liabilities. The With Profits Sub Fund continued to be managed in a manner consistent with the overriding principle that its assets should be sufficient to meet its liabilities, whilst maintaining a balance between risk and return for policyholders and the With Profits Sub Fund as a whole.

The proportion of the assets backing asset shares invested in fixed interest securities and equities remained broadly the same over the year with a slight increase in equities due to their slightly stronger performance. The allocation to property fell by around 1.5% largely due to the out performance of equities and fixed income securities. During 2012, exposure to overseas equities was increased by around 5% of asset shares as a result of switches from UK equities. There was also a movement from government backed securities and corporate bonds to short dated cash like securities for certain products which are close to their maturity dates. There were a small number of less material movements.

In order to part protect against possible falls in equity market and corporate bond prices and their potential adverse impact on the With Profit Sub Fund’s capital position, short positions in equities and in corporate bonds were maintained within the Inherited Estate. A partial hedge is also maintained in the Inherited Estate through derivative contracts to protect against possible falls in property values. The costs and benefits of this hedging accrue to the Inherited Estate and do not directly affect the investment returns credited to asset shares. In addition, derivative contracts were held in order to reduce exposure to property within asset shares. Equity put options are used to manage the guarantees on certain tranches of with profits bonds.

The investment management fees payable to Legal & General Investment Management Limited (LGIM) were reviewed and revised to ensure they remained appropriately benchmarked against other funds. The revised fees were implemented on 1 January 2013.

A review of the performance of the Society’s Investment Managers was undertaken in the second half of 2012, consistent with undertakings previously made. As a result of this review a decision was taken towards the end of the year to reduce the exposure to UK equity held in the active portfolio and increase the passive, indexed portfolio holding; and to increase the exposure to European equity held in an active portfolio from passive, index based holdings. These changes were implemented in 2013. (As a result of the 2011 review a proportion of UK equity held in the active portfolio was moved to passive in early 2012).

### 3.3 Surrender values

Surrender values (and transfer values for pension business) and MVRFs were regularly monitored throughout 2012, with appropriate changes made in accordance with the PPFM and consistent with past agreed practice, having regard principally to movements in the value of the underlying investments.

No changes were made during the year to the overall approach and methods used to determine surrender and transfer values for conventional business and MVRFs for unitised business.
3.4 New business terms and volumes
The Society remained open to new with profits business throughout the year and the With Profits Sub Fund continued to be managed on the basis that it will remain open to new business, although sales of new with profits products have generally declined over recent years.

The Retail Distribution Review, which took effect from 31 December 2012, has created some further uncertainty on future levels of new business.

Pricing terms for new with profits business written in the With Profits Sub Fund were regularly monitored and subject to prior approval by the relevant Board Committee.

The terms on which new business was written was reviewed during the year following the implementation of new Conduct of Business Sourcebook (COBS) rules, which took effect from 1 July 2012. Our previous practice for new with profits business had been for support to be provided from the Inherited Estate to meet part of the cost of the shareholder transfer and excess new business expenses above the level to be charged to asset shares (as described in our PPFM that applied up to 30 June 2012 and the 2011 report on PPFM compliance).

For new business written from 1 July 2012 the new COBS rules require new business to be financially self-supporting, so that no such support could continue to be provided from the Inherited Estate. A review of the terms for new business was undertaken to reconsider the balance between shareholder profitability, the impact on the Inherited Estate and value for money for customers. The PPFM and our operating practices were updated accordingly.

The Society regularly reviews the effect of writing new business on the With Profits Sub Fund and existing with profits policyholders, and concluded that new business written in 2012 did not have an adverse effect on either the Fund or its with profits policyholders.

While the Society’s planning process sets target volumes for new business having regard to insurance market conditions and the impact of new business on the With Profits Sub Fund, it was not necessary to restrict the level of new business written in 2012. No new with profits bonds with additional capital guarantees were sold after 31 March 2012.

3.5 Expenses and charges
Expense apportionment between the With Profits Sub Fund and the remainder of the Society’s Long Term Fund, and between different products, continued to follow the established approach. No changes were made to the methods used for expense apportionment in 2012, other than for new business written from 1 July 2012, as referred to above.

Judgements as to the level of support from the Inherited Estate, for example by limiting the amount of transfer to shareholders or expenses deducted from policies when determining levels of benefits, were taken by the Society Board in advance of the main bonus investigation exercise. In general, decisions relating to these matters were made at the product launch date (or date of subsequent review). Decisions on the treatment of exceptional expenses were made by the Society Board.

