Liverpool Victoria Financial Services Limited (LVFS) - Solo

(formerly Liverpool Victoria Friendly Society Limited)

Solvency and Financial Condition Report

For the year ended 31 December 2019

Contents

Summary

The purpose of the Solvency and Financial Condition Report (SFCR) is to provide information required by the Solvency II regulatory framework, in particular the capital position at 31 December 2019 of Liverpool Victoria Financial Services Limited. This report sets out different aspects of the Company's business and performance, system of governance, risk profile, valuation methods used for solvency purposes and its capital management practices.

Basis of preparation of the SFCR

The LVFS SFCR has been prepared on a Standard Formula basis. The calculation of the technical provisions is based on up-to-date and credible information and realistic assumptions as at 31 December 2019 and will therefore not reflect the estimated impacts of the Coronavirus outbreak.

Business and Performance

As at 31 December 2019, Liverpool Victoria Friendly Society Limited was a UK-incorporated and domiciled Friendly Society registered under the Friendly Societies Act 1992. On 2 January 2020, Liverpool Victoria Friendly Society Limited was converted to a company limited by guarantee registered under the Companies Act 2006, under the name Liverpool Victoria Financial Services Limited (LVFS).

LVFS is the parent company of the LV= Group and also writes the majority of the LV= Group's business. LVFS mainly underwrites life insurance contracts in the UK. LVFS is a mutual organisation, which means it is owned by its members. Its members are customers who have certain longer-term financial products underwritten by LVFS, such as life insurance, protection, investments or retirement policies.

LVFS reported an IFRS profit before tax, mutual bonus and unallocated divisible surplus transfer for the year of £30m (2018: £29m loss). The improved performance was mainly driven by positive market movements. At 31 December 2019 the LVFS Solo capital surplus on a Standard Formula basis was £769m (2018: £704m). The increase in capital surplus was mainly driven by the LV= Group sale of its remaining stake in its general insurance business.

Section A of this report sets out further details about LVFS's business structure, key operations, market position and financial performance over the reporting period, split by underwriting performance and investment performance.

System of Governance

The LVFS board is committed to high standards of corporate governance and stewardship. As a mutual, LVFS is owned by its members and strives to provide long-term benefits and confidence through the operation of an effective governance framework, efficient controls and transparent decision making.

There have been no significant changes in LVFS's system of governance in the year. The table below summarises the changes in membership of the Board in the year:

A Parsons – Resigned 17 October 2019
R Rowney – Resigned 31 December 2019

Tanya Lawler resigned from the board on 29 January 2020 and Seamus Creedon was appointed as a Non-executive director on 16 January 2020.

Following the resignation of Richard Rowney as Chief Executive Officer at the end of the year, Mark Hartigan was appointed as interim chief executive officer on 1 January 2020, subject to regulators' approval. Alan Cook, LVFS Chairman, has assumed the regulatory responsibilities of the chief executive officer pending the regulatory approval of the new chief executive officer.

Section B of this report describes the system of governance in place throughout LVFS by which its operations are overseen, directed, managed and controlled.

Risk profile

LVFS's business model involves taking on risk for its policyholders in order to provide security and aid in financial planning. LVFS aims to grow member value consistently over the longer term while managing the risk involved in doing so appropriately. LVFS operates a fully integrated risk management framework. This framework brings together the key processes and activities undertaken throughout the business to ensure that customers' and members' security is at the forefront of decision making.

Political, economic and regulatory uncertainty are identified as a key risk in the LV= Risk Management framework, as reported in the LV= Annual Report. 2019 has been a volatile year with political, economic and regulatory uncertainty caused by:

- A lack of clarity over the UK's future relationship with the European Union (EU) and the rest of the world following Brexit.
- An uncertain political landscape with a minority UK government in power for most of the year.
- Heightened concerns over the impact of US foreign policy.
- Increasing stakeholder and regulatory expectations over firms' environmental, social and governance activities in response to global issues such as climate change.
- A growing digital economy.
- Increasing data protection (and other) regulations.
- Heightened threats posed by cyber criminals.

The emergence of the Coronavirus represents a new uncertainty for 2020. At the time of writing the development of the virus in the UK and actions planned to contain it are uncertain and fast-moving. We have developed and put in place contingency plans to minimise business disruption. Our primary focus is the continued safety of our staff and our customers. Current indications are that the operational resilience of the business remains strong. Priority is being given to the needs of our existing customers and we fully expect to be able to meet all of our policyholder liabilities within reasonable timescales. Where possible new business continues to be written.

Our solvency position remains strong and our stress testing demonstrates that we are resilient to yield and equity impacts. We are also working closely with our asset managers to ensure that appropriate hedging arrangements remain in place during what is likely to be a prolonged period of increased market volatility. Our exposure to increased life insurance risks is largely reinsured. Our Solvency II Capital Coverage Ratio remains above risk appetite of 140% under a Coronavirus stressed scenario.

The types of risks to which LVFS is exposed have not changed significantly during 2019 and remain market, underwriting, liquidity and operational risks.

Section C of this report further describes the risks to which LVFS is exposed and how it identifies, measures, manages and monitors these risks, including any changes in the year to LVFS's risk exposures and specific risk mitigation actions taken.

Valuation for Solvency purposes

Assets, technical provisions and other liabilities are valued in LVFS's Solvency II Balance Sheet according to the Solvency II regulations. Assets and liabilities are valued at an amount for which they could be exchanged, transferred or settled by knowledgeable and willing third parties in an arms-length transaction.

The value of technical provisions under Solvency II is equal to the sum of a best estimate liability and a risk margin. Calculations are based on the Standard Formula approach using the Volatility and Matching Adjustment (for eligible business) and Transitional Measures on Technical Provisions.

Section D of this report provides further description of the bases, methods and main assumptions used in the valuation of assets, technical provisions and other liabilities for each material asset/liability class. In addition, it also provides an explanation of the material differences between the IFRS and Solvency II bases of valuation.

Capital Management

LVFS manages Own Funds in line with solvency capital requirements. In the calculation of the Solvency Capital Requirement ("SCR") LVFS uses a Standard Formula approach.

At 31 December 2019 the Eligible Own Funds to meet the SCR were £1,678m (2018: £1,543m), while the SCR was £909m (2018: £839m).

Section E of this report further describes the objectives, policies and procedures employed by LVFS for managing its Own Funds. The section also covers information on structure and quality of Own Funds and calculation of SCR.

Statement of directors' responsibilities

Financial year ended 31 December 2019

We certify that:

a) The Solvency and Financial Condition Report has been properly prepared in all material respects in accordance with the PRA rules and Solvency II Regulations; and

b) We are satisfied that:

    i. throughout the financial year in question, LVFS has complied in all material respects with the requirements of the PRA rules and Solvency II Regulations as applicable to the Society; and

    ii. it is reasonable to believe that, at the date of the publication of the Solvency and Financial Condition Report, the Society and its subsidiaries have continued so to comply, and will continue so to comply in future.

The Solvency and Financial Condition Report was approved by the Board of Directors on 2 April 2020 and signed on its behalf by:

…………………………………………………..
Alan Cook
Executive Chairman

2 April 2020

Liverpool Victoria Financial Services Limited
County Gates
Bournemouth
BH1 2NF

Report of the external independent auditors to the Directors of Liverpool Victoria Financial Services Limited (formerly Liverpool Victoria Friendly Society Limited (the "Society") pursuant to Rule 4.1 (2) of the External Audit Part of the PRA Rulebook applicable to Solvency II firms

Report on the Audit of the relevant elements of the Solvency and Financial Condition Report

Opinion

Except as stated below, we have audited the following documents prepared by the Society as at 31 December 2019:

- The 'Valuation for solvency purposes' and 'Capital Management' sections of the Solvency and Financial Condition Report of the Society as at 31 December 2019, ('**the Narrative Disclosures subject to audit**'); and
- Society templates S.02.01.02, S.12.01.02, S.22.01.21, S.23.01.01, S.25.01.21 and S.28.01.01 ('**the Templates subject to audit'**).

The Narrative Disclosures subject to audit and the Templates subject to audit are collectively referred to as the '**relevant elements of the Solvency and Financial Condition Report'**.

We are not required to audit, nor have we audited, and as a consequence do not express an opinion on the **Other Information** which comprises:

- The 'Summary', 'Business and performance', 'System of governance' and 'Risk profile' elements of the Solvency and Financial Condition Report;
- Society templates S.05.01.02;
- Information calculated in accordance with the previous regime used in the calculation of the transitional measure on technical provisions, and as a consequence all information relating to the transitional measure on technical provisions as set out in the Appendix to this report;
- The written acknowledgement by management of their responsibilities, including for the preparation of the Solvency and Financial Condition Report ('**the Responsibility Statement**').

To the extent the information subject to audit in the relevant elements of the Solvency and Financial Condition Report includes amounts that are totals, sub-totals or calculations derived from the Other Information, we have relied without verification on the Other Information.

In our opinion, the information subject to audit in the relevant elements of the Solvency and Financial Condition Report of the Society as at 31 December 2019 is prepared, in all material respects, in accordance with the financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based, as supplemented by supervisory approvals.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) (ISAs (UK)) including ISA (UK) 800 and ISA (UK) 805, and applicable law. Our responsibilities under those standards are further described in the *Auditors' Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report* section of our report. We are independent of the Society in accordance with the ethical requirements that are relevant to our audit of the Solvency and Financial Condition Report in the UK, including the FRC's Ethical Standard as applied to public interest entities, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Conclusions relating to going concern

We have nothing to report in respect of the following matters in relation to which the ISAs (UK) require us to report to you where:

- the directors' use of the going concern basis of accounting in the preparation of the Solvency and Financial Condition Report is not appropriate; or
- the directors have not disclosed in the Solvency and Financial Condition Report any identified material uncertainties that may cast significant doubt about the Society's ability to continue to adopt the going concern basis of accounting for a period of at least twelve months from the date when the Solvency and Financial Condition Report is authorised for issue.

However, because not all future events or conditions can be predicted, this statement is not a guarantee as to the Society's ability to continue as a going concern.

Emphasis of Matter - Basis of Accounting

We draw attention to the 'Valuation for solvency purposes' and 'Capital Management' of the Solvency and Financial Condition Report, which describe the basis of accounting. The Solvency and Financial Condition Report is prepared in compliance with the financial reporting provisions of the PRA Rules and Solvency II regulations, and therefore in accordance with a special purpose financial reporting framework. The Solvency and Financial Condition Report is required to be published, and intended users include but are not limited to the Prudential Regulation Authority. As a result, the Solvency and Financial Condition Report may not be suitable for another purpose. Our opinion is not modified in respect of this matter.

Other Information

The Directors are responsible for the Other Information.

Our opinion on the relevant elements of the Solvency and Financial Condition Report does not cover the Other Information and we do not express an audit opinion or any form of assurance conclusion thereon.

In connection with our audit of the Solvency and Financial Condition Report, our responsibility is to read the Other Information and, in doing so, consider whether the Other Information is materially inconsistent with the relevant elements of the Solvency and Financial Condition Report, or our knowledge obtained in the audit, or otherwise appears to be materially misstated. If we identify such material inconsistencies or apparent material misstatements, we are required to determine whether there is a material misstatement in the relevant elements of the Solvency and Financial Condition Report or a material misstatement of the Other Information. If, based on the work we have performed, we conclude that there is a material misstatement of this Other Information, we are required to report that fact. We have nothing to report in this regard.

Responsibilities of Directors for the Solvency and Financial Condition Report

The Directors are responsible for the preparation of the Solvency and Financial Condition Report in accordance with the financial reporting provisions of the PRA rules and Solvency II regulations, which have been supplemented by the approvals made by the PRA under section 138A of FSMA, the PRA Rules and Solvency II regulations on which they are based, as detailed below:

- Approval to use the matching adjustment in the calculation of technical provisions
- Approval to use the volatility adjustment in the calculation of technical provisions
- Approval to use the transitional measure on technical provisions

The Directors are also responsible for such internal control as they determine is necessary to enable the preparation of a Solvency and Financial Condition Report that is free from material misstatement, whether due to fraud or error.

Auditors' Responsibilities for the Audit of the relevant elements of the Solvency and Financial Condition Report

It is our responsibility to form an independent opinion as to whether the information subject to audit in the relevant elements of the Solvency and Financial Condition Report is prepared, in all material respects, in accordance with financial reporting provisions of the PRA Rules and Solvency II regulations on which they are based.

Our objectives are to obtain reasonable assurance about whether the relevant elements of the Solvency and Financial Condition Report are free from material misstatement, whether due to fraud or error, and to issue an auditors' report that includes our opinion. Reasonable assurance is a high level of assurance, but it is not a guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the decision making or the judgement of the users taken on the basis of the Solvency and Financial Condition Report.

A further description of our responsibilities for the audit is located on the Financial Reporting Council's website at: www.frc.org.uk/auditorsresponsibilities. This description forms part of our auditors' report.

This report, including the opinion, has been prepared for the Board of Directors of the Society in accordance with External Audit rule 2.1 of the Solvency II firms Sector of the PRA Rulebook and for no other purpose. We do not, in providing this report, accept or assume responsibility for any other purpose or to any other party save where expressly agreed by our prior consent in writing.

Report on Other Legal and Regulatory Requirements

In accordance with Rule 4.1 (3) of the External Audit Part of the PRA Rulebook for Solvency II firms we are also required to consider whether the Other Information is materially inconsistent with our knowledge obtained in the audit of the Society's statutory financial statements. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

The engagement partner on the audit resulting in this independent auditors' report is Andrew Hill.

PricewaterhouseCoopers LLP

Chartered Accountants

London

3 April 2020

Appendix – relevant elements of the Solvency and Financial Condition Report that are not subject to audit

The relevant elements of the Solvency and Financial Condition Report that are not subject to audit comprise:

- The following elements of template S.12.01.02
  - Rows R0110 to R0130 – Amount of transitional measure on technical provisions

- The following elements of template S.22.01.21
  - Column C0030 – Impact of transitional on technical provisions

- Elements of the Narrative Disclosures subject to audit identified as ‘unaudited’.

Glossary

For convenience a number of defined terms are used throughout this document. These are set out below:

The Liverpool Victoria Group

Group / LV=	LVFS together with its subsidiaries
LVFS or Society	Liverpool Victoria Financial Services Limited (formerly Liverpool Victoria Friendly Society Limited)
LVCAP	LV Capital Limited
LVLC	Liverpool Victoria Life Company Limited
LVPL	LV Protection Limited

TAC	Teachers Assurance Company Ltd
SBU	Strategic Business Unit
SSU	Strategic Support Unit
ExCo	The executive management committee of the Group established by the CEO

Other terminology

ABE	Actuarial Best Estimate
BEL	Best Estimate Liabilities
CEO	Chief Executive Officer of LVFS and the Group
CFO	Chief Finance Officer
CRO	Chief Risk Officer of LVFS and the Group
Delegated Acts	Refers to Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 unless another Delegated Regulation is specified
DTA	Deferred Tax Asset
DTL	Deferred Tax Liability
EIOPA	The European Insurance and Occupational Pensions Authority
ENID	Events not in data
esg	environmental, social and governance
ESG	Economic Scenario Generator
GAR	Guaranteed Annuity Rate
IAS	International Accounting Standard
IFRS	International Financial Reporting Standards
MA	Matching Adjustment
MAP	Matching Adjustment Portfolio
MCR	Minimum Capital Requirement
NED	Non-Executive Director

NNEG	No Negative Equity Guarantee
OB	Ordinary Business
ORSA	Own Risk and Solvency Assessment
PRA	Prudential Regulation Authority
PWC	PricewaterhouseCoopers, LLP
QRTs	Quantitative Reporting Templates
RFF	Ring-Fenced Fund
RNPFN	Royal National Pension Fund for Nurses
SCR	Solvency Capital Requirement
SF	Standard Formula
SFCR	Solvency and Financial Condition Report
SII	Solvency II
SII Directive	Refers to Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) unless another Directive is specified
TA Fund	Teachers Assurance Fund
TMTP	Transitional Measures on Technical Provisions
TPS	Teachers Provident Society (a RFF)
UK	United Kingdom
UWP	Unitised With-profits
VA	Volatility Adjustment

A. Business and Performance

A.1 Business

a) Name and legal form of undertaking

As at 31 December 2019, Liverpool Victoria Friendly Society Limited was a UK-incorporated and domiciled Friendly Society registered under the Friendly Societies Act 1992. On 2 January 2020, Liverpool Victoria Friendly Society Limited was converted to a company limited by guarantee registered under the Companies Act 2006, under the name Liverpool Victoria Financial Services Limited.

Registered office:
County Gates
Bournemouth
BH1 2NF
Telephone: 01202 292333

b) Name and contact details of the supervisory authority responsible for financial supervision.

Firm's reference number: 110035

The Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) are responsible for the financial supervision of LVFS, and the Group.

PRA
Address: 20 Moorgate
London
EC2R 6DA
Phone: 020 7601 4444

FCA
Address: 12 Endeavour Square
London
E20 1JN
Phone: 020 7066 1000

c) Name and contact details of the external auditor

The independent auditors are PricewaterhouseCoopers LLP

Address: 7 More London Riverside
London
SE1 2RT

d) Description of the holders of qualifying holdings in the undertaking

As LVFS is a mutual organisation, there are no external qualifying holdings within the meaning of the Solvency II regulations.

e) Details of the undertakings within the group

The material subsidiary undertakings of LVFS as at 31 December 2019 are as follows:

Name of Subsidiary	Principal activity	Percentage held
Frizzell Financial Services Limited	Property management	100%
Liverpool Victoria Financial Advice Services Limited	Financial advice services	100%
Liverpool Victoria Life Company Limited #	Life insurance	100%
LV Protection Limited #	Insurance	100%
LV Capital Limited	Holding company	100%
LV Equity Release Limited	Origination of equity release lifetime mortgages	100%
LV Life Services Limited	Management services	100%
LV Commercial Mortgages Limited	Commercial mortgages	100%
NM Pensions Trustees Limited	Self-invested personal pension (SIPP) administrator	100%
Teachers Property Limited	Property services	100%
Teachers Financial Services Limited	Insurance and financial intermediary	100%
Teachers Assurance Company Limited #	General insurance	100%
Teachers Management Services Limited	Management services	100%
Sovereign Unit Trust Managers Limited	Portfolio manager	100%
Wealth Wizards Limited	IT Software	70%
Wealth Wizards Benefits Limited *	Financial intermediary	70%
Wealth Wizards Advisers Limited *	Financial intermediary	70%

* Denotes indirect holdings # Denotes Solvency II regulated undertakings

The proportion of the voting rights in the subsidiary undertakings held directly by the parent company do not differ from the proportion of ordinary shares held. The Group and all principal undertakings are incorporated and domiciled in the UK.

