



# Principles and Practices of Financial Management

Report to With-Profits Policyholders on Royal Liver Assurance's Compliance for 2010

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**REPORT TO WITH-PROFITS POLICYHOLDERS ON COMPLIANCE DURING 2010  
WITH THE PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT OF ROYAL  
LIVER WITH-PROFITS BUSINESS**

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## SUMMARY

FSA regulations require that a firm must produce an annual report to its with-profits policyholders stating whether, throughout the financial year to which the report relates, the firm believes it has complied with the obligations relating to its Principles and Practices of Financial Management (PPFM) and setting out the firm's reasons for that belief. The report must address all significant relevant issues, including the way in which the firm has:

- (i) exercised, or failed to exercise, any discretion that it has in the conduct of its with-profits business; and
- (ii) addressed any competing or conflicting rights, interests or expectations of its policyholders (or groups of policyholders).

In the opinion of the Board of Royal Liver Assurance (RLA) the Society has, with one exception, complied with the obligations relating to its PPFM over the period from 1<sup>st</sup> January 2010 to 31<sup>st</sup> December 2010. The exception relates to an intention during 2010 to amend the practices of the PPFM and communicate this change to with-profits policyholders. This exception is outlined in more detail in section 3.5.

This report, commissioned by the Board, provides sufficient information in its relevant sections to support for each reader/user in their decision making.

This report is for the With Profit Committee and Board of Royal Liver Assurance and its purpose is to evidence that the Board has reported to with profit policyholders as required by regulation.

## 1. INTRODUCTION

RLA first published its PPFM on 30<sup>th</sup> April 2004.

The current PPFM and customer friendly versions of the PPFM are available on Royal Liver Assurance's website [www.royalliverassurance.com](http://www.royalliverassurance.com). The PPFM glossary provides an explanation of all technical terms used in this report.

The current version of the PPFM was published on 31/12/2009 and was not altered during 2010.

Each year, the Board must report to all with-profits policyholders on compliance with the obligations of their PPFM. These obligations are that the RLA should maintain governance arrangements designed to ensure that, in the conduct of with-profits business, it complies with, maintains and records any applicable PPFM.

This report covers:

- Governance arrangements for with-profits business.
- How RLA has complied with its PPFM in exercising discretion in managing their with-profits business.
- Equity between different groups of policyholders.
- Changes to the PPFM and communications to with-profits policyholders.
- Maintenance and recording of the PPFM document itself.

The annual report to with-profits policyholders by the With-profits Actuary (WPA) is also attached to this report.

RLA transferred some with-profits business from Caledonian Insurance Company Limited at 31<sup>st</sup> December 2000, from Friends Provident Life Office at 31 March 2001, and from Irish Life Assurance plc at 28<sup>th</sup> February 2002. These three blocks of transferred business all form part of the RLA single fund. Each block is covered in this report.

The report covers the period from 1<sup>st</sup> January 2010 to 31<sup>st</sup> December 2010 inclusive.

## **2. GOVERNANCE ARRANGEMENTS FOR WITH-PROFITS BUSINESS**

There are two specific roles which RLA has set up to ensure that it is managing its with-profits business in accordance with their PPFM; the With-Profits Committee (WPC) and the WPA.

### **2.1 THE ROLE OF THE WITH-PROFITS COMMITTEE (WPC)**

The WPC met eight times during 2010. One of the roles of the WPC is to advise the Board on the Society's with-profits business, including monitoring compliance with the PPFM. The WPC consists of non-executive directors of Royal Liver.

### **2.2 THE ROLE OF THE WITH-PROFITS ACTUARY (WPA)**

Scott Robinson, who is an employee of Towers Watson consulting actuaries, served as WPA during 2010. The WPA is responsible for advising the Board on compliance with the PPFM; interests of with-profits policyholders; areas of discretion and potential conflicts of interests.

The WPA's report to policyholders in respect of 2010 can be found in the appendix to this report.

### **3. HOW THE PPFM HAS BEEN COMPLIED WITH IN EXERCISING DISCRETION IN MANAGING THE WITH-PROFITS BUSINESS**

There are a number of important areas where RLA has exercised its discretion in managing its with-profits business.

#### **3.1 BONUS RATES**

This is probably the single most important item of discretion that RLA makes which affects with-profits policyholders.

There were three sets of bonus declarations relating to 2010.

- The end year 2009 bonus declaration which set final bonus rates and interim annual bonus rates for claims during 2010.
- The mid year 2010 bonus declaration which revised final bonus rates for claims applicable from 1<sup>st</sup> July 2010 to 31<sup>st</sup> December 2010.
- The end year 2010 bonus declaration which set annual bonus rates to apply for 2011, for policies that will become claims after 2010.

