Security of Assets Summary for Legal and General Assurance (Pensions Management) Limited

PMC

Year ended 31 December 2015

Legal & General Investment Management Limited
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Legal & General
INVESTMENT MANAGEMENT

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Introduction and Background

Legal and General Assurance (Pensions Management) Limited – otherwise known as PMC – is a European Economic Area long-term insurer, providing unit-linked pension policies and segregated investment management services.

Pooled fund assets are invested in a unit-linked long term insurance policy with PMC. Investment management of the assets is delegated to Legal & General Investment Management Limited ('LGIM').

PMC is wholly owned by Legal & General Investment Management (Holdings) Limited ('LGIMH'), which is itself wholly owned by Legal & General Group plc.

The purpose of this document is to provide information to PMC clients regarding the various mechanisms in place that support policyholder security, and to provide a summary of PMC's financial position under the Solvency II regime.

Executive overview

The mechanisms supporting policyholder asset security remain in place and unchanged compared to our previous Security of Assets Summary which was issued during 2015 reflecting the position as at 31 December 2014.

The introduction of the Solvency II regime from 1 January 2016 does not change the security structure.

The Solvency II regime requires a new methodology to be applied in the construction of the regulatory balance sheet and associated calculation of capital requirements. Further details are shown later in this document.

Following the regime change, PMC continues to be well capitalised and to hold capital which comfortably exceeds the regulatory requirements. Similarly to the position as at 31 December 2014, PMC continues to hold capital which includes in excess of £254m in UK gilts.

Corporate structure

PMC is a separate legal entity within the Legal & General Group, with its own Board of directors responsible for acting independently to promote the success of the company and exercise independent judgement. PMC's operational and governance arrangements are distinct from the Group's other major businesses.

As a result of the corporate structuring and the operation of English company law, PMC's assets are legally and financially separated from the rest of L&G Group and from other L&G entities, such as Legal and General Assurance Society Limited and Legal & General Insurance Limited.

Regulatory framework

Due to its status as a long-term insurer, PMC is authorised by the Prudential Regulatory Authority (PRA) and is regulated by the Financial Conduct Authority (FCA) and by the PRA.

LGIM is authorised and regulated by the FCA.

As part of the regulatory framework for long-term insurance companies as at 31 December 2015, the PRA takes a judgement-based approach to ensure that firms provide appropriate protection for policyholders which includes an assessment of solvency.

With effect from 1 January 2016, all insurance companies operating in the European Union are required to comply with the EU Solvency II Directive, which updates the regulatory framework for insurers and harmonises solvency capital and disclosure requirements across all EU Member States.

Under Solvency II, the PRA is required to ensure that firms provide appropriate protection for policyholders via an assessment of solvency. The calculation methodology under Solvency II differs from that under the preceding regime, and more detail is given on this later in this note. Irrespective of the regime change, PMC continues to be well capitalised in its own right and continues to hold capital which comfortably exceeds the regulatory assessment.

LGIMH uncalled share capital

PMC's capital could, subject to the approval of the LGIMH Board, be further increased by LGIMH's available consolidated net assets, which included £89.1m of uncalled share capital from Legal & General Group Plc as at 31 December 2015.

Policyholder protection

Given the regulatory framework, the nature of the business risks and PMC's level of capital retention, PMC insolvency is highly unlikely. Nevertheless, in an insolvency situation, PMC pooled fund policyholders are further protected by a floating charge which would crystallise over all of the rights, benefits and assets of PMC, and sums would only be paid to creditors in accordance with the priorities of the charge.

In broad terms, the floating charge together with the law on the winding-up of long-term insurers gives all pooled fund policyholders priority over the pooled assets for the value of their units.

Custodians and cash

All of PMC's invested assets are held by independent custodians (HSBC Bank Plc and Citibank, N.A. (London Branch)).

PMC sweeps significant amounts of uninvested Sterling and US Dollar cash from the pooled funds into LGIM Liquidity Funds Plc, which is an umbrella type investment company with variable capital incorporated with limited liability in Ireland and with LGIM as the investment manager. The custodian of the assets of LGIM Liquidity Funds Plc is Northern Trust Fiduciary Services (Ireland) Limited ('Northern Trust').

Where this has been indicated in the relevant PMC fund documentation, some PMC pooled funds invest in shares of sub-funds of LGIM (Ireland) Risk Management Solutions Plc (LIRMS), which is an umbrella type investment company with variable capital incorporated with limited liability in Ireland and with LGIM as the investment manager. The custodian of the assets of LIRMS is Northern Trust.