All holdings are in relation to ordinary shares. Dormant companies have been excluded from the above list.

During the year, the LV= Group completed the sale of its remaining 51% stake in LV= General Insurance Group to Allianz Holdings plc.

f) Material lines of business and material geographic areas.

LVFS mainly underwrites life insurance contracts within the UK.

LVFS conducts life assurance business through its Life operating segment. The principal activity is the provision of life, pensions and investments products and managing the Heritage legacy book. The core products offered by the Savings and Retirement business are Fixed-Term Annuities, Self-Invested Personal Pensions (SIPPs), Equity Release Mortgages, Flexible Guarantee Bonds and ISAs. The core products offered by the Protection business are Life, Critical Illness and Income Protection Insurance. Heritage products include legacy with-profits business (both Ordinary Branch and Industrial Branch), the ring-fenced RNPFN Fund, containing the business acquired from the Royal National Pension Fund for Nurses in 2001, and the ring-fenced TA Fund, containing the with-profits business acquired from Teachers Provident Society Limited in 2016. The Heritage products are no longer actively marketed, although LVFS continues to sell newer with-profits products via the Life business channels.

g) Significant business or other events occurring during the reporting period that have a material impact on the undertaking.

Business and Performance

The income statement numbers presented in the table below are based on the IFRS Financial Statements.

LVFS Solo P&L (£m)	2019	2018
Gross earned premium	**655**	787
Premiums ceded to reinsurers	**(266)**	(246)
Net earned premiums	**389**	541
Investment income	**335**	363
Net gains/(losses) on investments	**1,065**	(612)
Other income	**25**	24
Total income	**1,814**	316
Net benefits and claims	**(755)**	(665)
Net change in contract liabilities	**(761)**	539
Finance costs	**(23)**	(23)
Net operating and administrative expenses	**(245)**	(196)
Total benefits, claims and expenses	**(1,784)**	(345)
Profit/(loss) before tax, mutual bonus and UDS transfer	**30**	(29)
Mutual bonus	**(27)**	(26)
Income tax (expense)/credit	**(61)**	31
Pension scheme actuarial loss net of tax	**(2)**	(27)
Transfer from the Unallocated divisible surplus	**(60)**	(51)

LVFS reported an IFRS profit before tax, mutual bonus and unallocated divisible surplus transfer for the year of £30m (2018: £29m loss). The increase is driven by the positive impact of short-term investment fluctuations of £129m (2018: £66m negative), partially offset by adverse model and basis changes of £46m (2018: £24m favourable), an increase in total expenses to £245m (2018: £196m) and a reduction in the contribution from new business as premiums fell.

For further information on the results, please refer to the LV= Annual Report.

Capital position and changes in risk profile

At 31 December 2019 the LVFS Solo capital surplus on a standard formula basis was £769m (2018: £704m) with capital cover of 185% (or 193% excluding the impact of the ring-fenced funds) (2018: 184% or 193% excluding the impact of the ring-fenced funds), see table below for further details. The results shown below include the closed ring-fenced funds. The closed ring-fenced funds did not require capital support at the valuation date.

£m	**2019**	2018	**Change**
Eligible Own funds	**1,678**	1,543	135
SCR	**909**	839	70
Surplus capital	**769**	704	65
CCR	**185%**	184%	1%

Eligible own funds include the (unaudited) impact of £388m Transitional Measures on Technical Provisions (TMTP) (2018: £490m). TMTP has reduced by £102m, made up of the annual amortisation of £38m (2018: £38m) and a £64m reduction following the industry-wide recalculation at the end of the year. TMTP provides transitional relief from the financial impact on technical provisions of moving to the Solvency II regime over a period of up to 16 years from implementation of Solvency II. TMTP is therefore amortised annually over 16 years from 2016 and is subject to regular industry-wide recalculations to reflect business and economic change.

LVFS's risk profile and capital position was affected in the year by the following:

- **One-off impact from the sale of the general insurance business (increase in surplus capital of £205m, before TMTP recalculation).**
  - As at 31 December 2019 LVFS sold its remaining 51% holding in its general insurance business to Allianz. LVFS received £563m of premium in return for its 51% holding of the GI subsidiaries which was valued at £236m on the LVFS Solo balance sheet. In addition, LVFS incurred approximately £50m of costs in relation to the transaction.
  - The LVFS Solo SCR has increased by approximately £70m following the transaction. The total assets held in subsidiaries have increased following the general insurance sale as the premium received, which is currently held in a subsidiary, is greater than value of the general insurance holding on the balance sheet prior to sale. The value of subsidiaries is stressed as an equity holding in the Solo SCR. Hence, this increase in asset value drives the increase in equity risk in the Society's SCR.
  - When the premium is paid up from the subsidiary into LVFS there will be a significant reduction in LVFS Solo SCR. This is expected to occur during 2020.
- **TMTP Amortisation and Recalculation (reduction in surplus capital of £102m).**
  - The largest contributors to this were model and basis changes and management actions of -£68m and the annual TMTP amortisation of -£38m (unaudited).
    - The model and basis changes and management actions impact is largely driven by reductions in Solvency II Risk Margin which are not reflected under Solvency I, hence causing a reduction in TMTP.
    - The TMTP amortisation is the annual write-down of TMTP such that it fully expires after 16 years.
  - TMTP is typically recalculated biennially and therefore the recalculation impact is driven by items occurring in both 2018 and 2019. For example the total contribution of economic variances to the TMTP recalculation is minimal, but this is driven by a contribution of -£67m (unaudited) in 2018 offset by a contribution of +£69m (unaudited) in 2019. These offsetting movements are largely driven by the inverse direction of interest rates and corporate bond credit spread movements over the two years.
- **Economic impacts over 2019 (reduction in surplus capital of £65m, before TMTP recalculation).**
  - Interest rate exposure across the life business continues to be managed on a post-TMTP recalculation basis. This gives rise to interest rate exposure and gilt spread exposure on a pre-TMTP basis, leading to a reduction in surplus when interest rates fall as has happened this year. When including the above +£69m(unaudited) of TMTP recalculation the economic impact is +£4m, illustrating the above point that interest rate exposure is managed on a post-TMTP recalculation basis.

Key elements of LVFS's capital management strategy during the year were as follows:

- Interest rate exposure across the Life business is managed on a post-TMTP recalculation basis. This gives rise to interest rate exposure and gilt spread exposure on a pre-TMTP basis.
- LVFS has exposure to equity markets via annual management charges and cost of smoothing and guarantees. This exposure has been reduced further over 2019 by increasing the scope of internal hedging arrangements. External hedges also remain in place.

A.2 Underwriting performance

Underwriting performance by line of business compared to the previous reporting period

The following tables provide further information on IFRS underwriting income and expenses analysed by material lines of business.

All business is underwritten in the UK.

Net earned premiums

Gross earned premiums	2019 £m	2018 £m
Long-term insurance and participating investment contracts		
Single premium		
New business		
Investments and savings	**169**	354
Pensions and annuities	**223**	170
Regular premium		
New business		
Life and health protection	**32**	33
Existing in-force business		
Investments and savings	**24**	28
Pensions and annuities	**7**	8
Life and health protection	**200**	194
Gross earned premiums	**655**	787
Premiums ceded to reinsurers		
Long-term insurance premiums	**(266)**	(246)
Net earned premiums	**389**	541

2019 gross earned premiums of £655m fell by 17% compared to 2018. The reduction in Investment and savings new business premiums is driven by the significant slowdown in defined benefit to defined contribution transfers following renewed guidance to advisers from the Financial Conduct Authority which impacted the wider market. In addition the performance of the flagship flexible guarantee (smoothed) fund range was adversely impacted by asset allocation earlier in the year. Changes were made at mid-year to make the strategic asset allocation more globally balanced, performance began to recover although volumes inevitably suffered and the full effect of the actions taken are only expected to be seen during the first half of 2020.

Net benefits and claims

	2019			2018		
	Gross £m	Reinsurance £m	Net £m	Gross £m	Reinsurance £m	Net £m
Long-term insurance and participating investment contracts						
Benefits and claims paid	**999**	**(254)**	**745**	895	(232)	663
Change in the provision for claims	**19**	**-**	**19**	8	-	8
Fair value adjustment to reinsurance receivables	**-**	**(9)**	**(9)**	-	(6)	(6)
	1,018	**(263)**	**755**	903	(238)	665

2019 net benefits and claims of £755m have increased by 14% compared to 2018. This is mainly caused by the increase in maturities relating to Flexible Guarantee Bonds, driven by the large increases in sales of these products five years ago.

Net change in contract liabilities

	2019 £m	2018 £m
Gross (increase)/decrease in long-term contract liabilities		
(Increase)/decrease in long-term insurance contract liabilities - participating	**(239)**	187
(Increase)/decrease in investment contract liabilities - participating	**(65)**	55
(Increase)/decrease in long-term insurance contract liabilities - non-participating	**(45)**	101
(Increase)/decrease in investment contract liabilities - non-participating	**(414)**	135
(Increase)/decrease in long-term linked insurance contract liabilities	**(1)**	34
	(764)	512
Mutual bonus	**27**	26
	(737)	538
(Decrease)/increase in long-term contract liabilities ceded to reinsurers		
(Decrease)/increase in long-term insurance contract liabilities relating to non-participating contracts	**(89)**	51
Increase/(decrease) in long-term insurance contract liabilities relating to participating contracts	**60**	(36)
Decrease in long-term linked insurance contract liabilities	**(1)**	(24)
	(30)	(9)
Increase in non-participating value of in-force business	**6**	10
Net change in contract liabilities	**(761)**	539

The gross increase in long-term contract liabilities for 2019 was £737m (2018: £538m decrease). This increase is mainly due to the higher levels of policyholders' investment gains, following favourable movements in the UK and overseas stock markets and interest rate changes driving increases in gilts and bonds values. These gains are partially offset by the excess of benefits and claims over premiums.

Other operating and administrative expenses

	2019 £m	2018 £m
Commission paid on acquisition of business	**52**	50
Amortisation and impairment of intangible assets	**3**	3
Depreciation on property and equipment	**3**	2
Loss on disposal of property and equipment	**1**	-
Investment management expenses and charges	**13**	10
Auditors' remuneration	**1**	1
Employee benefits expense	**96**	101
Management charge allocated to group undertakings	**(57)**	(58)
Rent, rates and other facilities expense	**10**	9
Marketing and advertising	**6**	7
Other staff costs	**34**	20
IT costs	**39**	25
Fees	**38**	27
Other expenses	**10**	3
Claims handling cost recognised in Gross benefits and claims	**(4)**	(4)
Net operating and administrative expenses	**245**	196

2019 net operating and administrative expenses of £245m have increased by 25% compared to 2018. Although operating expenses reduced slightly, there were significant increases in other staff costs, IT costs and fees relating to restructuring activities and other one-offs.

Solvency II lines of business

In addition to the above, the material Solvency II lines of business by reference to IFRS gross written premiums, a component of underwriting performance, are outlined below based on gross written premium analysed within the Quantitative Reporting Template (QRT) S.05.01.02, which is annexed to this SFCR.

Life insurance

LVFS's long-term business segment, which represents 100% of total gross premiums written, includes participating insurance and investment business and non-participating insurance and investment business. The material life insurance Solvency II lines of business for the year ended 31 December are as follows, based on contribution to life insurance business gross written premiums:

Life insurance	**2019**	2018
Insurance with-profit participation	**19%**	31%
Index-linked and unit-linked insurance	**39%**	37%
Other life insurance	**36%**	27%
Health	**6%**	5%

Gross written premiums collected under non-participating investment contracts are deposit accounted rather than accounted for through the income statement under IFRS.

A.3 Investment performance

Income and expenses with respect to investment activities

Components of investment activities

Investment income is reported consistently with IFRS. Investment income includes dividends, interest from investments at fair value, interest on loans and receivables and interest on loans secured on residential and commercial property. Dividends are recorded on the date on which the shares are declared ex-dividend.

Realised gains and losses on investments are calculated as the difference between net sales proceeds and purchase price.

Unrealised gains and losses on investments represent the difference between the valuation of fair value assets at the Statement of Financial Position date and their valuation at the previous Statement of Financial Position date or, where purchased during the year, the purchase price. An adjustment is made to unrealised gains and losses for the prior year's unrealised element included in the current year's realised gains and losses.

Investment management expenses and charges of £13m (2018: £10m) are reported in Other operating and administrative expenses. These expenses are directly attributable to investment activities.

Investment performance

The following tables summarise the investment performance, on an IFRS basis:

Investment income

LVFS	**2019 £m**	2018 £m
Income from investments at fair value through income:		
- Dividend income	**112**	113
- Interest income from debt and fixed interest securities	**131**	141
- Interest on loans secured on residential property	**33**	34
- Interest on loans secured on commercial property	**9**	8
Dividend income from group undertakings	**50**	67
Total investment income	**335**	363

Net gains/(losses) on investments

	2019 £m	2018 £m
Investment properties	**-**	1
Investments at fair value through income:		
- Debt securities	**210**	(160)
- Equity securities	**812**	(432)
- Loans and mortgages	**23**	(6)
- Other	**-**	(3)
Derivatives at fair value through income	**22**	(5)
Investments in group undertakings	**(2)**	(7)
Total gains/(losses) on investments	**1,065**	(612)

Gains on investments of £1,065m (2018: £612m losses) are driven by favourable market movements, especially on equities. Included within net gains/(losses) on investments are realised gains of £384m (2018: £253m).

Investments in securitisation.

There are no material investments in securitisation (2018: £nil).

A.4 Performance of other activities

The results of other activities are as follows:

Finance costs

	2019 £m	2018 £m
Interest expense on subordinated liabilities	**23**	23
	23	23

In 2013 LVFS issued £350m of Fixed Rate Reset Subordinated Notes at par. The directly related costs of £4m incurred to issue the Notes have been capitalised as part of the carrying value and are being amortised using the effective interest rate basis over the period to the first call date in 2023. The effective interest rate on the £350m liability is 6.654% resulting in a £23m finance charge for the year.

The Notes have a maturity date of 22 May 2043 but the issuer has the option to redeem the Notes at the first call date of 22 May 2023 and at five yearly intervals thereafter up to the maturity date.

Interest is payable on the Notes at a fixed rate of 6.5% (£23m) per annum for the period until the first call date on 22 May 2023, payable annually in arrears on 22 May each year. If the Notes are not redeemed on 22 May 2023, the interest rate is reset on that date and at five yearly intervals thereafter at a rate equal to the five year gilt rate quoted on the day before the reset date plus an initial margin of 463 basis points and a step up margin of 100 basis points.

Other income

	2019 £m	2018 £m
Asset management charges	**22**	19
Other fee income	**3**	5
	25	24

Other income is mainly made up of asset management charges relating to policyholder pension business and is broadly in line with 2018 at £25m.

Leasing arrangements

LVFS has leases in place for a small number of regional offices. At 31 December 2019 right of use assets held by LVFS are £3m and lease liabilities are £5m. Right of use assets and lease liabilities are unwound over the lease terms which, on adoption of IFRS 16, averaged 5 years for regional offices. Lease rentals are typically renegotiated every 5 years to market rentals and include break clauses for additional flexibility.

A.5 Any other information

The emergence of the Coronavirus represents a new uncertainty for 2020. At the time of writing the development of the virus in the UK and actions planned to contain it are uncertain and fast-moving. We have developed and put in place contingency plans to minimise business disruption. While new business will continue to be written where possible, it is anticipated that new business volumes could be below plan for 2020, with consequential impacts for expense reserves.

LVFS is well protected from recent economic impacts, with our stress testing demonstrating that we are resilient to yield and equity impacts. However, LVFS is managed on a Solvency II basis and the majority of hedging arrangements have been set up accordingly. This means that on an IFRS basis, LVFS is not fully protected from some of the current market movements being experienced, in particular the negative impact from widening credit spreads.

B. System of Governance

The Directors of LVFS during the year were as follows:

A. Cook	A. Hutchinson
R. Rowney – resigned 31 December 2019	L. Savage
D. Neave	W. Snow
D. Barral	T. Lawler
A. Parsons – resigned 17 October 2019	
C. Ledlie	

Tanya Lawler resigned from the board on 29 January 2020 and Seamus Creedon was appointed as a Non-executive director on 16 January 2020.

Following the resignation of Richard Rowney as Chief Executive Officer at the end of the year, Mark Hartigan was appointed as interim chief executive officer on 1 January 2020, subject to regulators' approval. Alan Cook, LVFS Chairman, has assumed the regulatory responsibilities of the chief executive officer pending the regulatory approval of the new chief executive officer.

This section outlines how LVFS is directed and controlled, and provides an overview of the LVFS system of governance. It also describes the remuneration policy and practices, and adherence with the 'Fit and Proper Requirements', which is the regulatory standard required when appointing those who effectively run the organisation or have other key functions.

The Board is committed to high standards of corporate governance, which it believes are critical to business integrity and performance. The Board believes that implementing an effective Risk Management System is fundamental to achieving these high standards, and this section describes how this works in detail.

Unless otherwise stated, the risk management and internal control systems described in this section are implemented consistently across LVFS and its subsidiaries.

Adequacy of the governance structure

LVFS monitors and assesses its system of governance on an ongoing basis. There have been no significant findings during the reporting period which have indicated to the Board that the system of governance is not adequate. The Board has adopted a governance structure based on the principles and provisions of the Financial Reporting Council's UK Corporate Governance Code (the 'Code'). The Board has confirmed its compliance with the Code and the Board believes that its practices are consistent with the principles of the Code and are appropriate and suitable for LVFS and its members.