As described in the PPFM, the bonus rates are assessed by reference to asset shares. In the end-2009 bonus investigations bonuses were reduced, in some cases significantly, as a result of the movements in financial markets, during 2009. At Mid Year 2010, reflecting the change in Society's financial circumstances, it was necessary to implement further reductions to final bonuses on Industrial Branch contingent policies, which were set to 0%.

The Board was supplied with sufficient information for it to confirm that in its opinion the declarations were consistent with the PPFM.

The bonus declarations were reviewed by both the WPA and the WPC.

#### **3.2 INVESTMENT STRATEGY**

The investment strategy was regularly monitored by the Executive Investment Committee (EIC) (formerly the Capital Management Group (CMG)) of which the WPA is a member. Proposals for any changes in strategy are put before the EIC, WPC and Board for approval. Consideration is given to expectations of with-profits policyholders in determining the investment strategy.

The Society's aim, during 2010, was to hold a significant proportion of return seeking investments such as equities, alternatives and property in respect of with-profits asset shares. These investment classes were seen to provide longer term growth prospects. By the end of 2010 the Society's aim was to hold around 50% of return seeking assets in respect of with-profits asset shares, with the remainder in cash and fixed interest investments (both government and corporate bonds). The Society will continue to monitor and as necessary adjust this investment mix. The PPFM describes some of the criteria applied in this consideration.

### **3.3 SURRENDER VALUES**

The methodology and approach used to determine surrender values during 2010 was the same as that applied in 2009.

No changes were made to the approach for determining Market Value Adjustments (MVA) on unitised with-profits business during 2010. MVA were reviewed on a monthly basis to reflect investment conditions.

### **3.4 VOLUMES OF NEW BUSINESS AND ARRANGEMENTS ON STOPPING NEW BUSINESS**

When setting the planned levels of new business sales, RLA aims to ensure that there is sufficient capital in the RLA fund to support new sales without adversely affecting the financial position of the RLA fund.

RLA was open to new unitised with-profits premiums until the Caledonian With-Profit bond was withdrawn on 31/12/2010. RLA was open to new protection business throughout 2010 however a decision was taken at the end of September 2010 to cease writing new protection business in the UK via the Progress brand.

### **3.5 CHARGES AND EXPENSES**

In the early part of 2010 the Society revisited its expense allocation methodology, and the outcome of this analysis was utilised in the expense apportionments for 2009 onwards. The revised expense analysis resulted in expenses being split in different ways than previous methods. Given the Society's predominantly legacy book of business, and the activities involved in running this business, this changed approach was considered more appropriate. The application of the revised methodology to with-profits business was considered to be acceptable under the PPFM. However, there is one area where this application resulted in a required change in the Society's PPFM Practices. This related to section 2.7 of the PPFM, which indicates that the per policy expenses applying to conventional business will be dependent on the premium paying status of the policy, and that such per policy expenses will be lower after a policy ceases paying premiums. The latest expense analysis indicated that there was no material difference in the expenses incurred in administering premium or non-premium paying policies, and therefore the expense methodology used by the Society was amended to reflect this analysis.

As it was acknowledged by the Society that the revised basis of expense allocation did not necessarily align to the wording of section 2.7 of the PPFM, the intention was to amend the PPFM Practices during 2010 and to communicate this to with-profits policyholders at the earliest practical opportunity. However, the change to the PPFM for this issue was not undertaken in 2010 and therefore the delay in doing this could be considered to be a breach of the PPFM.

The Society intends to alter the PPFM and communicate this matter to with-profit policyholders in the near future, again when it is practical to do so.

The WPA and the WPC reviewed the expense apportionment and the level of investment fees.

### **3.6 MANAGEMENT OF THE INHERITED ESTATE**

The fund contains an amount of money in excess of the amount expected to be paid to existing policyholders. This is known as the inherited estate. It has built up over many years from a number of sources and it provides working capital, to support current and future business.

The Board has regard to the current and projected financial position of the inherited estate in its financial management of the fund.

The inherited estate was used to support new with-profits and non-profit business. This outlay would be expected to be repaid as further premiums are received and hence any initial outlay was not expected to be a permanent reduction in the size of the inherited estate. However, for new Caledonian Bond with-profits business, and the protection business written in the UK (via the Progress brand), it was considered to be marginal as to whether business could be supported in the longer term. Therefore, in the latter part of 2010 a decision to close to new with-profits business, and also a decision was made to close the protection business written under the Progress brand.

