2016 Annual Report from the Board of Liverpool Victoria Friendly Society Limited to its With-Profits Policyholders

1. Summary

We describe the way in which we manage the with-profits business written by Liverpool Victoria Friendly Society Limited[1] ('LVFS' or 'the Society') in a formal document known as the 'Principles and Practices of Financial Management' (or 'PPFM'). Each year we review our compliance with the PPFM and report the results of that review to you.

This report to policyholders examines the management of the Society's with-profits business during 2016. It covers the governance arrangements, the exercise of discretion and how any competing interests between different classes of policyholders were addressed. It does not apply to policies in the RNPFN Fund (a ring-fenced fund within LVFS) or the Teachers Assurance Fund (a ring-fenced fund established within LVFS on 1 June 2016). These have their own Principles and Practices of Financial Management documents and separate reports on compliance with them.

In the opinion of its Board of Directors ('the Board'), the Society materially complied with the obligations set out in the PPFM during 2016. The reasons for this opinion are outlined in this report. The With-Profits Committee concurs with this view.

2. Governance Arrangements

The Board is ultimately responsible for the management of the Society's with-profits business. The With-Profits Committee is a sub-committee of the Board, set up to provide independent judgement relating to the exercise of discretion in respect of this business within the scope of this report. It also monitors compliance with the PPFM. Throughout 2016, it comprised a Chairman who is independent of the Liverpool Victoria Group, another independent member, a non-Executive Director and a member of management. A third independent member joined during 2016.

The Society also has a With-Profits Actuary authorised by the Prudential Regulation Authority, who provides advice to the Board and the With-Profits Committee on the exercise of discretion relating to matters affecting the Society's with-profits business. The current With-Profits Actuary, who acted in that capacity throughout the period covered by this report, is Mr Andrew Walton. His report is annexed to this report.

3. Compliance with PPFM in exercising discretion

There are a numbers of areas where discretion was exercised in relation to the Society's with-profits business during the year under review. These are discussed below.

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[1] Including some minor business from historic acquisitions.

3.1 Amounts payable under a with-profits policy

For those groups of policies where their own asset share is used to set final bonus rates we aim to make payouts on maturing, surrendering and transferring policies that are within 80% and 120% of asset share (known as the target range). For these groups of policies, 99.5% of maturity claims and 95.1% of surrender claim payouts during the year were within the target payout range[2].

For the following groups, other methods are used to set payouts and no target range is set:

- conventional paid-up policies (which receive the same final bonus rate as a premium-paying policy of the same type and duration);
- IB whole-of-life policies sold before 1980 (which receive the final bonus rate for a taxable policy sold in 1980);
- OB whole-of-life policies sold before 1968 (which receive the final bonus rate for a policy sold in 1968);
- the extra benefit paid in respect of Life Assurance Premium Relief on IB policies issued before 6/4/1979; and
- conventional pension policies with annuity guarantees (the value of the guaranteed benefits on vesting is currently above the asset share, while cash values include a prospective element based on the guaranteed benefits).

The Flexible Guarantee Bond (and similar policies) do not have a final bonus and use a mechanistic derivation of the payout, normally based on the investment return averaged over a rolling six-month period and no target range is defined.

Given With Profits Pension Annuity and Pension Income Plus Annuity policies do not have a single payout, a target range is not appropriate.

Two significant changes were made during 2016 to the approach used to set payouts under with-profits policies:

- Surrender values under conventional whole-of-life policies were set equal to the death benefit. Previously, reduction factors were applied which led to payments that fell materially below the asset share as defined in the PPFM[3].
- Previous investment management fees charged to asset shares on Appropriate Personal Pension policies were removed, given they were contrary to the PPFM (though were in accordance with the original policy literature). Future investment management fees will be taken following a change to the PPFM in 2017.

Regarding these changes, it was identified that some compensation payments were required for past claims, as detailed in section 3.10.

3.2 Regular bonus rates

Regular bonus rates were reviewed during the year in accordance with the PPFM. The rates declared on 1 March 2016[4] remained the same as the previous year, except for With Profits Pension Annuity policies where the rate was decreased from 1.4% to 1.3% p.a.. For conventional policies, interim bonus rates were maintained at the same level as the regular bonus rates declared on 1 March 2016.