B.1 General information on the system of governance

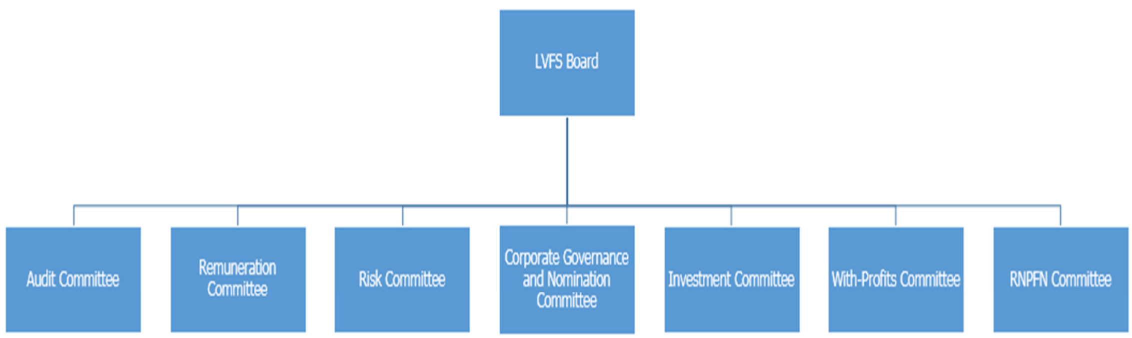
Governance structure

Liverpool Victoria Financial Services Limited (LVFS) is the ultimate parent undertaking of LV=. The LV= Board is ultimately accountable to the members and exercises stewardship over its subsidiaries through its right to appoint subsidiary board members and through the reservation to LV= of certain matters in the constitutions of the subsidiaries (the Articles of Association).

The LV= Board is comprised of an independent non-executive chair, independent non-executive directors and executive directors. The directors collectively have the appropriate balance of skills, knowledge and experience in the financial services industry, in particular life insurance, investments, risk and governance. Following the announcement of the departure of our chief executive Richard Rowney, on 11 December the chair assumed the regulatory responsibilities of the chief executive officer pending the regulatory approval of a new chief executive officer.

In setting its governance arrangements, the Board either reserves decision making powers to itself, or delegates these powers to a Board approved sub-committee or the Chief Executive Officer. A full description of the Board's role and responsibilities is set out in the Governance section of the 2019 LV= Annual Report.

The following chart illustrates the governance structure:



During the period up to completion of the strategic partnership transaction with Allianz on 31 December 2019, the LV= Board and the Chief Risk Officer retained overall responsibility for the management of risk within the General Insurance business.

The LV= Board have overall responsibility for the Group's risk management, internal control and reporting systems. Accordingly, they ensure that Group-wide requirements across all these areas are set on a consistent basis throughout the business.

Within its Systems of Governance, the LVFS Board has adopted a Three Lines of Defence model with key oversight functions being Risk, Compliance, Financial Crime, Actuarial and Internal Audit. In setting up these functions, the Board has ensured that:

- They are free from influences that may compromise their ability to undertake duties in an objective, fair and independent manner.
- Each function operates under the ultimate responsibility of, and reporting to, the Board.
- They have the necessary authority, resources and expertise, as well as unrestricted access to all relevant information necessary to carry out their responsibilities.

The scope, authority and responsibility for each of the Three Lines of Defence is set out in a Board-approved Risk Mandate, which is included as part of the Risk Strategy. The Mandate, in conjunction with the Risk Operating Model, confirms how each function achieves independence and how potential conflicts of interest are managed.

The following table summarises the key roles and responsibilities for each function:

Risk Management function	The Risk Management function sets the strategic direction on risk matters and provides oversight of the operation of the Risk Management Framework (LV=RM) across LVFS. Risk Management activity is an enabler for the business achieving its goals. To ensure that there is a cohesive and co-ordinated approach to managing risk, the various resources across LVFS must be deployed efficiently and effectively in order that risks and exposures are identified, managed and mitigated. LVFS's approach to risk management and risk governance is based upon the 'Three Lines of Defence Model'. The LV= Risk Strategy provides an in-depth overview of the mandate of the Risk Management function and the 'Three Lines of Defence Model'. A detailed account of all Risk Management activity is provided in section B.3.
Compliance function	The Compliance Function reports to the Chief Risk Officer. The Compliance function is a fundamental element of the Second Line of Defence, with key compliance responsibilities included in the following roles: • Director of Regulatory Risk reports to the Chief Risk Officer and whose primary responsibilities relate to advising on conduct risk compliance and oversight of non-prudential regulatory change. The Chief Risk Officer retains accountability for advising the business on compliance with prudential risk matters, including the impact of prudential regulatory change on the Group's risk profile. • The Group Compliance team reports to the Director of Regulatory Risk and is responsible for designing and facilitating the implementation of the Regulatory Risk Management Framework. Further details of Compliance Function responsibilities and activities are included within section B.4.
Actuarial function	The Actuarial Function forms part of the Second Line of Defence led by the Chief Risk Officer. The Actuarial Function: • Provides oversight and challenge to the calculation of the technical provisions of the Group and reports to the relevant governance committees on the appropriateness of the methodologies, models, assumptions and data used. • It also reports on the appropriateness of the underwriting and reinsurance policies and arrangements applied. Further details are provided in section B.6.
Internal Audit function	Internal Audit act as the third line of defence. The internal audit team provides independent and objective assurance to the Audit Committee and to the executive team on the effectiveness of the systems of risk management and internal controls across the business. A detailed account of the function's operations and responsibilities is provided in section B.5.

Remuneration

The Group has a Remuneration Committee consisting of non-executive directors of the Board. Its main responsibilities are to recommend to the Board the policy on the structure of remuneration across the Group; determine and oversee the design and implementation of the Remuneration Policy and associated remuneration practices for executive directors and senior management; to determine specific remuneration packages for executive directors and senior management; and to oversee the policy, design and governance of variable remuneration schemes across the Group, including sales incentive schemes.

The Remuneration Policy is designed to support LV='s strategy, promote long-term sustainable success and seeks to align remuneration with performance. Variable remuneration, with the amount paid linked to performance, forms an important part of the remuneration package for all employees. All employees are eligible to participate in the annual bonus, with the total pool to be shared amongst all employees calculated based upon Group performance. Group performance for the purposes of determining the annual bonus pool is assessed based upon the Balanced Scorecard with a mix of financial and non-financial performance conditions.

Each person's bonus amount is determined based on their individual performance. For more senior employees, a proportion of any bonus award may be deferred and paid out in a later year, ensuring that the executives remain focused on both the short and long-term health of the business.

Senior employees also participate in the Long-Term Incentive Plan (LTIP). The final value of an LTIP award is determined based upon long-term performance conditions measured over a three year period. The LTIP therefore incentivises senior employees and rewards them for delivering the strategic priorities and strong business performance over the long-term.

The full Report on Directors' Remuneration can be found in the 2019 LV= Annual Report.

B.2 Fit and proper

Everyone employed by the LV= Group needs to meet defined criteria for being Fit and Proper as defined in the Fit and Proper Policy, which is owned by Group Human Resources. This policy requires that everyone meets the following principles:

- Honesty, integrity and reputation.
- Competency and capability.
- Financial soundness.

Key management personnel of the Company are aligned to the FCA/PRA Senior Managers and Certification Regime and include Board members as well as Senior Management Function holders within Risk Management, Internal Audit, Compliance, Actuarial, the Money Laundering Reporting Officer and other roles seen as being a Significant Management Function. Collectively, these personnel possess professional qualifications, experience and knowledge in multiple areas.

These include, but are not limited to:

- Business strategy, including financial and actuarial analysis
- Regulatory framework and requirements
- System of governance and risk management
- Insurance and financial markets
- Information technology and project management

A standard recruitment process exists, which is based on multiple factors including consideration of experience, skills, qualifications, behaviours and attitude. The Referencing Minimum Standard establishes the key checks to be performed to ensure that candidates meet the Fit and Proper standards.

The following key checks are completed:

- 2 year employment history
- Right to work in the UK
- 5 year address history
- Fraud checks
- Credit checks
- Sanctions checks
- Qualification checks (depending on role)

An application to the FCA/PRA is required when recruiting Senior Management Function Holders and the organisation conducts additional checks for these roles including:

- 6 year regulatory employment history
- Completion of fitness, propriety and conflicts of interest questions
- FCA/PRA prohibitions
- Directorships
- Criminal Records Bureau (For Senior Manager Function only)

All referencing for any Senior Manager Functions, Key Function Holders and Certified Staff need to be completed prior to commencement of employment.

On an annual basis, a Fitness, Propriety and Conflicts of Interests attestation is conducted for all Senior Manager Functions, Key Function Holders and Certified Staff. This check includes directorships, financial soundness and conflicts of interest.

B.3 Risk management system

LV= operates a fully integrated risk management framework we call the LV=RM. This framework brings together the key processes and activities undertaken throughout the business to ensure that our customers' and members' security is at the forefront of our decision making. Structuring engagement, risk management and our values around this framework enables senior management to demonstrate that the right things are being done to manage risks within the business.

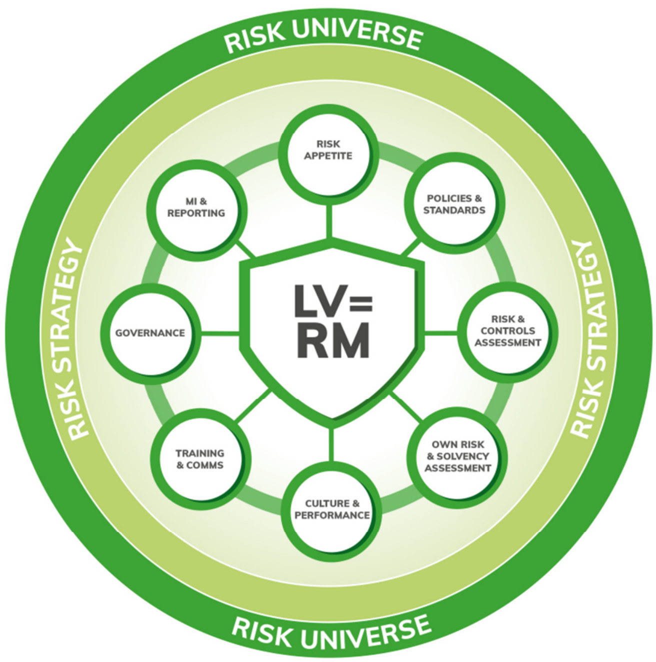
The board are responsible for determining the risks that the business faces and ensuring that these are appropriately controlled. Our risks include those that affect the business model and future performance, those which threaten policyholder security and those which could have a detrimental impact upon member outcomes.

The board carries out this responsibility by ensuring that LV=RM continues to include the setting of a proportionate risk strategy, risk appetite and a clear risk mandate and organisational design. The Risk Committee, on behalf of the board, regularly monitor the operation and effectiveness of the LV=RM to ensure that it continues to drive a suitably robust risk culture within LV=.

Risk Management Framework

The LV=RM framework is owned by LV='s chief risk officer on behalf of the board. It provides a systematic set of processes, tools and behaviours which allow senior management to respond effectively to any potentially significant internal or external event that may have an impact on delivering the business strategy. The LV=RM further enables us to enhance our business and risk based decisions, whilst ensuring that as an insurance business we remain compliant with all regulatory and legislative requirements, as well as internal policies.

The risk universe, risk strategy and the eight key elements of the LV=RM are summarised below and on pages 26 to 28



Risk universe

As an insurance provider, we are exposed to both financial and non-financial risks, with profitability and growth dependent upon the proactive management of these risk types. As we continue to structure and run the business as a mutual organisation in accordance with our values, we have put in place a detailed risk hierarchy which breaks down the financial and non-financial risks into a set of high level risk categories supported by a series of more detailed risks.

The high level risk categories which we are exposed to are:

Financial risks:

- Life insurance risk
- Financial markets risk
- Credit counterparty risk
- Liquidity risk

Non-financial risks:

- Strategic risk
- Conduct risk
- Operational risk

Clear executive accountabilities for managing each of these high level risks have been articulated and agreed at the Risk Committee.

Risk strategy

Operating in a complex and highly regulated market, we are exposed to a wide range of risks from past, present and future activity. Our risk strategy is aligned with the business strategy and ensures that an effective approach to risk management is in place, in line with business and financial goals. This risk strategy seeks:

- To inform the board in setting a robust risk appetite which ensures that the business model and strategy are designed and executed in a controlled manner to safeguard member value.
- To drive a strong risk culture that ensures the business is managed in line with the board's risk appetite.

The risk strategy and associated LV=RM is reviewed on at least an annual basis as part of the broader strategic planning process and considers changes in both the internal and external environment.

Risk governance

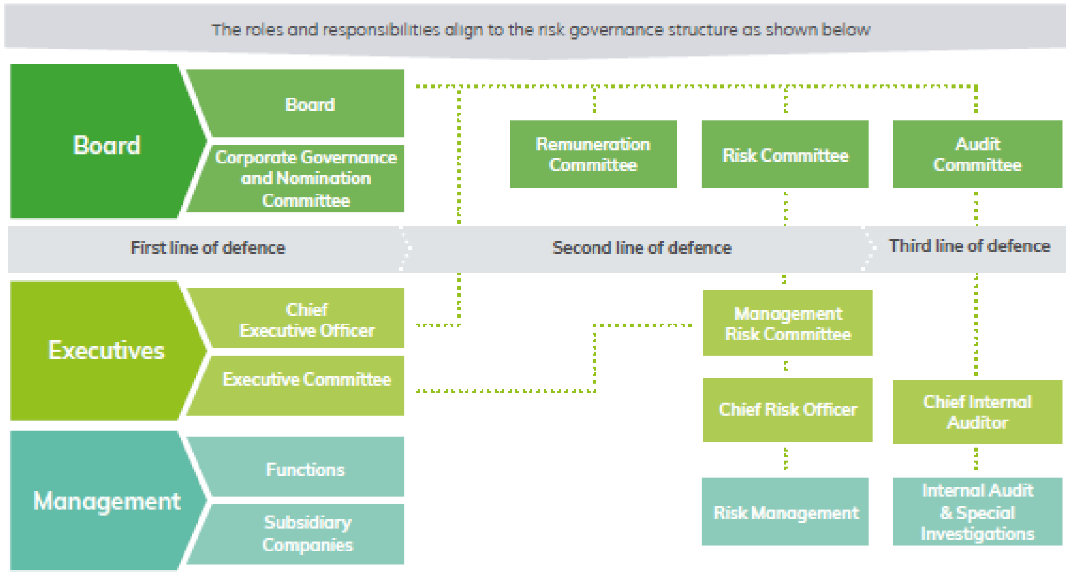
We operate a three lines of defence model as part of our day-to-day risk management operations, as prescribed within a board-approved risk mandate. The board delegates much of its oversight of risk matters to the Risk Committee, which together with the Management Risk Committee, the chief risk officer and the risk management teams, ensures that the business is operating in line with the requirements of the LV=RM.

The roles and responsibilities for the three lines of defence model are included within the risk strategy. Ownership of risk within this model is managed across all levels of the business and is summarised as follows:

- **First line of defence:** led by the chief executive officer who is supported by the executive and senior leadership team. The executive team are accountable for the management of risks and are required to identify, assess, manage and report on the risk profile on a current and forward looking basis. Sound risk management tools, practices and knowledge facilitate informed business decision making in accordance with the LV=RM, and in particular our risk appetite.

- **Second line of defence:** led by the chief risk officer who is supported by the risk management team, compliance and actuarial functions and other risk management professionals across the business. The risk management team develops and directs the implementation of the LV=RM. It also monitors, reviews and challenges first line compliance with this framework and escalates material breaches to the board.

- **Third line of defence:** led by the chief internal auditor who is supported by the internal audit team and the Audit Committee. The internal audit team provides independent and objective assurance to the Audit Committee and to the executive team on the effectiveness of the systems of risk management and internal controls across the business.



Subsidiary board committees are subordinate to the board and are excluded from this diagram.

Risk appetite

The board risk appetite comprises a suite of quantitative and qualitative statements that are used to measure current and future business performance and cover five broad dimensions:

- Overall attitude to risk
- Financial
- Conduct
- Operational and transformation
- Regulatory and stakeholder engagement

Each of these appetite statements provides direction to senior management regarding their priorities in the execution of the risk strategy and where appropriate, are underpinned by a suite of more granular supporting measures, limits and triggers. These risk appetite statements are reviewed at least annually and are embedded within the operation of the LV=RM. Clear governance exists in respect of ownership, oversight and the treatment of risks which are considered to be outside of risk appetite. Operation of the risk appetite methodology is evidenced through the provision of clear and timely management information which delivers insight to senior management and helps to drive robust and well informed risk based decision-making.

Risk policies and standards

A suite of risk policies that have been approved by the board (plus associated supporting policies and standards) are in place which document both the board's requirements, as well as our senior management's approach to meeting those requirements. Policy owners are aligned to our high level risk categories and have individual accountability for delivering ongoing effective risk management in accordance with the overall direction set by the board.

The second line risk management function maintains the integrity and consistency of the policy suite on behalf of the board. Ongoing policy compliance is considered through regular risk and control self-assessment and through annual risk and controls attestation.

Risk and control assessment

We undertake a quarterly assessment of our key risks and controls to determine whether the risk and control environment is appropriately defined, is operating in line with expectations and that the first line risk teams understand the key exposures within their business area. There is an LV= wide process for the identification, escalation and remediation of risk events and control failures. In addition, independent risk-based assurance reviews are undertaken on a regular basis by both the second and third lines in order to confirm that the overarching LV=RM processes are working effectively.

Own risk and solvency assessment (ORSA)

The ORSA is an integral part of our capital management processes and the overall LV=RM. The ORSA comprises iterative internal risk and capital assessment processes operated throughout the year to monitor ongoing risk exposures relative to appetite, and to ensure solvency and liquidity needs are met on both a current and forward-looking basis. These processes support the implementation and embedding of the LV=RM and include:

- Risk strategy and risk appetite
- Risk identification, assessment and measurement
- Risk monitoring and reporting
- Linking back to business strategy
- Stress and scenario testing

The ORSA is an effective tool used to inform strategic decision-making. The annual ORSA Report is presented to the board and consolidates the findings from the ORSA processes. The ORSA report also includes key outcomes, for example, from the risk review of the business financial plan, stress and scenario testing (including reverse stress testing), the assessment of the appropriateness of the Standard Formula, and regular solvency and risk exposure monitoring. The solvency position of the business is determined in accordance with the Solvency II Standard Formula requirements and the 2019 ORSA report which was finalised in August.

