PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT

LEGAL & GENERAL ASSURANCE SOCIETY LIMITED

REPORT TO WITH PROFITS POLICYHOLDERS ON COMPLIANCE FOR 2018
# PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT – REPORT ON COMPLIANCE FOR 2018

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1. INTRODUCTION AND SUMMARY


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 2018 to 31 December 2018, including the bonus declaration for the year ending 31 December 2018, announced on 21 February 2019.

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 With Profits Committee provided independent judgement relating to the management of the with profits business and compliance with the PPFM. This report includes statements from both the With Profits Committee and the With Profits Actuary.

The Society Board took the decision to close the With Profits Fund to new business with effect from 31 January 2015 due to a continued fall in new investments into the With Profits Fund.

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 legalandgeneral.com

2. GOVERNANCE ARRANGEMENTS FOR WITH PROFITS BUSINESS

The With Profits Committee is a sub-committee of the Society Board and is chaired by an Independent Chairman. In December 2017 an independent member of the Committee stood down and the Committee now comprises four members, two of whom are independent. One role of this Committee is to provide 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 With Profits Committee met regularly during 2018 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 2018.

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

3. KEY DEVELOPMENTS DURING 2018 AFFECTING THE WITH PROFITS FUND

In December 2017 Legal & General sold its with profits business to ReAssure Ltd. The transfer of the business is subject to a court order which is governed by Part VII of the Financial Services and Markets Act 2000. The effective date of the transfer is expected to be in 2019. With profits customers will receive further information about the transfer and its timing as part of this process.

Expenses charged to the With Profits Fund include regular payments into the Legal & General defined benefit pension schemes. In 2017, the Board decided to transfer all ongoing expenses in respect of these schemes to the Shareholder in consideration of a single one off payment from the With Profits Fund which was made at the start of 2018. This means that these ongoing payments into the pension schemes from the With Profits Fund have ceased.

In 2018 an expense arrangement was established whereby the majority of the expenses charged to the With Profits Fund are set at a fixed rate depending on policy type. The PPFM was updated in 2018 to reflect this change.

In 2018 the Board decided to commence distribution of the estate, making an addition of 0.3% to asset shares which was reflected in the bonuses declared on 21 February 2019.
4. 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.

4.1 Bonus rates

Decisions regarding bonus rates were taken by the Society Board, having received advice from the With Profits Actuary. 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 Fund, such as surrender, expense and mortality profits or losses. The work carried out to investigate operating experience grouped together similar policies. Allowance is also made for tax.

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.

4.2 Target ranges and payout ratios

The Society’s PPFM contains target ranges for payout ratios on with profits policies. The target range for both maturities and surrenders is 80% to 120% of asset share. These ranges were reviewed during 2017 and were found to appropriately reflect the aims of the Society to achieve fair customer outcomes whilst allowing an appropriate degree of smoothing, which is a key element of with profits products.

The Society manages its with profits business with the aim that at least 90% of payouts fall within the target range. Analysis of maturity and surrender claims has confirmed that the Society complied with its policy on target ranges during 2018.

To ensure ongoing compliance, payout ratios are regularly monitored throughout the year so that bonus rates and market value reduction factors can be adjusted if necessary.

During 2018 no issues have been identified as a result of the regular monitoring of payout ratios.

4.3 Investment policy

The Society Board and its committees regularly monitor investment performance and are required to approve any proposed changes in policy. Asset allocation, counterparty exposure, liquidity and performance, together with deviations from benchmarks, are monitored monthly and action is taken to ensure these remain in line with the investment policy. 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 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 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.

In order to partly protect the With Profits Fund’s capital position against possible changes in equity, property, corporate bond and government bond prices, hedging positions were maintained within the Inherited Estate. The costs and benefits of this hedging accrue to the Inherited Estate and do not directly affect the investment returns credited to asset shares.

The investment management fees payable to Legal & General Investment Management Limited (LGIM) were previously reviewed in 2012 and revised to ensure they remained appropriately benchmarked against other funds. The revised fees were implemented on 1 January 2013. These rates were reviewed during 2017 after consideration of further benchmarking information and a new schedule was agreed which was implemented on 1 April 2018.
4.4 Surrender values

Surrender values (and transfer values for pension business) and MVRFs were regularly monitored throughout 2018, with appropriate changes made in accordance with the PPFM and consistent with past 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.

4.5 New business terms and volumes

The Society closed to new with profits business on 31 January 2015. However, new members to existing group personal pension schemes were permitted during the year.

Each year we review the effect of writing new business on the With Profits Fund and on existing with profits policyholders. This review was completed in 2018 and appropriate action taken to ensure that new business is not expected to have an adverse effect on either the Fund or its with profits policyholders. We will continue to review the impact of the new business written in order to ensure that it does not generate any adverse impact on existing policyholders.

4.6 Expenses and charges

The Society has established an expense agreement under which the majority of the expenses of the With Profits Fund have been replaced by a fixed amount per policy, varying by policy type. The majority of investment management expenses, commission and any rectification payments to policyholders are not included within the expense agreement. The agreement came into force on 1 January 2018 and applied for the whole of 2018.