Where this has been indicated in the relevant PMC fund documentation, certain PMC pooled funds invest in shares of sub-funds of Legal & General Investment Management Funds (ICVC), which is an umbrella type investment company with variable capital incorporated with limited liability in England & Wales and with LGIM as the investment manager. HSBC Bank plc is appointed to act as ICVC Depositary (a similar function to a custodian).

Where this has been indicated in the relevant PMC fund documentation, certain PMC pooled funds invest in shares of sub-funds of the Legal & General SICAV (Société d'Investissement À Capital Variable)(SICAV), which is an open-ended investment company with variable capital incorporated in Grand-Duchy of Luxembourg and authorised by the Commission de Surveillance du Secteur Financier and with LGIM as the investment manager. The custodian of the assets of the SICAV is Bank of New York Mellon (Luxembourg) S.A.

Where this has been indicated in the relevant PMC fund documentation, certain PMC pooled funds invest in shares of sub-funds of LGIM Commodity Composite Source ETF a sub-fund of Source Markets PLC; an umbrella type investment company with variable capital incorporated with limited liability in Ireland (LGIM-Source ETF) and listed on the London Stock Exchange. The LGIM-Source ETF is not managed by PMC or an Affiliate of PMC but LGIM is the index sponsor of the LGIM Commodity Composite index. The custodian of the assets of LGIM-Source ETF is Northern Trust.

Where this has been indicated in the relevant PMC fund documentation, certain PMC pooled funds invest in units of the Legal & General UK Property Fund, a Property Authorised Investment Fund constituted in England & Wales and authorised and regulated by the Financial Conduct Authority (FCA), of which LGIM is the manager. The custodian of the non-real property assets of Legal & General UK Property Fund is The Northern Trust Company.

In summary, where this has been indicated in the relevant PMC fund documentation, certain PMC pooled funds invest in units of collective investment vehicles managed by external fund managers. The custodian of the underlying assets will vary according to the particular collective investment vehicle.

Financial Services Compensation Scheme

In the event of PMC insolvency, if there is any shortfall after the operation of the floating charge, PMC clients who are eligible claimants under Financial Services Compensation Scheme (FSCS) criteria may be able to make recoveries of the shortfall (if any) from the FSCS up to 100% of any eligible claim.

Solvency and Financial Condition Report

PMC is required to disclose its 2015 year-end financial position via the PRA Return as per existing practice. The year-end 2015 return will be the last report under the ‘Solvency I’ regime.

As part of the live Solvency II regime, we will be preparing an annual Solvency and Financial Condition Report (SFCR), which will be a public report covering PMC’s risk and capital management, internal governance controls, balance sheet and solvency capital requirement.

The first such full report will be available in May 2017, reflecting the position as at 31 December 2016.

However, in order to aid our clients at this time, we set out below some brief additional information reflecting the position as at the commencement of the Solvency II regime. Going forward, annual updates of this information will be provided within the published full SFCR, which is expected to be available in April/May each year.

Summary

There have been no material changes to the nature or risk profile of PMC’s business during 2015.

The introduction of Solvency II does not reduce the capital we consider is needed to run the PMC business, giving due regard to the value of assets under management and the nature of the underlying business risks.

Capital management during 2015 had regard to both the prevailing regime and the projected impact of the Solvency II regime, and PMC remains well capitalised in its own right under both regimes.

The Solvency Capital Requirement (SCR) on the Solvency II basis for PMC is calculated using an Internal Model which received regulatory approval in December 2015.

As at 31 December 2015, PMC’s solvency coverage ratio on the Solvency II basis (i.e. the ratio of eligible own funds to the SCR) was 239%.

Business and Performance

As reported in PMC's 2015 annual Report and Accounts as at 31 December 2015, PMC had £253 billion of funds under management, excluding segregated business.

Further information is available within the Report and Accounts and the PRA Return, and is not repeated here.

System of Governance

PMC is a separate legal entity within the Legal & General Group, with its own Board of directors responsible for acting independently to promote the success of the company and exercise independent judgement. PMC's operational and governance arrangements are distinct from the Group's other major businesses.

The investment management of PMC's policyholder assets operates under a strict set of policies, procedures and controls.

Risk Profile

The most significant line of business comprises unit-linked pooled contracts whereby the investment risk is borne by the policyholders and the benefits provided are directly linked to the value of assets contained in internal funds notionally divided into units. There are no material financial options or guarantees. As such the key risks are primarily operational and lapse-related, and PMC is generally not exposed to other traditional insurance risks such as longevity risk.