Culture and performance

The LV=RM has been designed to ensure the embedding of a strong, behavioural based risk culture across the business. This is driven by a distinct tone from the top and its application forms part of our remuneration policy. The operation of the LV=RM is assessed on an annual basis and is part of the inputs to employee variable remuneration. Risk performance features as part of an overall balanced scorecard and on an individual basis via a risk adjusted remuneration process, which is overseen by the Remuneration Committee.

Training and communication

A programme of training and communication is in place to ensure that the components of the LV=RM are understood and applied consistently across the business. This training and communication is targeted at all levels to ensure that everyone has an appropriate level of understanding of the framework requirements which apply to them. The programme includes board and executive training but also includes components that are used in the induction of new colleagues joining LV=.

Management information and reporting

Regular, relevant and timely risk reporting is in place across all three lines of defence to demonstrate the operation of the LV=RM. As part of the development of this management information, the Risk Committee has helped to define the report structure and content. This is to ensure that the material provided to them contains information which is sufficient and appropriate so they can exercise their oversight responsibilities.

Risk management effectiveness

We conduct an annual risk maturity and culture assessment to gauge the effectiveness of the embedding of the LV=RM and to test how risk culture is evolving over time. The outputs from this assessment are used to determine areas for further development under our programme of continuous improvement.

B.4 Internal control system

The internal control system includes a range of functions, roles and activities that collectively ensure an appropriate control environment for the business. It enables us to operate efficiently and respond to any significant or evolving risks that could prevent or limit the achievement of our business objectives, through implementing the following requirements:

- Control Environment: The setting of a robust control environment and business culture.
- Risk Identification: Maintaining the LV= RM and associated procedures which enable the identification of all material risks to the achievement of our business objectives.
- Risk Assessment: Operating a Risk Management System and procedures which enable the assessment, control and reporting of all material risks and the assessment of controls to manage these risks within risk appetite.
- Control Activities: Having in place business processes/procedures that provide assurance that all necessary control activities are in place and are working effectively.
- Control Standards: Having a policy framework and policy suite that are fit for purpose and provide the Board's minimum requirements for the management of Operational, Financial and Conduct controls.
- Information and Communication: Ensuring clear information and communication in respect of our internal control systems, including responsibilities and core risk management objectives.
- Monitoring Activities: Performing periodic and regular attestation reviews of the effectiveness of Operational, Financial and Conduct controls across the business, and reporting on the status of control design and performance through regular risk assessment processes.

Compliance with these requirements will support an integrated and standardised approach to establishing and maintaining an effective and efficient internal control system.

Group compliance

The Compliance function is a fundamental element of the Second Line of Defence, with key compliance responsibilities included in the following roles:

- Director of Regulatory Risk reports to the Chief Risk Officer and whose primary responsibilities relate to advising on conduct risk compliance and oversight of non-prudential regulatory change. The Chief Risk Officer retains accountability for advising the business on compliance with prudential risk matters, including the impact of prudential regulatory change on the Group's risk profile.

- The Group Compliance team reports to the Director of Regulatory Risk and is responsible for designing and facilitating the implementation of the Regulatory Risk Management Framework.

The Group Compliance Policy sets out mandatory requirements to reasonably assure that the Group remains compliant with the legal environment within which it operates, and remains within Risk Appetite. It includes the principles by which the compliance system is designed and operated, and sets out the key components of the system that support understanding and effective operation across the Group.

The policy is owned by the Director of Regulatory Risk, who is responsible for ensuring that it is produced and kept current and is reviewed by all SBUs and SSUs prior to formal approval submission. It is approved by the Chief Risk Officer who is accountable for ensuring maintenance of the policy content as well as supporting policies, processes and procedures.

The policy requires that Group Compliance implement and maintain a Regulation and Legislation Matrix which sets out individual departmental responsibilities for compliance. Each such department is required to:

- Establish a robust compliance system to identify and assess the impact of new requirements or changes to requirements in the legal environment.
- Advise the Board, senior management and other personnel regarding changes to the legal environment, as appropriate.

In addition, Group Compliance is responsible for developing and implementing:

- **Compliance Plan**: An annual compliance plan which oversees the implementation of changes to the legal environment and strategic priorities of the Compliance function, to feed the Group Risk annual plan for review and approval by the Management Risk Committee and the Board Risk Committee.

- **Compliance Monitoring Plan**: An annual risk-based compliance monitoring plan which sets out the key independent assurance activities to be undertaken, for review and approval by the Board Risk Committee.

B.5 Internal audit

Internal Audit

The purpose of IA is to add value to LV='s business through facilitating the identification and management of risk, influence positive change by delivering independent strategic insight and confidence with a responsibility to report key conclusions to the Audit Committee. Throughout the year, the Chief Internal Auditor regularly meets with the Audit Committee Chair to provide updates on the work of Internal Audit.

At each Audit Committee, the Chief Internal Auditor will provide a report on:

- The delivery of the Audit Plan for the year and any proposed changes to the plan.
- Key findings from audit reports and any emerging themes across the business.
- The status of management's implementation of agreed improvement actions.
- The assessment on the quality of the internal control environment, including its financial reporting process, and its overall risk culture.

Internal Audit undertakes an annual planning exercise to determine which activities and controls should be subject to audit review over the following year. The audit plan is set by reference to the audit universe, the principal risks facing the business, any emerging risks and hot topics for auditing reported at an industry level. The Audit Committee reviews and approves the scope and content of the plan.

During 2019, Internal Audit provided assurance to the Audit Committee, through the delivery of audit reports, over all areas that included but were not limited to:

- Business Continuity Planning and Operational Resilience
- IT Systems Separation
- Transformation management
- Risk Management Framework Effectiveness
- Insurance Distribution Directive
- Investment Portfolio Oversight

Following each review, any control weaknesses are discussed and agreed with management. Management is responsible for designing and implementing action plans to address the issues highlighted. The actions arising are tracked to ensure timely completion and reported to the Audit Committee. In addition, the reviews highlight any themes emerging across the audit findings and allow the Committee to challenge the management response and monitor the resolution of action plans.

Independence and Objectivity

The effectiveness and independence of internal audit is evaluated on an annual basis by the Audit Committee to ensure that the function has the relevant experience, expertise, objectivity and quality to add value to the business. In accordance with Institute of Internal Auditors' requirements, a cyclical external review was undertaken by BDO in December 2019. The purpose of this review was to:

- Determine whether internal audit's opinions are robust and reliable.
- Confirm that internal audit is focused on the areas of strategic importance and material risk of the business.
- Assess the content and progress of the internal audit improvement plan.
- Conclude on the plans in place to safely deliver internal audit separation and exit from the agreement to provide central services to the general insurance business.

The review concluded that:

- Internal audit opinions are robust and reliable - no material gaps were identified with regards to the robustness and reliability of the internal audit report opinions that were reviewed.
- Internal audit is focused on the areas of strategic importance and material risk of the business; due to the strategic change programme being undertaken by LV=, the internal audit plan was considered risk based, focused on strategic change and aligned to the current key risks within the business.
- The internal audit improvement plan and internal audit separation and exit from the agreement to provide central services to the general insurance business was considered as part of the wider review and no material issues were identified as part of the review performed.

B.6 Actuarial function

The Actuarial Function forms part of the Second Line of Defence led by the Chief Risk Officer, who reports directly to the Chief Executive Officer.

The Actuarial Function provides oversight and challenge to the calculation of the technical provisions of the Group and reports to the relevant governance committees on the appropriateness of the methodologies, models, assumptions and data used. It also reports on the appropriateness of the underwriting and reinsurance policies and arrangements applied.

The methodology and assumptions used in the calculation of the Life Insurance technical provisions are proposed by the Actuarial Analysis and Reporting teams who also perform the calculation. These teams sit within the Group Finance Function, reporting to the Group Finance Director, independently of the Chief Risk Officer. The proposed methodology and assumptions are reviewed by the Life Chief Actuary, as are the technical provisions themselves. The methodology, assumptions and results, along with the independent Actuarial Function reviews, are considered subsequently by the Audit Committee, before being recommended to the LV= Board for approval.

The Actuarial Function also provides advice and guidance to the Chief Risk Officer on the operation of the Risk Management Framework, especially the Capital Management Framework. This includes assistance with the oversight of risk exposures and advice on various capital management initiatives.

B.7 Outsourcing policy

To ensure a consistent approach across the Group, the Group maintains an Outsourcing and Sourcing Policy. This policy is reviewed on an annual basis and sets out detailed requirements on areas including:

- overall sourcing strategy
- supplier assessment criteria
- principles for identifying critical and important relationships
- contractual and operational requirements and ongoing supplier relationship management.

Critical or important operational functions or activities which have been outsourced

In line with other large financial services organisations, the Group has a number of critical or important external suppliers and service providers. These provide support for asset management, IT application and maintenance and system hosting.

These partners provide several benefits for the Group, including cost efficiency and access to improved technology within the Group's administrative capability. Wherever processing or specialist work is undertaken by these partners, the Group remains fully responsible for the oversight, management and performance of the outsourced activity.

The nature of the services provided, and the jurisdictions they operate in, are listed below:

Description of Function or Activities	Jurisdiction of Service Providers
Investment of Group Assets, Investments in commercial mortgages	England and Wales
Infrastructure Management & systems development, Desktop services and Telephony	England and Wales
Outbound Printing and Inbound Scanning services	England and Wales
Software As A Service and Hosting arrangement	England, Wales and Scotland
Software and customer facing applications development	England, Wales and Scotland

Material intra-group outsourcing arrangements
Currently there are no material intra-group outsourcing arrangements.

B.8 Additional information

In response to the Coronavirus outbreak LVFS has developed and put in place contingency plans to minimise business disruption, with our primary focus being the continued safety of our staff and our customers.

A formal business continuity plan process was invoked on 17 March and as a result, a Crisis Management Team has been created, with Georgina Farrell (Chief Administration Officer) chairing. The Crisis Management Team meets on a daily basis and reports to the Board on a weekly basis to highlight key issues and decisions taken.

C. Risk Profile

C.1 Overview

C.1.1 Overview of risk exposures

LVFS's business model involves taking on risk for its policyholders in order to provide security and aid in financial planning. In order to facilitate this, LV= offers a range of Life and Health insurance products. These cater to differing policyholder needs and a widely diversified customer base in terms of age, gender and geographical location.

LVFS manages its risk using a range of techniques, including European Insurance and Occupational Pensions Authority (EIOPA) prescribed Standard Formula capital calculations, internal views of risk and sensitivity testing. A number of committees, attended by senior stakeholders, meet regularly to consider LVFS's risk exposure, and whether it is in line with risk appetite. This enables informed decision making on where risk mitigation is required or where further risk can be taken on. Furthermore, external opinions are sought from consultancies and regular reports are made to the PRA.

The table below shows the 31 December 2019 split of the Standard Formula Solvency Capital Requirement (SCR) by risk type. The results for 31 December 2018 are provided for comparison. Reference to the SCR in this and later sections is to the final post-diversified SCR including ring-fenced funds unless stated otherwise. The amount of SCR illustrated below is £966m (2018: £886m). This differs from the total SCR reported in section E.2 as it excludes the loss absorbing capacity of deferred tax.

SCR split by risk type, for the year ended 31 December	**2019**	2018	**Change**
Market risk	**67%**	60%	7%
Underwriting risk	**28%**	35%	(7)%
Operational risk	**4%**	4%	0%
Counterparty risk	**1%**	1%	0%
Total	**100%**	100%	

The weighting of the high level risk categories shown within the SCR has shifted from underwriting risk to market risk since 2018. This is largely because LVFS sold its remaining 51% holding of its general insurance business on 31 December 2019. See section C.3.2 for further details.

C.1.2 Measurement of risk exposures

LVFS's measurement of risk exposures has not changed materially over the reporting period.

LVFS measures its risk exposures using a variety of metrics. These metrics are reported to senior management, the Audit Committee and the Board. This allows management to identify the key areas of risk exposure and make informed decisions as to whether the current levels of exposure are consistent with LVFS's risk appetite. The monitoring is primarily performed on a Group basis but the gap between Group and Solo positions is also monitored to ensure any movements in the Solo position are well understood.

LVFS uses the following metrics:

- Regulatory capital is measured using the Standard Formula approach prescribed by EIOPA, and reported to the PRA on a quarterly basis.
- LVFS maintains its own internal view of capital measurement, which informs risk appetite surrounding regulatory surplus capital. This uses internal and external knowledge to assess risk in a more bespoke way than can be done using the Standard Formula approach.
- An analysis of change is performed on Own Funds on a quarterly basis for LVFS, including evaluating how actual experience compares to the expected position. An analysis of change is also performed on the capital requirements on a quarterly basis, looking at individual risks as well as the whole SCR.
- Capital and Own Funds are monitored using sensitivities and approximations on a regular basis and the results reported to Senior Management. These results are then compared to actuals on a quarterly basis.
- Regular experience analysis is performed on key assumptions to evaluate their continued suitability. This includes both demographic experience and expenses.
- Stress and scenario testing is performed annually for the Own Risk and Solvency Assessment (ORSA) and business planning exercises.

C.1.3 Prudent person principle

LVFS operates within an investment framework which ensures that all assets are invested in accordance with the prudent person principle. The investment framework is suitably flexible to manage the different investment needs of the diverse business areas within LVFS. All investment and strategic management decisions are set within Board approved risk appetite limits. Working within this risk framework, considerations of commerciality, treating the customer fairly and policyholders' reasonable expectations are embedded into the investment strategies for each business unit as appropriate.

All invested assets are managed by external investment managers under an investment management agreement. Within the agreement, there are a number of investment guidelines which reflect the risk appetite limits and investment management parameters. All investment guidelines are approved by the Board or a delegated authority of the Board. Derivatives are used to manage risk and balance sheet volatility. All derivative strategies are approved by the relevant management or Board governance body.

C.1.4 Risk concentration

LVFS offers a wide range of product options catering to differing policyholder needs and a widely diversified customer base in terms of age, gender and geographical location. As such, LVFS has a diverse and balanced mix of business and risk exposures.

In addition, LVFS uses a variety of measures to limit any excess concentrations:

- investing in a range of assets governed by investment mandates and asset counterparty limits set by LVFS.
- using various hedging and asset liability matching strategies to reduce market risk.
- managing counterparty risk through risk limits on exposure and concentration.
- limiting excess concentrations of underwriting risk through a range of reinsurance strategies.

As LVFS has substantially written all of its business in the UK, results are sensitive to demographic and economic changes arising in the UK.

Where material, further information on risk concentrations relating to particular risks are given in sections C.2 to C.6.

C.2 Underwriting risk

In determining the price of its insurance products, and when reporting the financial results relating to these products, LVFS makes a number of assumptions related to the future amounts and timing of payments. Underwriting risk arises from the actual outcome being different to these assumptions.

C.2.1 Underwriting risk exposure

LVFS writes the majority of Life and Health business within the Group and is exposed to underwriting risk in these areas. LVFS wrote a small amount of non-life business within its subsidiary LVPL. The table below shows the 31 December 2019 split of underwriting risks within the Standard Formula SCR. The results for 31 December 2018 are provided for comparison. The amount of SCR illustrated below is £271m (2018: £310m). This differs from the underwriting risk capital shown in section E.2 as it fully allows for diversification within the SCR calculation.

SCR split of underwriting risk, for the year ended 31 December	**2019**	2018	**Change**
Life lapse	**60%**	62%	(2)%
Life expenses	**19%**	18%	1%
Health	**14%**	13%	1%
Life longevity	**6%**	5%	1%
Other	**1%**	2%	(1)%
Total	**100%**	100%	

Lapse risk is generally a significant risk across the life insurance industry, due to the long-term nature of life business. As a result, lapse rates on material product lines are closely monitored. Lapse risk also captures the risk associated with the take-up of policyholder options, notably the option to take a cash lump sum at retirement instead of the annuity on OB Pensions deferred annuity with-profits business. The cost of fewer policyholders taking cash at retirement has a material contribution to the lapse risk of LVFS.

Expense risk affects all business lines and covers the possibility of higher than expected expenses, for example due to higher than expected inflation.

All health exposure comes from protection products which behave similarly to life insurance policies, but pay out on the diagnosis of a serious illness or on the loss of earnings due to illness. This category includes the risk of pandemics and the expense risk on health products.

The remaining risks include the risk of higher than expected mortality, life catastrophe risk such as a pandemic, and disability claims. These risks are relatively minor for LVFS, being either small in nature, heavily reinsured, or heavily diversified against other sources of risk. Pandemic remains a minor risk to LVFS despite the on-going COVID-19 situation. The greatest impact to LVFS from COVID-19 is likely to be from sudden changes in economic conditions. LVFS has a strong capital position to deal with any economic shocks. See section C3 for further details on LVFS's exposure to market movements.

C.2.2 Material changes over the reporting period

Model and basis changes on the OB Pensions deferred annuities business and protection business have driven a fall in the weighting of lapse risk capital more than offsetting the increase seen from falling interest rates.

The sale of the remaining stake in the general insurance business does not have a significant impact on the weighting of risks within underwriting risk exposure, only the change in weighting of the higher level categories as shown in C1.1. This is because the general insurance business was held in a subsidiary of LVFS and was therefore stressed as market risk.

C.2.3 Risk mitigation techniques

Reinsurance is used as a risk mitigation technique across a range of products to transfer mortality, morbidity, longevity, and catastrophe risk outside of LVFS. Reinsurance is used for various reasons including managing risks within appetite, capital financing, protection against large individual losses and access to expertise. The effectiveness of reinsurance is monitored through the review and approval of new reinsurance arrangements by the relevant governance committees, the ongoing monitoring of counterparty credit risk at the relevant governance committees, and the internal and external audit review of governance and processes.

C.2.4 Risk concentrations

LVFS has developed its insurance underwriting strategies to diversify the type of insurance risks accepted and, within each of these categories, to achieve a sufficiently large population of risks to reduce the variability of the expected outcome. LVFS minimises the level of insurance concentration through the use of portfolio analysis and reinsurance. LVFS is exposed to material changes in policyholder behaviour, for example through lapses, cash commutation and guaranteed annuity option take-up rates. These risks are captured within the underwriting risk modules.