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2 90% is the minimum required under Financial Conduct Authority regulation.
3 This was noted as a material item of non-compliance in the 2015 report to policyholders.
4 Except for With Profits Pension Annuity policies, where the declaration date was 1 February 2016.

Quarterly declarations were made in respect of the Declared Investment Return for Pension Income Plus Annuity policies, taking effect from 1 February, 1 May, 1 August and 1 November 2016 which changed rates at each declaration.

Regular bonus rates are not applied to Flexible Guarantee Bonds and similar policies.

3.3 Final bonus

A final bonus declaration for conventional with-profits policies was made with effect from 1 March 2016 which changed claim payments from that date. Top-up bonus rates for With Profits Pension Annuities were declared with effect from 1 February 2016. The declarations were made in accordance with the PPFM. Discretion was exercised with regards to smoothing, the level of charges allocated to asset shares, the investment return used to project asset shares to the period covered by the review, tax (where applicable) and the choice of sample policies used to translate the asset shares into final bonus or top-up bonus rates.

Final Bonus rates and any market value reductions (where allowed under policy conditions) are calculated on an individual policy basis for Appropriate Personal Pension policies and old-style unitised with-profits policies, with investment returns smoothed over a rolling two-year period. The Society operated in accordance with this practice during 2016, with no market value reductions being applied during 2016.

No final bonus is paid on Pension Income Plus Annuity policies, Flexible Whole Life policies or Flexible Guarantee Bonds (and similar policies).

3.4 Mutual bonus

A mutual bonus of 1% of asset share was declared for the trading year 2015. This was added to the asset shares of most policies on 1 March 2016[5].

3.5 Surrender bases for conventional policies

Discretion is exercised in the methods and assumptions used to calculate surrender and early transfer values for conventional with-profits policies. For conventional endowment policies, the method used during 2016 applies the same rate of final bonus to the recalculated guaranteed benefits as would apply to a maturity or death claim for the same policy type and duration in force. For conventional whole-of-life policies the surrender value is set to be the same as the death benefit. For conventional pension policies, cash values include a prospective element based on the guaranteed benefits.

3.6 Smoothing of payouts

The Society uses various methods of smoothing depending on the type of the policy as detailed in the PPFM. The Society operated in accordance with these methods during 2016.

The methods used give an appropriate level of smoothing to with-profits policyholders invested in the Society, given the asset mix of the asset share pools.

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[5] For certain policy types the bonus was added shortly before or after 1 March 2016.

They balance the needs of those leaving the Society with the need to protect policyholders remaining with the Society.

Where applicable, the target range of 80% to 120% of the asset share is appropriate taking into account the investment strategy, the smoothing methods and the frequency of reviews of final bonuses.

The Flexible Guarantee Bond and similar policies use a mechanistic derivation of the payout, normally based on the investment return averaged over a rolling six-month period and no target range is defined.

3.7 Investment strategy

In accordance with the PPFM, the investment strategy was monitored during 2016 to ensure that it remained appropriate. Discretion was exercised with respect to the types of investment held and the proportions invested in different types of asset. A review of the investment strategy for the main asset share pool led to benchmark allocations for the mix of assets being adjusted and some new asset classes being added. A detailed review of the investment strategy of the other asset share pools is expected in 2017. Different investment strategies are maintained to manage the guarantee annuity benefits of the conventional pensions, for the assets backing the non-profit policies written by the Society and its inherited estate.

Columbia Threadneedle Investments carried out the day-to-day investment management of the Society's assets during 2016[6]. Information was provided by them to demonstrate that asset holdings were within limits prescribed by the Board.

The Society's strategic investment in its General Insurance business was maintained during 2016 as the Board believed it was likely to have no adverse effect on the interests of the Society's with-profits policyholders, and continuing with the investment through 2016 was in the best interests of all the Society's policyholders.

3.8 Charges and expenses

There were no significant changes to the method of apportioning the expenses of the Society to with-profits policies during 2016. For some policy types, the Society exercised discretion in applying these expenses as charges to asset shares. For other policy types, the charges applied were in line with charges set out in policy conditions or similar documents.