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 alongside 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.

Certain pension plans currently benefit from our Stakeholder Charge Cap under which the value of the plan will not be less than it would have been if they had transferred to a Stakeholder Pension in April 2001. When operating this cap for with profits policies the Society applies some averaging to the charge refunds in order to remain consistent with the approach to grouping used in formulating bonus rates.

New government regulations came into force from 31 March 2017. Consequently with profits customers aged 55 or over at the time they access their pension pot will have any exit charges that may apply to their plan capped at 1% of their total pension pot.

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. Following the closure of the With Profits Fund to new business, this framework was discontinued. As outlined in section 4.7 the Board assesses annually whether any part of the estate should be distributed to policyholders and any charges or refunds with respect to guarantees and options are now incorporated into this assessment. Any future charges or refunds with respect to guarantees and options are now incorporated into the estate distribution mechanism. A refund of charges for guarantees and options of 0.2% was reflected in the bonuses declared in February 2019 in respect of 2018.
4.7 Management of the Inherited Estate

The With Profits 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 to meet part of the cost of shareholder transfers. Management of the Inherited Estate is therefore critical to the financial health of the With Profits 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 estate distribution mechanism, and the hedging of certain market risks, is designed to protect solvency in adverse conditions and provide greater stability.

The Board is required to consider the size of the Inherited Estate annually with a view to assessing whether any may be distributed or whether a charge is required to increase its size. The Board considered the size of the Inherited Estate in 2018 and concluded that a distribution of the estate was appropriate and would not adversely affect the management of the Fund in future. As a result there was a distribution of the estate of 0.3% of asset shares in 2018.

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

5. COMPETING OR CONFLICTING RIGHTS, INTERESTS AND EXPECTATIONS

5.1 Equity between with profits policyholders and shareholders

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

5.1.1 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 Fund and the rest of the Society. The Society has an established practice of charging to the With Profits Fund an amount of tax calculated on a stand-alone basis, thus addressing this potential conflict. This practice continued in 2018. Audited expense processes are in place, so that an appropriate split of expenses between the With Profits Fund and the other parts of Legal & General can be achieved.

5.1.2 Distribution of surplus

Shareholders are entitled to not more than 10% of distributed surplus from the With Profits Fund, but may be required to provide support if the With Profits 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 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 2017, except for certain new business written after 1 July 2012 for which the percentage of distributed surplus receivable by the shareholders is reduced.

The UK regulatory regime changed in 2016, resulting in a change to the methods and assumptions required for the calculation of the With Profit Fund liabilities. However, the basis of the amount paid to shareholders in respect of 2016 and 2018, along with the amount deducted from policyholder assets to contribute to this amount, continued on the previous calculation methodology. The financial impact of this on the Fund and policyholders was immaterial.
5.2 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;
- level of risk embedded in the non-participating business held.

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, interests and expectations of policyholders were managed in accordance with the PPFM.

6. PPFM CHANGES AND COMMUNICATIONS WITH POLICYHOLDERS

Statements were sent to with profits policyholders setting out details of the bonuses added to their policies following the 21 February 2018 bonus declaration. They also received information on investment performance, the asset mix applicable to their policy and how investment performance affects bonus rates.

During 2018 a number of guides and factsheets including guides on how we manage policyholders’ with profits investments, the annual bonus factsheet and the report to policyholders on compliance with the PPFM were available on the Society’s website at legalandgeneral.com/existing-customers/with-profits-support/guides-and-factsheets. This information remains available.

7. STATEMENT FROM THE WITH PROFITS COMMITTEE

The With Profits Committee provided independent oversight of the management of the Society’s with profits business for the period 1 January 2018 to 31 December 2018. The With Profits Committee assessed, challenged and provided advice to the Society’s Board on key proposals affecting the With Profits Fund over the period, most notably including the sale of the With Profits Fund to ReAssure Limited.

The With Profits Committee has reviewed the management of the Society’s with profits business over the period 1 January 2018 to 31 December 2018, the With Profits Actuary’s report on PPFM compliance and the LGAS Board report to with profits policyholders. The With Profits Committee has confirmed that it is satisfied that any competing or conflicting rights and interests of policyholders and shareholders were reasonably addressed and is also satisfied with the contents of the Board’s report.
8. APPENDIX

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

The Financial Conduct Authority’s rules require 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.

This is my report for the financial year ended 31 December 2018. 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 (effective June 2017 and October 2018). I have also had regard to the relevant Technical Actuarial Standards issued by the Financial Reporting Council.

I have carried out a review of the Society’s compliance with the PPFM and its exercise of discretion over 2018. A key element of the Society’s use of discretion is the setting of bonuses and hence payouts to customers.

I am satisfied that the Society has complied, in all material respects, with the principles and practices set out in the PPFM for the year ended 31 December 2018. 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.

Tricia Ross FIA
With Profits Actuary