A framework for assessing the level of deductions from asset shares in respect of the cost of guarantees and options was introduced in the 29 June 2005 PPFM. The following adjustments were allowed for in the calculation of bonus rates for the 2012 declaration:

<table>
<thead>
<tr>
<th>Year</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deduction/Refund</td>
<td>Deduction</td>
<td>Refund</td>
<td>Deduction</td>
<td>Deduction</td>
</tr>
<tr>
<td>%</td>
<td>0.75%</td>
<td>0.40%</td>
<td>0.20%</td>
<td>0.75%</td>
</tr>
</tbody>
</table>

Financial conditions as at 31 December 2012 meant that there will be a refund of 0.75% of asset shares for 2012, which will be reflected in subsequent bonus declarations. This refund will however be taken into account when calculating MVRFs, surrender values (and transfer values for pension business) during 2013. In practice, the Society implemented an interim bonus update on 30 May 2013, and this interim update fully incorporated the 0.75% refund in respect of 2012.
3.6 Management of the Inherited Estate

The With Profits Sub Fund contains an excess of assets over liabilities known as the Inherited Estate, which is used to provide freedom for the Fund’s investment policy, enable smoothing of benefits, absorb financial strains and provide potential support for expenses and the cost of shareholder transfers. Management of the Inherited Estate is therefore critical to the financial health of the With Profits Sub Fund and the continuation of with profits business.

The Inherited Estate and assets backing the cost of guarantees and options follow a different investment strategy to that for the assets backing asset shares. This strategy, coupled with the framework used to assess deductions and refunds in respect of the cost of guarantees and options, and the hedging of certain market risks, is designed to protect solvency in adverse conditions and provide greater stability.

The Society Board had regard to the financial position of the With Profits Sub Fund, including its Inherited Estate, in its financial management.

The financial effect of writing new business on the With Profits Sub Fund, including any potential support from the Inherited Estate for expenses or costs of shareholder transfer or tax, was reviewed and reported to the Society Board.

4. COMPETING OR CONFLICTING RIGHTS, INTERESTS AND EXPECTATIONS

4.1 Equity between with profits policyholders and shareholders

Audited accounts provided evidence of the separate treatment of the With Profits Sub Fund. The audited calculation of distributed surplus and shareholder transfer from the With Profits Sub Fund was consistent with the statements made in the PPFM.

4.1.1 Apportionment of tax and expenses

Inequity between with profits policyholders and shareholders could occur from the apportionment of tax and expenses between the With Profits Sub Fund and the rest of the Long Term Fund or shareholder funds. The Society has an established practice of charging to the With Profits Sub Fund an amount of tax calculated on a stand-alone basis, thus addressing this potential conflict. This practice continued in 2012. Audited expense apportionment processes are in place, so that an appropriate split of expenses between the With Profits Sub Fund and the other parts of the Long Term Fund can be achieved.

4.1.2 Distribution of surplus

Shareholders are entitled to not more than 10% of distributed surplus from the With Profits Sub Fund, but may be required to provide support if the With Profits Sub Fund is in financial difficulty. Both policyholders and shareholders have an interest in the controlled distribution of surplus, including the split of the distribution to policyholders between annual and final bonus, and in the continued prudent financial management of the fund.

It has been the established practice that shareholders receive 10% of distributed surplus from the With Profits Sub Fund, and that additional tax due in respect of this transfer is charged to the Inherited Estate. The Society Board decided to continue this practice in 2012, except for new business written from 1 July 2012 for which the percentage of distributed surplus receivable by the shareholders is reduced.

4.1.3 Capital support

As a result of changes made to the Society’s structure at the end of 2007, a minimum level of capital support, called the With Profits Capital Support (WPCS) was introduced. The WPCS specified a minimum level of capital support available to the With Profits Sub Fund from either the Non Profit Sub Fund or shareholders’ funds over a period of up to 10 years. Capital support at the agreed level was made available to the With Profits Sub Fund throughout 2012.

4.2 Equity between different groups of with profits policyholders

Different groups of with profits policyholders may have competing or conflicting rights, interests or expectations. For example, holders of:

- different products;
- policies of different sizes or policy terms;
- policies with different entry or maturity dates,

or policyholders:

- of different ages;
- claiming for different reasons (e.g. maturity, death, surrender);
- exercising different policy options,

could receive different benefits relative to each other depending on how discretion is exercised.
The main areas in which judgement and discretion are exercised in balancing the interests of these groups are in the:

- smoothing of policy benefits;
- grouping of policies for setting bonus rates and surrender values and sharing of investment and other experience;
- relative levels of benefits paid on surrender or maturity;
- allocation of asset mix and investment returns.