C.3 Market risk

Market risk arises as part of LVFS's general investment performance and product pricing. The risk to LVFS arises from the performance of the investments being different from that assumed in the planning and pricing processes.

C.3.1 Market risk exposure

As an institutional investor, LVFS invests in a range of assets, governed by the mandates and limits it sets. The table below shows the 31 December 2019 split of market risks within the Standard Formula SCR. The results for 31 December 2018 are provided for comparison. The amount of SCR illustrated below is £644m (2018: £527m). This differs from the market risk capital shown in section E.2 as it fully allows for diversification within the SCR calculation.

SCR split of market risk, for the year ended 31 December	**2019**	2018	**Change**
Equity	**50%**	44%	6%
Spread	**45%**	50%	(5)%
Interest rates	**4%**	3%	1%
Currency	**1%**	2%	(1)%
Property	**0%**	1%	(1)%
Concentration	**0%**	0%	0%
Total	**100%**	100%	

LVFS is exposed to equity risk through its holdings in subsidiaries as its equity holding in each subsidiary is treated as an asset. For this reporting period a significant proportion of LVFS's assets comprised the value of its subsidiaries, resulting in the large amount of equity risk capital shown above. Approximately 75% of LVFS's equity capital derives from equity holdings in its subsidiaries (60% in 2018); see section C3.2 for further details.

Equity risk otherwise arises primarily from the defined benefit pension schemes and LVFS's with-profits business. For the pension schemes, investment returns have no direct impact on scheme members' benefits, so any reduction in equity values reduces surplus. For with-profits business, falls in equity markets increase the costs associated with guarantees.

Spread risk is a significant risk for LVFS as it has a high exposure to corporate bonds. This arises primarily from the enhanced and fixed annuity business, where corporate bonds are used to back a large proportion of the liabilities. There is also a material contribution to spread risk from the defined benefit pension schemes, which invest a significant proportion of their assets in corporate bonds. Spread risk also arises from LVFS's equity release mortgage loans. As a major risk, spread risk is considered in more detail within LVFS's internal view of risk, where alternative calibrations and approaches (such as looking at the yield of gilts above swaps) are considered.

Interest rate risk is present under all lines of business, as the level of best estimate liabilities are calculated by discounting future cashflows.

LVFS has only a limited exposure to currency (foreign exchange) risk through its investment in overseas assets.

A small amount of commercial property risk arises mainly from the with-profits business and from LVFS's pension schemes. Note that residential property risk also arises from LVFS's equity release mortgage portfolio but this is not directly stressed within the Standard Formula calculation of the SCR and is instead monitored using LVFS's internal view of capital.

Sensitivities to key market risks are provided in section C.8.1.

C.3.2 Material changes over the reporting period

Equity risk capital has increased by £93m over the year, primarily due to the sale of the remaining 51% holding in the general insurance business. The total assets held in subsidiaries has increased following the general insurance sale as the sale proceeds received, which are currently held in LV Capital, a subsidiary of LVFS, are greater than the value of the general insurance holding on the LV Capital balance sheet prior to sale. This increase in asset value drives the increase in equity risk in LVFS's SCR. This also explains why selling the general insurance business holding does not provide a benefit to LVFS's SCR on a Solo basis.

In addition, there has been an increase in market risk capital over the year due to positive equity returns and the fall in interest rates.

C.3.3 Risk mitigation techniques

LVFS uses derivatives as part of its management of market risk. Derivatives are currently used to manage interest rate risk, equity risk and currency risk.

Risk type	**Description**
Equity	Equity exposures across LVFS are managed using portfolios of options and futures. This has included implementing internal hedges to manage the costs we are exposed to on our with-profits business, including smoothing, guarantees and expenses, with options used to manage the remaining exposure. The exposure associated with the annual management charges on unit- linked business are managed using futures contracts.
Interest rates	A number of strategies are employed by LVFS to manage interest rate risk, beyond its selection of physical assets to match the exposure arising from the liabilities. Interest rate swaps are used to improve asset and liability matching across LVFS, including that arising from the SCR. A cash flow swap is used by the matching adjustment portfolio to facilitate strong cash flow matching on annuity business. Transitional measures on technical provisions ("TMTP") is utilised by LVFS and used to manage interest rate risk to the Solvency II balance sheet.
Inflation	Inflation exposure across LVFS and within the defined benefit pension schemes is managed using inflation linked assets and inflation swaps.
Currency	LVFS invests in a variety of foreign denominated assets, primarily in asset share and UWP backing funds. LVFS employs currency hedges to remove the currency exposure where it is believed that policyholders' interests are best served by doing so.

Spread risk is not mitigated but managed in-line with LVFS's policies.

C.3.4 Risk concentrations

Equity risk is managed by investing in a diverse portfolio of high quality securities. This ensures that holdings are diversified across industries. Concentrations in any one company or industry are limited by parameters established by the Investment Committee. The exposure to property risk, from equity release mortgages, is managed through limits on the maximum loan to value ratio and seeking to limit concentrations in particular geographic areas.

C.4 Credit counterparty risk

Credit counterparty risk arises from the holding of certain investment assets, hedging, and reinsuring certain product related risks to third parties. The risk to LVFS is that a counterparty defaults on its obligations or fails to meet them in a timely manner.

C.4.1 Credit counterparty risk exposure

The principal risk that LVFS is exposed to is the default of an external counterparty. This risk arises in a number of areas:

- The default of assets LVFS has invested in, including derivatives. This is both for monies invested by LVFS and monies invested on behalf of policyholders.
- The default of reinsurers, to the extent that the reinsurer owes money to LVFS. Given reinsurance is a key risk mitigant then any reinsurance default could significantly impact LVFS's capital position above and beyond any base balance sheet losses.
- The default of insurance intermediaries on money owed to LVFS.

C.4.2 Risk Mitigation techniques

LVFS policy and risk limits are applied to credit counterparty risk covering aspects such as the total exposure and concentration and by taking action where necessary to avoid the limits being breached. LVFS counterparty exposures are monitored by the Asset Liability Committee. Reinsurance concentration risk is managed through contracting with a diverse range of reinsurers with credit ratings within an agreed risk appetite.

C.4.3 Material changes over the reporting period

There were no material changes to credit counterparty risk during 2019.

C.4.4 Risk concentrations

In order to limit its exposure to a single default, LVFS monitors its concentration to individual counterparties on a quarterly basis. This enables management decisions such as investment strategy and reinsurance arrangements to be evaluated against the total exposure of LVFS and its Risk Appetite.

C.5 Liquidity risk

Liquidity Risk is the risk that LVFS and/or its subsidiaries, though solvent, either do not have sufficient financial resources available to meet their obligations when they fall due, or can secure them only at excessive cost. This may arise either because of the nature of the investments held or adverse market conditions.

Liquidity within LVFS is maintained at a prudent level, with a buffer to cover contingencies including the provision of temporary liquidity to subsidiary companies. LVFS does not hold capital for liquidity risk but has a liquidity risk appetite statement which requires that, across LVFS, the business must be able to meet its BAU and stressed liquidity requirements from high quality liquid assets. Adherence to the risk policy and monitoring of the liquidity cover ratio is performed by the Asset Liability Committee on a monthly basis.

Liquidity risk is managed using several methods, these include:

- maintaining forecasts of cash requirements and adjusting investment management strategies as appropriate to meet these requirements, both in the short and long term.
- holding sufficient assets in investments which are readily marketable in a sufficiently short timeframe to be able to settle liabilities as they fall due.
- forecasting additional cash demands under stressed conditions, including demands for collateral, and identifying management actions to be taken to liquidate sufficient assets to meet the increased demands.
- the appropriate matching of the maturities of assets and liabilities, whereby LVFS undertakes asset and liability management to ensure that the duration and term structure of liabilities is matched by the assets held to support them.

There were no material changes to liquidity risk during 2019.

LVFS is not exposed to concentrations of liquidity risk.

The expected profit included in future premiums (EPIFP) is the change in technical provisions, excluding risk margin, under the assumption that the premiums relating to existing insurance and reinsurance contracts that are expected to be received in the future are not received for any reason other than the insured event having occurred, regardless of the legal or contractual rights of the policyholder to discontinue the policy.

The expected profit in future premiums (EPIFP) for LVFS at the end of 2019 was £318m (2018: £297m). The expected profit in future premiums primarily results from our LVFS Protection business, where we expect to receive future premiums for the benefits promised within the contracts.

C.6 Operational risk

Operational risk is the risk of loss arising from inadequate or failed internal processes, personnel or systems, or from external events. Operational risk arises as a natural consequence of business activity and is managed actively within the business.

Over the past year, the top risks faced by LV= are summarised within the table below. The LV=RM Framework ensures that these risks are monitored and regularly reported as the internal and external environment evolves over time.

Key risks	Potential impact	Mitigation	Change from last year
Political, economic and regulatory uncertainty e.g. Brexit The risk of a reduction in solvency, policyholder value or customer returns as a result of material and prolonged uncertainty within the political economic and regulatory landscape.	We remain exposed to political risk from Brexit as it is implemented during 2020. The UK's exit from the European Union (EU) continues to create uncertainty in both the financial markets and the UK economy as a whole. This is expected to continue through 2020, leading to market volatility in investment returns, inflation, and the value of sterling, along with weakened consumer confidence.	The UK's exit from the EU in itself is not expected to have a materially adverse impact on our business strategy as we operate solely in the UK. Our business will be affected by any regulatory changes that may be implemented as a result of leaving the EU, and from any UK government changes to the UK pensions and savings industry. Operational hedging programmes have been put in place to manage and mitigate such risks relating to volatility within the financial markets.	This risk exposure remains unchanged from last year, but is expected to decrease during 2020 as greater certainty emerges over the nature of the UK's exit from the EU.
Conduct risk The risk that key operational controls are ineffective, resulting in negative customer outcomes.	The complexity and long-term nature of life and pensions products means that, as customer needs change over time, there is the potential that products do not perform as customers would expect and that the products no longer deliver appropriate customer outcomes.	We have in place a product governance framework which ensures each new product or changes to products are subject to review. In addition, regular product reviews are undertaken which ensure existing products perform as customers would expect and continue to deliver appropriate customer outcomes.	During 2019, we established our value for money framework, designed to mitigate against poor customer outcomes.
Cyber security The risk of customer data loss or a severe reduction in customer service as a result of a successful cyber event.	The high level of threat from the external environment continued during 2019.	We operate a comprehensive cyber risk strategy which is designed to ensure that the business continues to identify, assess and respond to the ever changing threat of a cyber-attack.	Further development of our cyber risk strategy, embedding of controls targeted at data privacy and enhanced mechanisms for monitoring and reporting to respond to this heightened risk.

Delivery risk (e.g. separation of LVGIG to Allianz) The risk that the quality, timing and / or cost of delivering business objectives is impacted due to the loss of key staff, or poorly executed change.	During 2019, we undertook a series of strategic initiatives, including the completion of the separation of the general insurance business and the move to a fitter mutual for the future. This created pressure upon people, processes and IT systems which could have a detrimental impact on business delivery to customers and other external stakeholders.	The board has established a structure of executive sponsorship and strong programme governance, challenge and escalation for all of the key initiatives undertaken across the business. This is delivered through the centralised transformation directorate and is subject to board oversight.	This risk exposure has reduced since last year following the successful separation of the majority of the general insurance business processes, systems and people. Which is due to conclude by the end of March 2020

C.7 Emerging and other material risks

As well as monitoring near-term risks, the Risk Committee also considers potential risks, threats and opportunities which may impact us at some point in the future. This process normally takes place twice per year (with more frequent assessments taking place as and when required) and captures emerging risks such as the key risks described below:

New market entrants/disruption from digital	New players enter the market, most likely in the protection sectors.
More sophisticated financial crime	This could include an organised crime attack on customer pension or savings data, which could impact a significant number of customers, create severe brand damage and require significant resource to remediate the situation.
New regulation	Regulators introducing new regulation (e.g. in the pension transfer market or more onerous capital standards), or raise the bar in terms of the standards expected for compliance.

Each emerging risk is assigned to an executive team owner, who regularly reports to the Risk Committee and will include an updated assessment of the emerging risks assigned to them. This will include (where appropriate) how the risk is being tracked, the actions that can be taken to respond to the risk and the triggers for the action to be considered.

Climate Change risk
During 2019 there has been increased focus across a range of stakeholders on the financial risks associated with climate change. We recognise the importance of understanding and managing the potential short and long-term implications of climate-related risk and have taken initial steps to incorporate this risk within our LV=RM framework, to ensure appropriate oversight is maintained and enhanced over time.

The financial performance of the business may be adversely affected by harmful environmental events and developments including those related to (i) physical risk, and (ii) asset transition risk, as described below:

i) **Physical risks:** due to climate change arise from a number of factors and relate to specific weather events (such as heat waves, floods, wildfires and storms) and longer-term shifts in the climate (such as changes in precipitation, extreme weather variability, sea level rise and rising mean temperatures).

   Longer-term changes to the climate are likely to affect the longevity, morbidity and mortality risks to which our business is currently exposed, although the scale and direction attributed to climate change is not yet known. Currently we mitigate these risks through the use of reinsurance and other risk reduction instruments. We will continue to monitor evolving industry best practice and regulatory guidance for assessing and adjusting for mortality and longevity changes as the experience emerges over time.

   We are also exposed to physical risk through potential adverse impacts to property values arising from our investments in commercial property and residential property from equity release loans.

   Following the sale of the general insurance business at the end of 2019, we no longer have any direct significant short-term exposure to the immediate physical risks of climate change (e.g. claims from flood or storm damage to insured properties).

ii) **Asset transition risks:** can arise from the process of adjustment towards a low-carbon economy. A range of factors influence this adjustment, including:
- Climate-related developments in policy and regulation
- The emergence of disruptive technology or business models
- Shifting sentiment and societal preferences
- Evolving evidence, frameworks and legal interpretations

We are exposed to a reduction in the value of assets held which are either considered environmentally unfriendly or whose prospects may be adversely affected by climate change. In addition, we are also exposed to a potential fall in the value of equity or corporate bond investments, and/or counterparty default as a result of a business failure particularly related to climate risks.

We are addressing asset transition risk as part of our approach to environmental, social and governance ('esg') investment management. In addition, we are currently working with our asset managers, Columbia Threadneedle Investments, to understand how the 'esg' ratings of potential investments influence fund managers' decision making.

We recognise that these risks may also impact our clients, members and suppliers. Consumers and companies will increasingly consider the environmental impact of their investments and select investments which take into account 'esg' factors, rather than those with a greater carbon footprint. To this end, during 2019 we added eight new 'esg' funds to our existing range available to personal pension customers.

We have also taken certain actions to enhance the management and governance oversight of climate-related risks, such as:

- Wayne Snow, chief risk officer, has been appointed as the Senior Manager Function (SMF) for the business who is responsible for ensuring there is appropriate oversight, including at board level, of climate-related risks.

- We have developed a plan to address and integrate risks associated with climate change into our LV=RM framework. This is in line with the PRA supervisory statement (SS3/19) 'Enhancing banks' and insurers' approach to managing the financial risks from climate change' requirements and will be overseen by the chief risk officer as part of the SMF.

- Initial briefing sessions to discuss potential risk exposures and external requirements have been held with the Risk Committee and Investment Committees. In addition, there continues to be wider discussion on the 'esg' Investment strategy within the Investment Committee. We expect this engagement to be ongoing as part of regular risk reporting.

- We participated in the 2019 PRA stress testing industry exercise which included consideration of climate-related scenarios. The intention is to leverage these insights as part of further internal stress and scenario testing in future.

We hold capital against unexpected and extreme changes to our business model from both insurance and asset related risks, in line with prudential regulations. This is considered sufficient at the current time but will be adjusted in line with emerging climate related risk experience.

Coronavirus

The emergence of the Coronavirus represents a new uncertainty for 2020. At the time of writing the development of the virus in the UK and actions planned to contain it are uncertain and fast-moving. We have developed and put in place contingency plans to minimise business disruption. Our primary focus is the continued safety of our staff and our customers. Current indications are that the operational resilience of the business remains strong. Priority is being given to the needs of our existing customers and we fully expect to be able to meet all of our policyholder liabilities within reasonable timescales. Where possible new business continues to be written.

Our solvency position remains strong and our stress testing demonstrates that we are resilient to yield and equity impacts. We are also working closely with our asset managers to ensure that appropriate hedging arrangements remain in place during what is likely to be a prolonged period of increased market volatility. Our exposure to increased life insurance risks is largely reinsured. Our Solvency II Capital Coverage Ratio remains above risk appetite of 140% under a Coronavirus stressed scenario.

C.8 Sensitivities

This section sets out LVFS's sensitivity to various economic and demographic assumptions. The sensitivities in this section show the impact of changes in key assumptions in isolation. In reality, there may be an interaction between the assumption and other factors. The sensitivities do not always behave in a linear way so using these sensitivities to assess a larger or smaller movement may not give an accurate result. They should only be treated as estimates which give a broad indication of the direction and magnitude of the change in surplus capital. The estimates have been calculated using a combination of analysis and expert judgement and include some approximations where these are not material to the final results.

C.8.1 Economic sensitivities

Market risk arises as part of the general investment performance and product pricing. The risk to LVFS arises from the performance of the investments being different from that assumed in the planning and pricing processes. The estimated impact on LVFS's surplus capital to a range of economic changes is shown below. These have been aligned with the sensitivities disclosed within the LV= Annual Report.

The following sensitivities are performed:

- An immediate 25% decrease in the market values of equities.
- An immediate 100 bps decrease in all risk-free interest rates.
- An immediate 100 bps increase in all risk-free interest rates.
- An immediate 50 bps increase in gilt interest rates but with swap rates remaining fixed. Note that the risk of gilt-swap spreads widening is not captured as part of SCR.
- An immediate 100 bps increase in corporate bond interest rates but with gilt and swap rates remaining fixed. Unlike the SCR calculation, the impact on the volatility adjustment has been taken into account in calculating this sensitivity.

The sensitivities assume that the TMTP is not recalculated. If there was an extreme stress that caused a material change in the LVFS risk profile, then the TMTP might be recalculated (subject to the approval of the PRA), which could impact some of the sensitivities shown.