3.9 Business risk

Discretion was exercised in determining the amount of business risk taken by the Society during 2016 through writing non-profit and with-profits business and through the Society's subsidiary companies. Following agreement of its members and the regulators, the business of Teachers Provident Society Limited was transferred to the Society on 1 June 2016. The Board of LVFS was satisfied that this transaction did not have a detrimental effect on its own policyholders.

The RNPFN Fund benefits from a capital support facility provided by the Society. This requires a contingent loan to be advanced to the RNPFN Fund should a deficit arise. No such loan was advanced in 2016.

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[6] Other than assets held in respect of some of the business transferred from Teachers Provident Society.

3.10 Rectification

The issues identified in section 3.1 leading to the two significant changes in approach used to set amounts payable under with-profits policies were historic. In respect of conventional whole-of-life policies, certain previous claims were found to be underpaid and compensation was paid in respect of this during 2016. In respect of Appropriate Personal Pension policies, compensation is expected to be paid on all materially affected prior claims that can reasonably be found, during 2017. It is noted that following product reviews undertaken during the year, investigations are ongoing into other potential issues that may require rectification.

3.11 Changes to the PPFM

The following material changes were made to the PPFM Practices during the year in the version of the PPFM that became effective on 1 December 2016:

- An amendment was made to reflect a new regulation that, from the introduction of Solvency II (a new regulatory regime), requires strategic investments (such as the Society's investment in its general insurance business) to be made in the best interests of all the Society's with-profits and non-profit policyholders.
- An amendment was made, following the introduction of Solvency II, such that the RNPFN capital support facility will now be called on if the RNPFN Fund fails to cover its own Solvency Capital Requirement.

4. Competing or conflicting rights, interests or expectations of policyholders

LVFS is run as a mutual which therefore avoids having any competing or conflicting interests with shareholders.

Potentially competing or conflicting rights, interests or expectations of with-profits policyholders may come about, for example, between:

- different types of policy;
- policies with varying benefits and policy conditions;
- policies with different terms or of different sizes;
- policies with different entry or maturity dates; and
- different types of claim on a policy (for example, a maturity or surrender).

To ensure that LVFS with-profits policyholders are treated fairly in balancing their respective interests, throughout 2016 the Society exercised discretion between these groups of policyholders through:

- the choice as to how policy benefits are smoothed;
- maintaining different series of annual bonus rates for different policy types;
- the method used to group policies when allocating investment returns, tax (where applicable) and charges to asset shares; and
- the management of the Society's capital resources.

5. Conclusion

The discretions exercised, as detailed in section 3, were reviewed by the With-Profits Committee and by the With-Profits Actuary. The Board can confirm that, in its opinion, the discretion exercised materially complied with the PPFM during 2016.

The Board can also confirm that, in its opinion, potentially competing or conflicting rights, interests or expectations of policyholders, as detailed in section 4, were managed in accordance with the PPFM and treated with-profits policyholders fairly. The advice of the With-Profits Actuary was given with regard to these issues, which were also reviewed by the With-Profits Committee.

The Board of Directors
Liverpool Victoria Friendly Society Limited
3 May 2017

Annex

Report from the With-Profits Actuary to the With-Profits Policyholders of Liverpool Victoria Friendly Society

It is my responsibility as With-Profits Actuary of Liverpool Victoria Friendly Society Limited ('the Society') to advise the Society's Board of Directors on the management of the Society's with-profits business, and to report annually to with-profits policyholders on the exercise of discretion in relation to that business.

In my opinion the Board's report, and the discretion exercised by the Society's Board of Directors in relation to the Society's with-profits fund in 2016, may be regarded as having taken the interests of with-profits policyholders into account in a reasonable and proportionate manner.

In reaching this opinion I have taken into account the information and explanations provided to me by the Society, relevant rules and guidance issued by the Prudential Regulation Authority and the Financial Conduct Authority and applicable standards and guidance issued by the Financial Reporting Council[7].

Andrew Walton
With-Profits Actuary
3 May 2017

[7] The Insurance TAS, TAS D (Data), TAS M (Modelling) and TAS R (Reporting Actuarial Information)