Where bonus rates are guided by asset share calculations, a consistent approach to smoothing across product types was applied, in which a proportion of investment and other experience was not immediately reflected in policy benefits at contractual points. In the minority of cases where bonus rates are not guided by asset share calculations, other techniques, such as comparison with similar products whose bonus rates are guided by asset share calculations, were used in order that a consistent approach to smoothing could be applied across different groups of policies.

The approach of grouping of policies has evolved gradually and depends on the different aspects of experience (such as investment returns, expenses and mortality). For a particular aspect of experience, policies judged to have similar characteristics were grouped together, in order that a practical and equitable approach to the sharing of experience could be achieved.

Surrender values were reviewed with the aim that payments to those policyholders taking benefits other than at contractual points did not adversely affect the interests of remaining with profits policyholders.

Exercise of discretion in the setting of investment policy, used in the determination of investment returns applicable when setting policy benefits, and the split of asset mix between different groups of policies, is performed taking into account the nature and relative values of guarantees and options provided on different groups of policies.

The Society Board confirms that, in its opinion, these potentially competing or conflicting rights, interest and expectations of policyholders were managed in accordance with the PPFM.

5. PPFM CHANGES AND COMMUNICATIONS WITH POLICYHOLDERS

There was an update to the PPFM as at 30 June 2012 to reflect changes in COBS rules. Details of this were published on our website.

Statements were sent to with profits policyholders setting out details of the bonuses added to their policies following the 16 February 2012 bonus declaration. They also received information on investment performance, the asset mix applicable to their policy and how investment performance affects bonus rates.

Customer friendly versions of the PPFM are available on the Society’s website at www.legalandgeneral.com

6. INDEPENDENT REVIEW

The Society Board asked Nick Dumbreck of Milliman to perform an independent review of compliance with the PPFM and to report on how competing or conflicting rights, interests and expectations of policyholders and shareholders have been addressed. The Independent Reviewer has provided the following statement for with profits policyholders:

‘I have reviewed the management of the Society’s with profits business for the period 1 January 2012 to 31 December 2012, including the bonus declaration as at 31 December 2012. On the basis of this review, I am satisfied that the Society complied with its PPFM during that period. I also consider that any competing or conflicting rights and interests of policyholders and shareholders were reasonably addressed.

In giving this opinion I have relied upon both written and oral information provided by the Society. I have generally accepted the information reviewed without independent verification. In particular I have not checked the application of various assumptions made, or the accuracy of the calculations undertaken. I have assumed information provided to me is complete and that there are no significant decisions or actions on the management of with profits business which have not been disclosed to me.’
7. APPENDIX

Report of the With Profits Actuary to the with profits policyholders of the Legal & General Assurance Society Limited

The Financial Conduct Authority’s rules requires an actuary appointed to perform the With Profits Actuary function to report to the with profits policyholders as to whether the annual report of the firm and the discretion exercised by the firm in respect of the period covered by the report may be regarded as having taken the interests of the with profits policyholders into account in a reasonable and proportionate manner.

I became the With Profits Actuary on 20 March 2013, prior to which I had engaged in extensive discussions with the previous With Profits Actuary in relation to the operation of the With Profits Fund since 1 January 2012.

This is my report for the financial year ended 31 December 2012. In producing this report, I have based my opinion on the information and explanations provided to me by Legal & General Assurance Society Limited (the Society), having regard to the Principles and Practices of Financial Management (PPFM) of the Society’s With Profits Fund. I have also had regard to the relevant Technical Actuarial Standards issued by the Financial Reporting Council.

As noted in the annual report to the with profits policyholders produced by the Society, there was an update to the PPFM effective from 30 June 2012. This update made amendments in the areas of the terms under which new business is written and the application of Market Value Reduction Factors. I am satisfied that these changes both represent improvements for with profits policyholders.

I have carried out a review of the Society’s compliance with the PPFM and its exercise of discretion over 2012.

I am satisfied that the Society has complied with the principles and practices set out in the PPFM for the financial year ended 31 December 2012. Moreover, I am satisfied that the Society’s report and its exercise of discretion over this period may be regarded as having taken the with profits policyholders’ interests into account in a reasonable and proportionate manner.

John A Jenkins
Fellow of the Institute and Faculty of Actuaries
Partner KPMG LLP
With profits Actuary

10 June 2013