The regulations require that TMTP is recalculated every two years. Given its strong capital position LVFS utilises the recalculation of TMTP as part of its hedging strategy, since TMTP recalculation removes a large amount of the interest rate, credit spread and gilt swap sensitivity shown below. LVFS monitors the impact of change in market conditions regularly between recalculations. Equity exposure within the insurance business is largely managed using a portfolio of derivatives with additional exposure arising from the defined benefit pension schemes.

Furthermore, the sensitivities assume no management actions are taken, above those already modelled as part of the valuation of technical provisions and SCR, in order to mitigate any adverse impacts.

Surplus capital at 31 Dec 2019:	**£769m**			
Sensitivities	**Change in Surplus above SCR (£m)**	**Change in SCR (£m)**	**Change in CCR (%)**	**% of individual risk post-diversified SCR**
25% market fall in equities	(40)	(21)	(2)%	12%
100 bp fall in interest rates	(56)	95	(14)%	228%
100 bp rise in interest rates	22	(55)	8%	(88)%
50 bp rise in gilt swap spreads	(143)	0	(16)%	n/a
100 bp rise in credit spreads	150	(15)	18%	(52)%

The equity sensitivity reduces the value of LVFS's assets, including those in the defined benefit pension schemes. It also increases the guarantee costs associated with the with-profits business.

The interest rate sensitivities impact all fixed interest assets held by LVFS such as government and corporate bonds and interest rate derivatives. It also impacts liabilities which are discounted using swap rates. Where the assets and liabilities are closely matched, these impacts broadly offset each other. However in other areas, such as the Risk Margin, there is no corresponding offset which leads to a material sensitivity. The rise in interest rate sensitivity as a percentage of the post-diversified interest rate SCR is negative despite the rise in interest rates being the biting stress in the Standard Formula SCR calculation. This is because the sensitivities include a stress to the Risk Margin and SCR which both fall under a rise in interest rates scenario. The benefit from the fall in Risk Margin and SCR more than offsets the cost on assets less liabilities. A more granular split of the interest rate sensitivities is used to manage LVFS's interest rate exposure.

The gilt-swap spread sensitivity is an increase in gilt interest rates but with swap rates remaining fixed. Many of the assets held by LVFS are government or corporate bonds, and are therefore linked to gilt yields. In contrast, swap rates are used to calculate liabilities, SCR and Risk Margin so the impact on this side of the balance sheet is only through an assumed increase in the volatility adjustment and matching adjustment. A widening of gilt spreads, relative to swaps, therefore reduces the value of LVFS's assets by more than that of its liabilities which leads to a material sensitivity.

The credit spread sensitivity as a percentage of the post-diversified credit spread SCR is negative because of the difference in approach between the sensitivity and the SCR calculation. Credit spreads widening causes the value of corporate bond assets held by LVFS to fall, which causes a reduction in surplus within the SCR calculation. However, in reality the volatility adjustment and discount rate used to value defined benefit schemes' liabilities increase in the event of credit spreads widening. In the sensitivity calculation this has been taken into account and has a beneficial impact because it reduces the value of liabilities which more than offsets the reduction in value of assets. However, the calculation of the SCR does not permit the recalculation of the volatility adjustment or defined benefit schemes' liability discount rate and so this benefit is ignored.

C.8.2 Demographic sensitivities

Life business

Demographic stresses relate to the behaviour and circumstances of policyholders. In pricing its products, LVFS makes certain assumptions about how policyholders will behave, and how many policies will result in a claim under different policy conditions (such as accident, death and ill health). By their nature different products are affected differently by different demographic trends. For example protection products pay out on death, but annuity products generally pay an income until death.

The sensitivities shown below are in respect of the Solvency II Surplus (excluding the RNPFN and Teachers ring-fenced funds), allowing for the benefit of reinsurance, and only relate to those policies exposed to the relevant risk. So for example, the mortality sensitivity assumes a 15% increase in the mortality of protection policyholders (and hence more claims). However, it does not allow for a 15% increase in the mortality rate of the annuitants which would increase surplus. They are therefore provided merely to illustrate the magnitude of any downside in extremely severe scenarios.

The following sensitivities are performed:

- 15% increase to mortality rates.
- 20% decrease to mortality rates.
- 50% increase to lapse rates for all products. Early retirements are excluded from this sensitivity.
- 50% decrease to lapse rates for all products. Early retirements are excluded from this sensitivity.
- 50% decrease in OB Pension cash-take up rates at retirement.

The mortality stresses refer to the assumed rate of future mortality, and represent a percentage change in the volume of death claims.

The lapse stresses are calculated in a similar way and represent a percentage change in the volume of lapses or surrenders.

The sensitivities make an approximate allowance for TMTP recalculation by not including a change in Risk Margin which is generally hedged by changes in TMTP when recalculated. They also assume that no management actions are taken, above those already modelled as part of the valuation of technical provisions and SCR, in order to mitigate any adverse impacts. The sensitivities should only be treated as estimates which give a broad indication of the direction and magnitude of the impact of the sensitivity.

LVFS has entered into a number of reinsurance arrangements, the benefits of which are included within the results below.

Surplus capital at 31 Dec 2019:	**£769m**			
Sensitivities	**Change in Surplus above SCR (£m)**	**Change in SCR (£m)**	**Change in CCR (%)**	**% of individual risk post-diversified SCR**
15% increase in mortality rates (affected business only) *	(3)	0	0%	1,864%
20% decrease in mortality rates (affected business only) *	(47)	0	(5)%	280%
50% increase in lapses**	(34)	25	(6)%	18%
50% decrease in lapses**	71	(24)	10%	(10)%***
50% decrease in OB Pensions cash-take-up rates at retirement	(52)	(20)	(4)%	

** Affected business is defined in line with Solvency II Standard Formula.*

*** Early retirements have been excluded from this sensitivity.*

*** *Relates to combined impact on individual risk.*

For the increase in mortality rates, the exposure comes from products where claims are paid out on death. For these products, higher mortality rates increase the amount of claims paid out. The impact of this sensitivity on surplus is significantly higher than the SCR capital held in respect of mortality risk primarily because, within the SCR, mortality risk significantly diversifies with other risks.

For the decrease in mortality rates, the majority of the exposure comes from the deferred and in-payment annuities, where an income is paid for as long as the policyholder survives. The impact of this sensitivity on surplus is higher than the SCR capital held in respect of longevity risk primarily because, within the SCR, longevity risk significantly diversifies with other risks.

For the 50% increase in lapses, the majority of the exposure comes from changes to the SCR. Under Solvency II, the SCR lapse stress is applied as a proportion of the existing lapse assumption. Therefore, an increase to lapse rates increases the size of this stress. The impact of this sensitivity on surplus is significantly lower than the SCR capital held in respect of lapse risk primarily because, within the SCR, only those policies which would cause a strain to LVFS are used in the calculation.

For the 50% decrease in lapses, the benefit to surplus comes primarily from the unitised with-profits bonds and Protection business. The impact of this sensitivity on surplus is significantly lower than the SCR capital held in respect of lapse risk primarily because, within the SCR, only those policies which would cause a strain to LVFS are used in the calculation.

The 50% decrease in OB Pension cash take-up rates at retirement results in a higher proportion of policyholders taking the guaranteed annuity option. The increase in Best Estimate Liability (BEL) is partially offset by a reduction in SCR, where as more of the risk has been crystallised in the base position, there is less residual exposure under stress.

<u>Non-life business</u>

Following the sale of the remaining stake in the general insurance business to Allianz LVFS no longer has a significant sensitivity to non-life risks.

C.9 Additional information on risk profile

Further information can be found on an IFRS basis within the LV= Annual Report.

D. Valuation for Solvency Purposes

D.1 Assets

Assets on a Solvency II basis	**2019**	2018
	£m	£m
Pension benefit surplus	**214**	199
Property, plant and equipment held for own use	**8**	9
Investments (other than assets held for index-linked and unit-linked funds)		
- Property (other than for own use)	**-**	-
- Participations	**1,180**	896
- Equities	**564**	757
- Bonds	**4,610**	3,990
- Collective Investment undertakings	**2,910**	2,942
- Derivatives	**92**	65
- Deposits other than cash equivalents	**63**	38
- Other Investments	**-**	-
Assets held for index-linked and unit linked funds	**3,498**	2,969
Loans and mortgages	**855**	871
Reinsurance recoverables	**1,116**	1,175
Insurance and intermediaries receivables	**11**	9
Reinsurance receivables	**52**	31
Receivables (trade, not insurance)	**55**	72
Cash and cash equivalents	**77**	97
Any other assets, not elsewhere shown	**10**	15
Total Assets	**15,315**	14,135

For Solvency II valuation purposes, assets and other liabilities are valued consistently with IFRS provided that IFRS valuation methods are consistent with Article 75 of Directive 2009/138. Assets and other liabilities represent the fair value amount for which they could be exchanged between knowledgeable willing parties in an arm's length transaction.

Reconciliation between IFRS and Solvency II valuation	Note	2019 IFRS	Presentational adjustment	Solvency II valuation adjustment	Solvency II
		£m	£m	£m	£m
Intangible assets	#	**8**	-	(8)	**-**
Pension benefit surplus	1	**214**	-	-	**214**
Property, plant and equipment held for own use	#	**8**	-	-	**8**
Investments (other than assets held for index-linked and unit-linked funds)					
- Participations	2,3	**816**	48	316	**1,180**
- Equities	3	**6,977**	(6,413)	-	**564**
- Bonds	3	**4,152**	458		**4,610**
- Collective Investment undertakings	3	**-**	2,910	-	**2,910**
- Derivatives	3	**92**	-	-	**92**
- Deposits other than cash equivalents	3	**-**	63	-	**63**
Assets held for index-linked and unit linked funds	4	**-**	3,498	-	**3,498**
Loans and mortgages	5	**854**	1	-	**855**
Reinsurance recoverables	6	**1,708**	-	(592)	**1,116**
Insurance and intermediaries receivables	#	**62**	(51)	-	**11**
Reinsurance receivables	#	**-**	52	-	**52**
Receivables (trade, not insurance)	#	**80**	(25)	-	**55**
Cash and cash equivalents	7	**558**	(481)	-	**77**
Any other assets, not elsewhere shown	8	**68**	(58)		**10**
Total Assets		**15,597**	**2**	**(284)**	**15,315**

= Disclosure note not provided as Solvency II value equal to IFRS or the amounts are immaterial.

Supporting Notes

1. Pensions Benefit Surplus

For Solvency II purposes, any pensions benefit surplus is valued consistently with IFRS.

Under IFRS, any Pensions Benefit Surplus is valued under IAS19, whereby the net surplus or deficit is calculated annually with the assets valued at fair value and the liabilities discounted at the rate of return available on high quality corporate bonds. The net surplus, to the extent recoverable, or deficit is recognised as a pension benefit asset or liability in the Statement of Financial Position. No separate liability for funding requirement is recognised as LVFS has an unconditional right to any of the assets of the pension schemes which would remain following the schemes' termination.

2. Participations

Under IFRS, participations are held at cost less any provision for impairment. For Solvency II valuation purposes certain investments are not consolidated and are valued as participations using the adjusted equity method. The majority of the Adjusted equity method valuation differences reported in the table below relate to LV Capital Limited, a directly held subsidiary of LVFS. As at 31 December 2019 the net assets of this subsidiary were significantly in excess of LVFS's investment in this company, as it was holding the proceeds of the sale of the Group's general insurance business. Profit for the year of £272m for 2019 was retained in LV Capital Limited at the year-end.

Participations	**£m**
Shares in subsidiaries	796
Loan stock in subsidiaries	20
Investments in group undertakings - IFRS	**816**
Joint venture properties reclassified as participations	48
Adjusted equity method valuation differences	316
Participations - Solvency II valuation	**1,180**

3. Investments

Investments are measured at fair value for Solvency II purposes. When quoted prices in active markets are available for the valuation of investments, those prices are used for the measurement under Solvency II. An active market thereby follows the IFRS definition, where an active market is a market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis. If quoted prices in active markets for the investments are not available, other valuation methods are used. These valuation techniques are consistent with the valuation techniques used in IFRS reporting.

Under IFRS, financial assets are valued at fair value through income which has two sub categories:

– Financial assets held for trading; and
– Those designated at fair value through income at inception.

Derivatives are classified at fair value through income as they are held for trading. Financial assets designated at fair value through income at inception are measured at market prices, or prices consistent with market ratings should no price be available.

There are mapping differences between the IFRS and Solvency II hierarchies, with certain assets being presented in different categories under IFRS.

Fair value estimation

For Solvency II valuation purposes, the fair value measurement hierarchy is as follows:

- Quoted market prices in active markets for same assets and liabilities (QMP). This is the default valuation method and is broadly consistent with Level 1 category assets under IFRS.
- Quoted market price in active markets for similar assets (QMPS). Maximum use is made of relevant market inputs such as quoted prices for identical assets in markets that are not active, quoted prices for similar assets in active markets and inputs to valuation models for the asset derived from observable market data. This is broadly consistent with Level 2 category assets under IFRS.
- Other alternative valuation method (AVM). Unobservable inputs reflecting the assumptions market participants would use when pricing the asset or liability, including assumptions about the risk inherent in both the inputs and the valuation technique. The undertaking uses various valuation approaches, including market, income and cost approaches. This is broadly consistent with Level 3 category assets under IFRS.
- Adjusted Equity Method (AEM) for Participations.

The following table presents the financial assets measured at fair value at 31 December 2019.

	QMP £m	QMPS £m	AVM £m	AEM £m	Total £m
Participations	-	-	48	1,132	1,180
Equities	526	-	38	-	564
Bonds	2,112	2,498	-	-	4,610
Collective Investment Undertakings	2,904	6	-	-	2,910
Derivatives	1	91	-	-	92
Deposits other than cash equivalents	63	-	-	-	63
Investments (other than assets held for index-linked and unit-linked funds)	5,606	2,595	86	1,132	9,419
Loans and mortgages (see note 5 below)	-	210	645	-	855
Total	5,606	2,805	731	1,132	**10,274**

4. Assets held for index-linked and unit linked funds

Under IFRS, assets held for index-linked and unit linked funds are included in financial assets at fair value through income. For Solvency II valuation purposes, these assets are valued consistently with IFRS but are reported separately.

5. Loans and Mortgages

For Solvency II valuation purposes, loans and mortgages are valued consistently with IFRS, with a reclassification adjustment for accrued interest which is included in investments rather than accrued interest.

	£m
Equity release mortgages	645
Commercial mortgages	209
Total included in Financial assets at fair value through income - IFRS	**854**
Reclassify accrued interest on commercial mortgages from accrued interest	1
Total Loans and Mortgages - Solvency II valuation	**855**

Equity release mortgages

Equity release mortgages are not actively traded in a secondary market and hence a mark-to-model valuation approach is used which is classified as other Alternative Valuation Method (AVM). (Please see note 3 Investments for a full definition of AVM and Section D.4 for more information). The fair value of the Equity Release mortgage assets is determined using a discounted cash flow model which takes into account the contractual rate of interest charged on the loans, the expected mortality and morbidity of the mortgagor and mortgagor actions.

The discount rate is the zero-coupon swap curve with adjustments for profit and liquidity premiums.

Commercial mortgage valuation

The fair value of the loans secured on commercial property is determined using discounted cash flows to reflect changes in underlying gilt yields and debt margins. Where the value is not expected to be recovered through ongoing loan payments, the fair value represents the recoverable value of the property in the market post transaction costs. Their basis is classified as Level 2 for IFRS and Quoted Market Price in active markets for similar assets (QMPS) for Solvency II. (Please see note 3 Investments for a full description of QMPS).

6. Reinsurance recoverables

The undertaking cedes insurance risk in the normal course of business. Reinsurance assets represent balances recoverable from reinsurance companies.

For Solvency II valuation purposes, reinsurance recoverables are valued using the cash-flow projection method and in a consistent manner with the calculation of the best estimate liabilities. (See Section D.2 Technical Provisions).

7. Cash and cash equivalents

For Solvency II valuation purposes, cash is valued consistently with IFRS with the following reclassification adjustments:

	£m
Cash and cash equivalents - IFRS	**558**
Reclassify short-term bank deposits to investments as deposits other than cash equivalents	(443)
Reclassify cash collateral pledged to receivables	16
Reclassify certificates of deposits to bonds	(49)
SII Linked assets presentational adjustment	(5)
Total Cash and cash equivalents - Solvency II valuation	**77**

8. Any other assets, not shown elsewhere

For Solvency II valuation purposes, prepayments and accrued interest are valued consistently with IFRS. On the Solvency II balance sheet, the accrued interest on bonds is included in the market value of investments.

Under IFRS, prepayments and accrued income balances are all due within one year. These are valued at fair value based on amounts receivable on demand.

	£m
Prepayments and accrued interest – IFRS	68
Any other assets, not elsewhere shown - IFRS	**68**
Reclassify accrued interest to investments	(58)
Total Any other assets, not elsewhere shown - Solvency II valuation	**10**

D.2 Technical provisions

D.2.1 Technical provisions by line of business

Total Technical Provisions by line of business:

Line of Business	2019 £m	2018 £m
Insurance with-profits participation	**5,923**	5,604
Index-linked and unit-linked insurance	**3,437**	2,949
Other life insurance (including Health)	**3,603**	3,418
Total Life insurance obligations	**12,963**	11,971

The following table sets out the LVFS technical provisions split by Solvency II lines of business as at 31 December 2019.

Line of Business	31 December 2019 - £m			
	Best Estimate Liability (BEL)	**Risk Margin (RM)**	**Transitional Measures on Technical Provisions (TMTP) Unaudited**	**Total Technical Provisions**
Insurance with-profits participation	5,940	130	(147)	5,923
Index-linked and unit-linked insurance	3,427	29	(19)	3,437
Other life insurance (including Health)	3,735	117	(249)	3,603
Total Life insurance obligations	**13,102**	**276**	**(415)**	**12,963**

D.2.2 Technical provisions methodology and assumptions

LVFS writes all the Life business in the Group with the exception of a small amount which is written by LVLC.

A description of the bases, methods and assumptions used for the valuation of the technical provisions is set out below. Assumptions relating to business within the Teachers Assurance (TA) Fund have largely been omitted on grounds of materiality.

Best Estimate Liability

The BEL is calculated in accordance with the Solvency II Directive, Delegated Regulations and regulatory guidance. The following sections describe how the rules and guidance have been applied. Unless otherwise stated the methodology and assumptions apply to all types of business.