Under asset stress within the unit-linked funds, PMC is exposed only to second order risk of lower fee income from assets under management and an associated pressure on continuing to meet expenses.

PMC only invests directly in assets whose risks can be properly identified, measured, monitored, managed, controlled and reported.

For the policy benefits which are directly linked to the value of units contained in an internal fund, PMC's existing matching philosophy is to hold assets which match the unit-linked liabilities (determined as the bid value of the units), and there is no change to this existing practice as reflected in current pooled policy terms.

Valuation for Solvency Purposes

The Solvency II Directive includes standards covering the valuation of assets and liabilities and the calculation of regulatory capital requirements. The new valuation standards are for reporting purposes only and do not impact in any way the asset values used to determine the bid value of units.

The Solvency II Balance Sheet is prepared on a market-consistent basis, whereby assets are accounted for at market value and liabilities are assessed on a best estimate basis. For PMC, the best estimate liability is a combination of the bid value of policyholder units and a discounted value of future expected cashflows (i.e. expected fee income less expenses) over a suitable projection period using risk-free rates of return.

Solvency II also introduces the concept of a Risk Margin, which insurers must hold in addition to the best estimate liability on their Solvency II Balance Sheet. The risk margin is designed with the aim of ensuring that the overall value of a firm's technical provisions (i.e. the best estimate liability plus the risk margin) is equivalent to the amount that would be expected to be required if a third party were to take over and meet the insurance obligations of the firm.

Compared with the previous solvency regime, the inclusion of a value of future cashflows increases the reported available capital on the Solvency II Balance Sheet.

The SCR calculation incorporates the impact of risk stresses and uncertainty in the value of the expected future cashflows, and as such the regulatory required capital under Solvency II is correspondingly increased compared to the preceding regime.

For avoidance of doubt, although under the new regime the reported excess of the value of assets over the value of liabilities includes a value of future expected cashflows, PMC continues to hold an appropriate amount of capital as physical assets, such as UK gilts.

No matching adjustment, volatility adjustment, or transitional measure is applied to PMC business.

Capital Management

The introduction of Solvency II does not reduce the capital we consider is needed to run the PMC business, giving due regard to the value of assets under management and the nature of the underlying business risks.

PMC determines its Solvency Capital Requirement (SCR) using an Internal Model, in which the risks are modelled and assessed based directly on the specific details of the business. The model received regulatory approval in December 2015.

The SCR under Solvency II is determined based on consideration of the relevant business risks, such as Operational risk and Liquidity risk.

In addition, the Solvency II SCR reflects potential stresses on the value of projected future cashflows, to the extent that these are recognised in the Balance Sheet. For PMC, this value is primarily exposed to the risk of higher than expected policyholder disinvestments.

The SCR is set such that the firm remains solvent following a 1 in 200 year stress event. In practice, our capital management policy is to hold an additional buffer above the calculated SCR such that the solvency coverage ratio exceeds 196%. Since PMC does not have a published credit rating from an external credit assessment institution, a coverage ratio at this level corresponds to the lowest risk of default for the purposes of capital calculations under the EU Directive. This is the same level of default risk assigned for capital calculations under the EU Directive for individual entities with a published credit rating of AA or better.

We aim to maintain a broadly stable solvency ratio, and the implied post-dividend coverage ratio on the Solvency II basis is one of our key metrics when recommending our annual dividend payment to our parent holding company.

PMC ***SII position as at 2015 year-end***	***Amounts in £ m***
SII Own Funds	**569**
SII Solvency Capital Requirement (SCR)	**238**
SII SCR coverage ratio	**239%**

PMC's own funds are all Tier 1 basic own funds and there are no potential ancillary own funds. As such, there are no ineligible own funds for the purpose of covering the SCR.

Assets held to cover the SCR are invested in short-dated sterling-denominated liquid instruments, such as UK gilts, so as to ensure appropriate security, quality, and liquidity of those assets. Whilst as at 2015 year-end this would imply a minimum holding in such assets of £238m, within its Own Funds PMC currently holds in excess of £254m in UK gilts.

Important Information

The information contained within this briefing is intended as general information only. It is a selective overview and is not intended to apply to specific circumstances and should not be regarded as constituting legal or regulatory advice. Please note that specific advice should be taken when dealing with specific situations. Legal & General Investment Management (Holdings) Limited and its subsidiaries, its and their officers, directors, employees, affiliates, advisors or agents accept no responsibility or liability to you or any other person in connection with your use of the information contained in this document.

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