In relation to with-profits business, cost will arise on a with-profits policy when the guarantees applying under the policy (such as the sum assured plus attaching regular bonuses) exceeds the policy's asset share. In order to meet the cost of providing such guarantees in the future, and to manage the inherited estate, the Board introduced a charge to asset shares for conventional with-profits policies from mid-2009. This charge was set at 1% per annum, and is operated via a deduction from the investment return that is credited to asset shares. The rate of guarantee charge on conventional business remained unchanged throughout 2010 although the rate will increase from 1% to 1.5% per annum in July 2011. In addition a similar guarantee charge on unitised with-profits business of 0.75% per annum was introduced in April 2011.

### **3.7 IB CONTINGENT BUSINESS**

During 2009, the Board considered the discretionary addition of final bonuses applied to IB contingent business, and a decision was taken to reduce the level of such bonuses. A further reduction to final bonuses of IB contingent business was applied within the mid-year 2010 bonus declaration. The Society still retains the ability to apply discretionary final bonuses to this business if the Society has such financial resources to commit to this, and it was considered appropriate from a fairness point of view (especially considering the rights of full with-profits policyholders). This issue was communicated to policyholders during the first half of 2011.

#### **4. EQUITY BETWEEN DIFFERENT GROUPS OF WITH-PROFITS POLICYHOLDERS**

Different groups of with-profits policyholders have potentially competing or conflicting interests, such as holders of:

- Different products.
- Policies of different sizes or policy terms.
- Policies with different entry dates or maturity dates or with-profit policyholders of different ages.
- Policies claiming for different reasons (e.g. maturity, death or surrender).
- Policies exercising different policy options, who could receive different benefits relative to each other depending on how discretion is exercised.

The main areas in which judgement and discretion are exercised in balancing the interests of these groups are:

- Smoothing of policy benefits.
- Grouping of policies for setting bonus rates and surrender values and sharing of investment and other experience, such as surrender, expenses and mortality profits or losses.

The approach taken to smoothing was as described in the PPFM, however as a result of the exceptional investment market movements that occurred during 2008 a material level of smoothing costs was incurred by the Society. A smoothing account had therefore been established up by the Society and it was intended to target a level of payout slightly below asset share (97.5% during 2009) until the costs incurred in 2008 and any subsequent costs have been recouped. This target payout figure for managing the smoothing account was altered to 96.5% at the mid-year 2010 bonus declaration.

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

#### **5. CHANGES TO THE PPFM AND COMMUNICATIONS TO POLICYHOLDERS**

No changes were made to the PPFM during 2010, although as stated in section 3.5 the Society had intended to make a change to the Practices during 2010 .

Statements sent to with-profits policyholders during 2010 set out details of the bonuses added to their investments following the year end 2009 bonus declaration. Policyholder communications are also reviewed for consistency with the PPFM.

Copies of the current PPFM and the CFPPFM are available on RLA's website [www.royalliverassurance.com](http://www.royalliverassurance.com).

## **6. MAINTENANCE AND RECORDING OF THE PPFM**

Ongoing review was carried out during 2010 to confirm that RLA's PPFM remained up to date with current practice.

During the period covered by this report (2010), in all material respects, full compliance with the processes and controls for the maintenance and recording of the PPFM was signed off, with the exception noted in section 3.5.

## **APPENDIX TO THE REPORT TO WITH-PROFIT POLICYHOLDERS**

### **REPORT FROM THE WITH-PROFITS ACTUARY**

As With-Profits Actuary, I advise the Board of Royal Liver Assurance Limited (“Royal Liver”) on key aspects of the discretion that they exercise with regards to with-profits business.

I have been involved in consideration of all the matters referred to in the report on Royal Liver’s compliance with its Principles and Practices of Financial Management. One issue has been identified whereby Royal Liver had intended in 2010 to amend its Practices (in relation to the differential of expenses when policies cease paying premiums). The Society has not updated its PPFM Practices in this area and therefore with-profits policyholders have not been informed of the amended approach taken to the expense allocation. This issue can be considered to be a breach of the application of the Royal Liver’s PPFM.

Overall, in my opinion, based on the information and explanations provided to me by Royal Liver, the discretion exercised by Royal Liver over 2010 took policyholders’ interests into account in a reasonable and proportionate manner.

In arriving at my opinion, I have taken into account, where relevant, the rules and guidance contained in the Financial Services Authority’s Conduct of Business Rules 20.2 (treating with-profits policyholders fairly).

**Scott Robinson**  
**With-Profits Actuary**

for Royal Liver Assurance Limited  
June 2011