The BEL is the probability weighted average of future cashflows required to fulfil obligations to policyholders under existing contracts taking account of the time value of money using the relevant risk-free interest rate term structure and allowing for contract boundaries. Allowance is made for contract boundaries, although the adjustment is not material. The cashflows are projected gross, without deduction of the amounts recoverable from reinsurance contracts. Recoverables from reinsurance contracts are calculated separately and are included as an asset on the balance sheet.

A number of the actuarial models have been moved to the Prophet software platform during 2019 as part of improvements to the modelling environment. This process has involved a comprehensive review of the modelling approach to ensure that it appropriately captures the relevant features of the contracts.

Risk Margin

The Risk Margin represents the estimated cost of the capital a third-party insurer would be required to hold to support the insurance business over its period of run-off. It is derived by projecting the SCR forward (under the Standard Formula, and removing MA and VA) using a cost of capital of 6%. The third-party insurer is assumed to hedge any market risks, where possible. All market risk exposures are assumed to be hedged, so the calculation allows only for non-market risks. The SCR is projected for most risks using a proxy (an item, such as the BEL, which is expected to move broadly in line with the size of the stress). However for material product and risk combinations, the SCR projection approach is used. The individual risk SCR's are then summed over all the products to produce the SCR for each risk. The aggregate SCR is determined by applying a correlation matrix. The correlation matrix assumed is the same as that used for the Life and Health Standard Formula SCR. These SCRs are then discounted and the prescribed cost of capital rate is applied.

Risk-Free Rates

The basic risk-free interest rate term structure of spot rates as published by EIOPA was used. No transitional adjustment was made to the discount rate.

Matching Adjustment

The Matching Adjustment (MA) has been applied (having been approved for use by the PRA) for all annuity business in the Matching Adjustment Portfolio. The MA is an addition that can be made to the risk-free yield curve to allow for the higher expected returns on the assets supporting the liabilities. This is available for annuity business where the cashflows are reasonably predictable, and therefore a portfolio of government and corporate bonds can be purchased with cashflows that match those of the liabilities sufficiently closely. The addition to the risk-free curve is calculated as the addition to the discount rate needed to set the value of liabilities equal to the value of assets. Within this calculation a deduction is made for potential defaults and the cost of downgrade on the bond portfolio (the 'fundamental spread'):
The assets used to back the annuities within the Matching Adjustment Portfolio are:

- Government bonds (including inflation-linked government bonds)
- Corporate bonds
- Commercial Mortgage Loans
- Cash flow swaps
- Cash.

The MA used at the valuation date was 98bps (2018: 133bps).

Volatility Adjustment

The Volatility Adjustment (VA) has been applied (having been approved for use by the PRA) for all Life policies outside the Matching Adjustment Portfolio, except for Protection, OB Pensions, Heritage non-profit pension annuities, Unit Linked Pensions and the business acquired from Teachers Provident Society.

The VA prescribed by EIOPA was 15bps (2018: 27bps) at the valuation date.

Transitional Measure on Technical Provisions (TMTP) - unaudited

The TMTP provides firms with relief from day 1 from the financial impact on technical provisions of moving to the Solvency II regime. The relief then reduces step-wise annually over 16 years. The TMTP was used for Life and Health business (except within the TA Fund). The TMTP is recalculated every 24 months or sooner if there is a change in risk profile that materially impacts the TMTP. The TMTP was recalculated as at 31 December 2019, in line with the biennial recalculation requirement. The TMTP is restricted where necessary so that the Financial Resources Requirement (the sum of the technical provisions, other liabilities and the SCR) is no lower under Solvency II than would have been the case under the previous solvency regime, although this restriction did not apply at the last recalculation point.

TMTP has reduced by £102m, made up of the annual amortisation of £38m (2018: £38m) and a £64m reduction following the industry-wide recalculation at the end of the year.

Impact of the Matching Adjustment, Volatility Adjustment and Transitional Measure on Technical Provisions (TMTP only unaudited)

The impact of not applying the MA, VA or TMTP is set out in the S.22.01.21 QRT annexed to this report, an extract of which is below.

£m	**Amount with Long Term Guarantee measures and transitionals**	**Impact of transitional on technical provisions (unaudited)**	**Impact of volatility adjustment set to zero**	**Impact of matching adjustment set to zero**
Technical provisions	12,963	415	30	174
Basic own funds	1,678	(389)	(19)	(174)
Eligible own funds to meet Solvency Capital Requirement	1,678	(389)	(19)	(174)
Solvency Capital Requirement	909	1	4	67

Tax

All products are classified as either Basic Life Assurance and General Annuity Business (BLAGAB) or non-BLAGAB business. As a mutual, the LVFS is exempt from tax on non-BLAGAB business, and therefore no allowance for taxation is made in the calculation of the BEL. For products classified as BLAGAB, allowance is made for "I-E" taxation, where "I-E" refers to the liability to tax on any excess of investment income over expenses.

With-Profits specific

The costs of guarantees, options and smoothing form part of the BEL. These are calculated using stochastic methods. A market-consistent set of economic scenarios is generated and the costs valued in each scenario using a discount curve equal to the projected future risk-free curve for that scenario. These scenarios are produced by an Economic Scenario Generator (ESG).

Actual historical investment data was used to derive retrospective asset shares. The assumed future investment returns for each asset class for with-profits business were derived using the market-consistent ESG.

A simplifying assumption of combining similar asset classes was used, such as modelling all equities (whether UK or Overseas) as UK Equities and treating all fixed interest bonds as zero coupon UK government bonds.

When projecting future investment returns, the various benchmark asset mixes are used throughout the projection. The Equity Backing Ratio is allowed to change in line with the future management action modelled for LVFS with-profits business in the main with-profits fund only.

Regular Bonus rates are generally assumed to continue at the same level as at the valuation date.

Profits from business risks are being allocated through the declaration of Mutual Bonus which is allowed for in the BEL.

Final Bonus rates are set equal to the current declared Final Bonus rates for the first time step. Thereafter, an algorithm is used to calculate future Final Bonus rates given the modelled economic scenario and the bonus philosophy set out in the Group's Principles and Practices of Financial Management.

Mortality and Morbidity

Life Protection and Annuity business is exposed to changes in life expectancy (mortality – reduced life expectancy, longevity – increased life expectancy) and health expectancy (morbidity) experience.

Protection business is exposed to mortality and morbidity risks as higher mortality rates and adverse morbidity will lead to increased claims, which in turn, lead to an increase in contract liabilities. Conversely, annuity business is exposed to an increase in life expectancy.

The assumed rates of mortality and morbidity are set in line with recent experience, where it is available in sufficient volume to provide reliable results. Where the experience is not considered sufficient, the assumptions are set by reference to either industry experience or the terms on which the business is reinsured.

The mortality assumed for the different modelled products for year-end 2019 is shown in the tables below.

LVFS

Product	Base Percentage	Mortality/Morbidity Tables
Enhanced Annuities	106%	PMA08/PFA08 with enhancements CMI_2018 1.5%/1.25% LT
Standard Annuities	106%	PMA08/PFA08 CMI_2018 1.5%/1.25% LT
Deferred Annuities (Pre-vesting)	105%	AMC00/AFC00 CMI_2018 1.5%/1.25% LT
Deferred Annuities (Post-vesting)	Various	PML08/PFL08 CMI_2018 1.5%/1.25% LT
Term Assurances (FPP)	84.42%	TMN00/TMS00/TFN00/TFS00 adjusted CMI_2018 1.5%/1.25% LT
Term Assurances (LVLI)	85.5%	TMN00/TMS00 TFN00/TFS00 adjusted CMI_2018 1.5%/1.25% LT
Term Assurances (LVFS)	Various	TMN00/TMS00 TFN00/TFS00 adjusted CMI_2018 1.5%/1.25% LT
IB Endowment/Whole of Life Assurance	80%	ELT16

Whole of Life Assurances (50+)	100%	AMC00/AFC00 adjusted CMI_2018 1.5%/1.25% LT
Whole of Life Assurances (Lifetime+)	100.8%	TMN00/TFN00/TMS00/TFS00 adjusted CMI_2018 1.5%/1.25% LT
Critical Illness	67.1%	Reinsurer rates
Income Protection Inceptions	Various	CMIR12
Income Protection Terminations	Various	CMIR12

RNPFN Fund

Product	Base Percentage	Mortality Tables
Annuities	90%-95%	PMA08/PFA08 CMI_2018 1.5%/1.25% LT
Other Life Assurance	50%-60%	AM00/AF00

The mortality rates used for the enhanced annuities were adjusted for the additional mortality expected to apply to the lives concerned, with an allowance for the mortality to converge to standard mortality at advanced ages. For this purpose, the business was divided into groups by broad types of medical condition or lifestyle.

Mortality Improvements

Future mortality improvements are allowed for using the Institute and Faculty of Actuaries Continuous Mortality Investigation (CMI) 2018 projection model, with extended settings for both the initial improvement and projection assumption sections. The period smoothing parameter was 7.0, the long term improvement rates were 1.5% for males and 1.25% for females, and additional loadings of 0.15% for males and 0.1% for females were applied to short term improvement rates.

Persistency

Persistency relates to how long a policyholder retains the product and influences the company's ability to recover initial costs of sale from premiums and charges that relate to the product. Persistency assumptions include allowances for lapse, becoming paid-up, surrenders, withdrawals and transfers. Additionally, cash commutation and guaranteed annuity rate (GAR) take up rates are covered; as is an allowance for "gone-aways" under IB whole-of-life with-profits business. These assumptions, which will typically vary by product line, duration in-force, fund size and sales channel, are largely based on internal experience investigations and expert judgement.

For unit linked pensions, separate persistency rates apply for surrender (including external transfers, early retirements, full encashments and partial encashments) and drawdown.

Cash commutation rates are segmented by relevant homogeneous groups. These are set using expert judgement and recent experience.

"Gone-aways" arise where policyholders are no longer aware of the existence of their policy and it is not practical to trace them, and so they are unlikely to give rise to a claim. The level of gone-aways is set by comparing the mortality experience under non-premium paying policies (where "gone-aways" arise) with that under premium paying policies (where there should be no "gone-aways") and applying expert judgement.

Policyholder behaviour

The BEL allows for the impact on cash flows of any policyholder actions, i.e. lapse, surrender, or the exercise of options. The value of future options and guarantees allows for the following policyholder actions.

The following policyholder behaviour is modelled deterministically:

- Surrender rate at guarantee points for FGB/F and All-in-1 bonds – at the guarantee date the surrender rate was increased to reflect the increased likelihood of policyholders lapsing (and therefore being entitled to the guaranteed return of premiums)
- Guaranteed annuity option take up rates on RNPFN Savings and Pensions
- Cash commutation option take up rates on LVFS OB Pensions.

The following policyholder behaviour is modelled dynamically:

- For FGB/F adjustments are applied for the following: lapse rates where guarantees are in the money (ITM); cancellations of out of the money (OTM) guarantees; and, for non-guaranteed policies, a mass lapse when the policyholder benefits from smoothing.

Expenses

All expense cashflows incurred in servicing the liabilities relating to existing contracts over their future lifetime were taken into account in determining the best estimate liabilities. The modelled expense cashflows assume maintenance unit costs that are derived from an internal expense analysis.

The following expenses were included in the internal expense analysis:

- Administrative expenses
- Claims management expenses
- Acquisition expenses.

This expense analysis allocates costs at cost centre level to acquisition and maintenance, and across product groups. The maintenance unit cost is then derived at a product level from the amount of allocated cost and the policy count.

The unit costs were adjusted to remove certain items of cost that are not expected to persist over the full term of the liabilities. These costs are instead allowed for through an Additional Expense Reserve held as a liability outside of the technical provisions. In addition, an allowance for diseconomies of scale is also included the Additional Expense Reserve.

In addition to maintenance services costs, investment expenses associated with products are allowed for in the Best Estimate Liabilities.

Inflation

The assumed inflation measure was the Retail Price Index (RPI). For with-profits business, inflation is linked to the Economic Scenario Generator (ESG).
RPI-linked liabilities were projected to increase in line with RPI, consistent with contractual terms. Expense inflation was based on RPI plus a margin.

Events not in data (ENIDs)

ENIDs refer to any events that are not captured within the data used to derive the assumptions underlying the Best Estimate Liabilities. For life business, material ENIDs are allowed for by adjusting the best estimate assumptions using expert judgement and any relevant available data.

Simplifications

The use of simplifications within the Group is not considered material.

Uncertainty within the Technical Provisions

The calculation of Technical Provisions uses established actuarial and statistical techniques that represent a best estimate of expected realistic future cash flows and liabilities. These calculations are nevertheless based on data, assumptions and models, which may not reflect actual future experience. In addition some simplifications are used where appropriate and as such, a level of uncertainty is associated with these results. Notable areas of uncertainty include:

- The quality of the data, especially around older policies on legacy administration systems.
- The assumptions used by the models; in particular in terms of investment experience or policyholder behaviour. These assumptions are discussed above. The sensitivity of the results to these assumptions can best be seen by considering the makeup of the SCR, and the underlying sensitivities. Details of this can be found in sections C and E.
- The modelling methodology, including the ESG. The Group uses stochastic techniques to value both the with-profits benefits and the value of guaranteed annuity options.
- The impact of potential management actions. The management actions of reducing the with-profits equity backing ratio and removing the smoothing of benefits for some Flexible Guarantee policies would impact policyholder benefits. The secondary impact on policyholder behaviour (primarily lapses) as a result of these management actions would also add to the uncertainty associated with the Technical Provisions.

D.2.3 Comparison of Solvency II and IFRS Technical Provisions

The table below shows the difference between the gross technical provisions under both Solvency II and IFRS.

Technical Provisions	Solvency II value £m	IFRS value £m	Difference £m
Insurance with-profits participation	5,923	6,087	164
Index-linked and unit-linked insurance	3,437	3,479	42
Other life insurance (including Health)	3,603	4,187	584
Total Life insurance obligations	**12,963**	**13,753**	**790**

Note: The IFRS value excludes outstanding claims of £77m.

The Risk Margin and TMTP are significant sources of difference between Solvency II and IFRS; there is no equivalent in the latter.

The other main differences between Solvency II and IFRS are set out below:

Discount rates: While the risk-free reference curve under IFRS is aligned to the rates prescribed by EIOPA for use under Solvency II (derived from swap rates), there are differences due to additions to the risk-free rates. Under Solvency II, LVFS makes use of the VA and MA, which allow the liabilities for some products to be discounted at rates higher than risk-free. There is no equivalent to the VA under IFRS but the illiquidity premium, which represents compensation for risks not borne by a portfolio of 'hold to maturity' assets (as is the case with annuity business), that is used for IFRS is broadly similar to the MA. Under IFRS, the illiquidity premium is applied to all non-profit annuity business but under Solvency II, the MA is applied to annuity business within the Matching Adjustment Portfolio and the VA applied to all other annuity business (including with-profits annuities). For the with-profits business where the VA is applied, the VA is the primary difference between Solvency II and IFRS (other than the Risk Margin and TMTP).

Prudent margins: Under IFRS, the technical provisions for non-profits business are calculated with margins for adverse deviation, and separately, the value of the release of these margins is calculated (PVFP). This prudence is not present in the direct BEL calculation under Solvency II, which contains a best estimate projection of future cash flows.

Surplus in closed funds: There is a presentational difference for the surplus in closed funds; under IFRS this is a liability whereas under Solvency II it is an adjustment to Own Funds.

Contract boundaries: These exist under Solvency II but not IFRS.

D.2.3.1 Description of Reinsurance Recoverables

The BEL is calculated gross without deduction of amounts recoverable from reinsurance contracts. The calculation of recoverable amounts is carried out separately for reinsurance contracts as the probability-weighted average of the discounted future cash flows allowing for contract boundaries.

The amounts recoverable are then adjusted to allow for the default risk associated with the reinsurance counterparties. The assumptions and models used were the same as those used for the BEL.

Reinsurance recoverables are reported as a reinsurance asset on the balance sheet and include a deduction for the risk of reinsurer default.

Generally, there is no allowance for any future reinsurance purchases that may be used to cover existing obligations or for future business in the BEL that was expected to be written under the treaties.

The Matching Adjustment was calculated using liability cash-flows gross of reinsurance, with the methodology allowing for longevity swap recoverables in the asset cashflows.

There are no Special Purpose Vehicles (SPVs).

D.2.3.2 Material changes in assumptions

Future mortality improvement rates have been updated from the 2017 to the 2018 version of the Institute and Faculty of Actuaries Continuous Mortality Investigation (CMI) projection model, and re-parameterised to reflect expected future experience.

The methodology used to derive IB whole of life “gone away” assumptions has been updated.

Cash commutation rates on OB Pensions, where deferred pensioners can choose cash rather than a regular pension (on guaranteed terms), have generally been reduced to reflect expected future experience.

Persistency assumptions on underwritten whole of life business have been reduced at later durations to reflect expected future experience.

Base mortality tables for annuities have been updated to more recent versions.

D.3 Other liabilities

Other liabilities on a Solvency II basis	**2019**	2018
	£m	£m
Provisions other than technical provisions	**9**	7
Deferred tax liabilities	**103**	78
Derivatives	**226**	190
Debts owed to credit institutions	**69**	59
Insurance and intermediaries payables	**98**	77
Reinsurance payables	**6**	9
Payables (trade, not insurance)	**102**	112
Subordinated liabilities	**360**	360
Any other liabilities, not elsewhere shown	**(8)**	13
Total Other Liabilities	**965**	905

Reconciliation between IFRS and Solvency II valuation		**2019**			
		IFRS	**Presentational adjustment**	**Solvency II valuation adjustment**	**Solvency II**
	Note	**£m**	**£m**	**£m**	**£m**
Provisions other than technical provisions	#	**9**	-	-	**9**
Deferred tax liabilities	#	**103**	-	-	**103**
Derivatives	#	**226**	-	-	**226**
Debts owed to credit institutions	#	**69**	-	-	**69**
Insurance and intermediaries payables	1	**27**	(6)	77	**98**
Reinsurance payables	#	**-**	6	-	**6**
Payables (trade, not insurance)	2	**117**	-	(15)	**102**
Subordinated liabilities	3	**348**	-	12	**360**
Any other liabilities, not elsewhere shown	#	**12**	2	(22)	**(8)**
Total Other Liabilities		**911**	**2**	**52**	**965**

#= Disclosure note not provided as Solvency II value equal to IFRS or the amounts are immaterial.

Supporting Notes

1. Insurance and intermediaries payables

For Solvency II valuation purposes, insurance and intermediaries payables are valued consistently with IFRS. However there are presentational differences where under IFRS, the Life Claims Outstanding are disclosed as part of the technical provisions and for Solvency II purposes are reclassified to insurance and intermediaries payables.

Under IFRS, insurance payables are recognised when due and include amounts due to policyholders, agents, brokers and intermediaries. Insurance payables are initially recognised at fair value and subsequently held at amortised cost.

Insurance and intermediaries payables	**£m**
Insurance payables - IFRS	**27**
Presentational adjustment to transfer Reinsurance payables	(6)
Reclassification from technical provisions to insurance and intermediaries payables	77
Total insurance and intermediaries payables - Solvency II valuation	**98**

The IFRS liabilities recognised above are all due within one year.

2. Payables (trade, not insurance)

For Solvency II valuation purposes, payables (trade, not insurance) are valued consistently with IFRS and then adjusted to remove the accrued interest on the subordinated debt, as this is classified within the Solvency II fair value of subordinated debts – see note 3.

Under IFRS, trade payables are recognised when due. Payables are initially recognised at fair value and subsequently held at amortised cost.

Payables (trade, not insurance)	**£m**
Bank overdrafts	13
Trade payables	5
Amounts owed to group undertakings	2
Other taxes and social security costs	6
Other creditors	21
Finance lease liabilities	5
Accruals	65
Total Payables (trade, not insurance) - IFRS	**117**
Remove subordinated debt interest accrual	(15)
Payables (trade, not insurance) - Solvency II valuation	**102**

The maturity profile of the liability recognised in the financial statements is summarised in the following table:

						£m
	Within 1 year	**1 - 3 years**	**3 - 5 years**	**Over 5 years**	**UL**	**Total**
Payables (trade, not insurance)	**113**	**2**	**2**	**1**	**-**	**118**

The financial liability is presented based on the undiscounted contractual obligations and as such will not agree with the balances disclosed within the Statement of Financial Position in the statutory financial statements.

3. Subordinated liabilities

In 2013 LVFS issued £350m of Fixed Rate Reset Subordinated Notes at par. The effective interest rate on the Notes is 6.654%. The Notes have a maturity date of 22 May 2043 but LVFS has the option to redeem the Notes at the first call date of 22 May 2023 and at five yearly intervals thereafter up to the maturity date.

Interest is payable on the Notes at a fixed rate of 6.5% per annum for the period until the first call date on 22 May 2023, payable annually in arrears on 22 May each year. If the Notes are not redeemed on 22 May 2023, the interest rate is reset on that date and at five yearly intervals thereafter at a rate equal to the five year gilt rate quoted on the day before the reset date plus an initial margin of 463 basis points and a step up margin of 100 basis points. There is an option of cumulative deferral of interest at the issuer's discretion and mandatory interest deferral in the event that a regulatory deficiency interest deferral event has occurred or is continuing (breach of the applicable regulatory solvency capital requirement of the issuer or group) or would occur if payment of interest on the subordinated notes were to be made. Following any deferral of a principal or interest payment, LVFS would be prevented from declaring any distribution to members which falls within the Mutual Bonus arrangements.

LVFS has the option to elect to defer payment of interest in whole or in part and this will not constitute a default or give the right to the noteholders or the trustee to accelerate repayment of the Notes or to take any enforcement action.
This Subordinated Note meets in full the requirements in Article 73 of the Delegated Acts and as such are classed as Tier 2 Capital.

For Solvency II valuation purposes, the Notes are measured using the risk-free rate at the valuation date, whilst keeping the spread versus risk-free rate at point of issue constant, thus eliminating the effect of changes in credit rating. The model uses the discounted cashflow approach with the spread measured against the risk-free rate to equate back to the amount of debt issued. It also allows for accrued interest at point of valuation.

Under IFRS, the Notes are initially measured at the fair value of the proceeds less attributable transaction costs. Subsequent to initial recognition they are measured at amortised cost. The transaction costs are amortised over the period to the earliest possible redemption date on an effective interest rate basis. The amortisation charge is included in the

Statement of Comprehensive Income within finance costs. An equivalent amount is added to the carrying value of the liability such that at the redemption date the value of the liability equals the redemption value.

Subordinated liabilities	**£m**
Subordinated notes (GBP 350m)	
Subordinated liabilities - IFRS	**348**
Revaluation of subordinated debt to fair value	12
Subordinated liabilities - Solvency II valuation	**360**

The subordinated liability is expected to be settled more than 12 months after the balance sheet date.

D.4 Alternative methods for valuation

Information is provided for assets valued using alternative methods.

Justification for using alternative methods

LVFS aims to use quoted market prices or observable inputs to value all assets and liabilities however where there is no external market or readily observable inputs, LVFS will use an alternative method such as discounted cash-flow or mark-to-model.

Assumptions used in valuation approach and areas of uncertainty

Alternative methods for valuation include the use of estimates and assumptions that are not market observable but are based on a combination of internally developed models, calibrated to market observable data where possible as well as independent third-party evidence. Valuation uncertainty arises where there is reliance on third-party adherence to expected valuation standards or potential variation in the expected range of the key inputs into models.

The following material assets have been valued using alternative valuation methods in accordance with Article 263 of the Delegated Acts:

1) Equity release mortgages are not actively traded in a secondary market and hence a mark-to-model valuation approach is used which is classified as other Alternative Valuation Method (AVM). The fair value of the Equity Release mortgage assets is determined using a discounted cash flow model which takes into account the contractual rate of interest charged on the loans, the expected mortality and morbidity of the mortgagor and mortgagor actions.

   The discount rate is the zero-coupon swap curve with adjustments for profit and liquidity premiums.

   Equity release mortgages are the only financial instrument LVFS has which is significantly impacted by reasonably possible changes in unobservable inputs. The loans secured on residential property are sensitive to changes in discount rate spread, which includes the profit and liquidity premium. The impact of reasonably possible alternative assumptions is shown in the table below:

		2019		
		Reasonably possible alternative assumptions		
Description	**Unobservable input**	**Current fair value £m**	**Increase in fair value £m**	**Decrease in fair value £m**
Loans secured on residential property	Discount rates +/- 50bps	**645**	**29**	**(26)**

2) Holdings in related undertakings (£48m) being joint venture properties reclassified as participations. LVFS measures its interest in the joint venture at fair value in accordance with IAS 28, using the adjusted net asset method using unobservable external prices factoring in distributions or calls since the latest valuations.

3) Unlisted equity (£38m) being private equity holdings are valued at net asset value using unobservable external prices factoring in distributions or calls since the latest valuations. The private equity valuations are reviewed on a monthly basis by LVFS Group Treasury to ensure ongoing validity and accuracy.

4) Property, plant and equipment (£8m) is valued at the IFRS carrying value, based on cost less accumulated depreciation with assets written down to their recoverable amount where this is less than the carrying value. The IFRS carrying value is deemed to be materially the same as fair value.

D.5 Any other information

During the first quarter of 2020 markets have been severely impacted by the Coronavirus outbreak. Equity markets have fallen sharply, but LV= closely manages and hedges its market exposures and therefore has not seen a material impact arise.

E. Capital Management

E.1 Own funds

Capital is managed in line with the capital management policy where the key objective is to ensure the target return on capital is met, subject to also managing the Capital Coverage ratio and Operating Capital Surplus Generation in line with Risk Appetite Statements and Business Plan targets respectively. The key management metric is the Solvency II Capital Coverage after allowance for TMTP which is considered alongside impacts to other key indicators. These include, but are not limited to:

- Solvency II Capital Coverage before allowance for TMTP
- Impact on With-profit members
- Surplus capital generation
- Economic value of new business
- Liquidity
- Capital quality and capital volatility

The following table details the structure, amount and quality of basic own funds.

	Tier 1 £m	Tier 2 £m	Tier 3 £m	Total £m
Surplus funds	1,387	-	-	1,387
Reconciliation reserve	(69)	-	-	(69)
Subordinated liabilities	-	360	-	360
Total Basic Own Funds	**1,318**	**360**	**-**	**1,678**
Total available Own Funds to meet the SCR	**1,318**	**360**	**-**	**1,678**
Total available Own Funds to meet the MCR	**1,318**	**45**		**1,363**

The following tables detail the eligibility of own funds to meet the SCR and MCR.

Total available Own Funds to meet the SCR	1,318	360	-	1,678
Tier 2 capital restriction	-	-	-	-
Total eligible Own Funds to meet the SCR	**1,318**	**360**	**-**	1,678

Total available Own Funds to meet the MCR	1,318	360	-	1,678
Tier 2 capital restriction	-	(315)		(315)
Total eligible Own Funds to meet the MCR	**1,318**	**45**		**1,363**

As a mutual LVFS does not have any shareholders.

There are no terms and conditions attached to the Tier 1 Own Funds which for LVFS comprise of the following;

- Surplus Funds
- Reconciliation reserve

Tier 2 consists of subordinated debt of £350m, issued by LVFS in May 2013 which has an original maturity date of May 2043 and the first opportunity to redeem the loan notes occurs on 22 May 2023. It meets the qualifying criteria to be classed as Tier 2 own funds. The current value of the subordinated debt is £360m

More information on the terms and conditions of Tier 2 subordinated liabilities can be found in Section D.3 Other Liabilities, note 3.

LVFS has no Tier 3 own funds

Surplus Funds

Surplus funds are similar to the unallocated divisible surplus of LVFS as reported under IFRS. This represents the excess of assets over technical provisions and other liabilities. It includes amounts that have yet to be formally declared as bonuses for the participating policyholders together with the free assets of the Group. Any profit or loss for the year is transferred to the surplus funds account.

UK regulations, LVFS's Principles and Practices of Financial Management, and the terms and conditions of participating contracts set out the bases for the determination of the amounts on which the participating additional discretionary contracts benefits are based and within which LVFS may exercise its discretion as to the quantum and timing of their payment to contract holders.

Reconciliation reserve

This reduces the tier 1 capital and represents surplus funds within ring-fenced funds which are not available to LVFS.

Subordinated liabilities

Details of the subordinated liabilities which are included as Tier 2 capital within own funds, together with the valuation methodology are given in the Section D.3.

Eligibility

For the SCR test the sum of the eligible amounts of Tier 2 and Tier 3 items shall not exceed 50% of the SCR. The SCR is £909m which therefore means a maximum of £454m of subordinated debt is eligible to meet the SCR.

For the MCR test, the eligible amounts of Tier 3 and Tier 2 own funds shall not exceed 20% of the MCR. The MCR is £227m which therefore means a maximum of £45m of subordinated debt is eligible to meet the MCR.

Changes in own funds during the reporting period

	LVFS		
	1 January 2019 £m	Movement £m	31 December 2019 £m
Eligible own funds			
Tier 1 capital	1,183	135	1,318
Tier 2 capital	360	-	360
Total capital	1,543	135	1,678
Made up of:			
Surplus funds	1,259	128	1,387
Reconciliation reserve	(76)	7	(69)
Subordinated liabilities	360	-	360
Total capital	1,543	135	1,678
Total eligible own funds to meet SCR	**1,543**	**135**	**1,678**

- Tier 1 capital includes movements in excess of assets over liabilities, adjusted for the movement in the reconciliation reserve.
- Tier 2 capital represents the subordinated debt.
- Surplus funds have increased due to the Solvency II profit generated during the year.
- The reconciliation reserve comprises of adjustments (e.g. Ring-fenced funds, Deferred tax etc.) to the capital elements used in the calculation of the SCR

Ancillary own funds

At 31 December 2019 there were no ancillary own funds.

Deductions from own funds

At 31 December 2019 there were no deductions from own funds.

Material differences between equity as shown in the undertaking's financial statements and the excess of assets over liabilities as calculated for Solvency II purposes

As a mutual insurer, LVFS it is owned by its members and not by any shareholders. Unallocated divisible surplus represents the excess of assets over and above the long-term insurance contract liabilities and other liabilities. It represents amounts that have yet to be formally declared as bonuses for the participating contract policyholders together with the free assets of LVFS. Any profit or loss for the year arising through the Statement of Comprehensive Income is transferred to or from the unallocated divisible surplus.

The following table provides a reconciliation of equity (Unallocated divisible surplus) under IFRS to Solvency II excess of assets over liabilities.

	At 31 December 2019 £m	£m
Analysis of Equity per the statutory financial statements		
Unallocated divisible surplus		**856**
Solvency II Adjustments (excluding reclassifications)		
Assets		
- Reduction in valuation of participations (Section D.1 note 2)	316	
- Reduction in valuation of intangibles	(8)	
- Reduction in valuation of linked assets		
- Reduction in valuation of reinsurance recoverable (Section D.1 note 6)	(592)	
		(284)
Technical provisions		
- Decrease in valuation of technical provisions (Section D.2)		**867**
Other liabilities		
- Increase in payables	(62)	
- Increase in subordinated debt	(12)	
- Other	22	
		(52)
Total Equity - Solvency II valuation		**1,387**
Restricted own fund items due to ring-fenced fund		(69)
Subordinated liabilities allowable as own funds items		360
Total own funds - Solvency II valuation		**1,678**

Excess of Assets over Liabilities - Solvency II valuation	
Total Assets	15,315
Total Technical Provisions	(12,963)
Total Other Liabilities	(965)
Excess of Assets over Liabilities - Solvency II valuation	**1,387**

As detailed in the table above, numerous Solvency II adjustments were made to the balance sheet values as reported in the statutory financial statements. The adjustments arose from different valuation rules under Solvency II compared to the statutory financial statements.

Under Solvency II requirements, subordinated liabilities are included as a reconciling item in the table above since they are treated as liabilities for IFRS but count towards own funds.

Own-fund item that is subject to the transitional arrangements

There are no own fund items subject to transitional arrangements for LVFS.

E.2 SCR and MCR

E.2.1 LVFS SCR and MCR

LVFS calculates its SCR using the accounting consolidation-based method set out as Method 1 in Article 230 of Directive 2009/138/EC, with the exception of the valuation of subsidiaries. On a Solo basis, subsidiaries are valued as debt or equity holdings, essentially treating them in a similar way to investments made outside LVFS.

The SCR for LVFS as at 31 December 2019 was £909m (31 December 2018: £839m). The increase in SCR over the period was driven by the sale of the remaining 51% holding in the general insurance business (+£66m) and the fall in interest rates over the year (+£41m).

The Minimum Capital Requirement (MCR) as at 31 December 2019 was £227m (31 December 2018: £210m).

The calculation of the MCR is laid out in the S.28.01.01 QRT annexed to this report. The MCR is calculated, as prescribed in the Solvency II regulations, involving the multiplication of prescribed factors to Technical Provisions (excluding Risk Margin) and capital at risk, subject to a floor of 25% of the SCR and a cap of 45% of the SCR. There is also an absolute floor specified as 3.7m Euros, converted to pounds sterling.

For LVFS the biting requirement is 25% of the SCR. The reason for the increase in the MCR over the year is the increase in SCR.

E.2.2 LVFS SCR split by risk

LVFS uses a Standard Formula approach for calculating its regulatory SCR, although it maintains its own internal view of capital. The following table shows the breakdown of the SCR by risk on the Standard Formula basis. In line with the construction of the Standard Formula SCR, the amounts for each risk module contain some diversification allowance within that module. For example, the market risk line includes diversification between equity and interest rate risk. The individual modules also include an allowance for the loss absorbing capacity of technical provisions.

The below figures allow for the structure of LVFS, and specifically RNPFN and Teachers ring-fenced funds contained within LVFS. The capital requirements for these funds are calculated in isolation and added to the remaining part of LVFS, with no credit being taken for diversification between them.

Risk Module (all figures in £m)	**2019**	2018
Market risk	**703**	592
Credit counterparty risk	**32**	34
Life underwriting risk	**349**	376
Health underwriting risk	**92**	89
Total before diversification	**1,176**	1,091
Diversification	**(248)**	(242)
Basic Solvency Capital Requirement	**928**	849
Operational risk	**39**	37
Loss absorbing capacity of deferred taxes	**(58)**	(47)
Solvency Capital Requirement	**909**	839

The market risk SCR has materially increased over the period. This was driven by the sale of the remaining 51% holding in the general insurance business and the fall in interest rates over the year. See section C3.2 for further details.

Life underwriting risk SCR has reduced over the period driven by model and basis changes on the OB Pensions deferred annuities business and protection business and the natural run-off of more capital-intensive and closed lines of business.

E.2.3 Diversification benefit

Diversification benefit within the SCR emerges from relative sizes of the risks and the correlation assumptions between them. As a result of using the Standard Formula approach to assess LVFS SCR, the stress assumptions used to calculate the risk capital amounts, and the level of correlation between risks, are prescribed by Solvency II regulations.

LVFS's Solo SCR has material sources of diversification benefits arising from the life business written directly by LVFS, which diversifies within itself. For example, LVFS's with-profits business diversifies against its protection business due to the different risks to which these businesses are exposed.

E.2.4 Basis of calculation

LVFS uses a Standard Formula basis to calculate the SCR. The approach to calculating the SCR and MCR is in accordance with the Solvency II Directive. LVFS is not using any material simplifications or undertaking specific parameters in the calculation of the SCR and does not have any regulatory capital add-ons.

Calculation of Minimum Capital Requirement

MCR Calculation	**£m**
Linear MCR	156
SCR	909
MCR Cap (45% of SCR)	409
MCR Floor (25% of SCR)	227
Minimum Capital Requirement	**227**

E.3 Use of a duration-based equity risk sub-module

LVFS has not applied the duration-based equity risk sub-module in the calculation of the SCR.

E.4 Differences between Standard Formula and any Internal Model used

This does not apply as LVFS does not use an Internal Model to calculate its SCR.

E.5 Non-compliance with the MCR and the SCR

LVFS has been compliant with the MCR and SCR throughout the reporting period.

E.6 Any other material information

Our solvency position remains strong and our stress testing demonstrates that our Solvency II Capital Coverage Ratio remains above risk appetite of 140% under a Coronavirus stressed scenario.

Further details on the insurance entities owned by LVFS can be found in the relevant SFCRs.