LIBERTY

Principles and Practices of Financial Management (PPFM)

Liberty: Growth Pension (2018)
May 2021

1 INTRODUCTION

1.1 Principles and Practices of Financial Management (PPFM)

This document sets out the Principles and Practices of Financial Management (PPFM) of the Growth Pension (2018) annuity in accordance with Directive 147 issued by the Financial Services Board (FSB) superseded by the Financial Sector Conduct Authority (FSCA).

The purpose of this PPFM is to document how Liberty will manage its discretion on the Growth Pension (2018) annuity. In managing such business, Liberty relies on its ability to use discretion, in particular over the methodology of distributing the bonus pool to eligible annuitants.

This document:

- explains the nature and extent of the discretion available; and
- shows how competing or conflicting interests or expectations of different groups and generations of annuitants are managed so that annuitants are treated fairly.

Users of the PPFM should note that this document explains the management of discretion on the Growth Pension (2018) annuity. It does not give advice as to the benefits of the product.

Liberty is committed to providing open and honest communication and believes that the PPFM assists with that aim. Liberty's Growth Pension (2018) annuity is managed in accordance with these Principles and Practices.

1.2 Discretionary Participation Products (DPP)

Growth Pension (2018) pays an annuity for the life of the annuitant and the surviving spouse (where applicable). The initial annuity is guaranteed and is increased via the declaration of an annual bonus, the level of which is at Liberty's discretion. The increase will be derived according to the formula described in 3.3.4. Once an increase has been granted, the new, higher annuity is guaranteed for life.

A PPFM is required for Discretionary Participation Products (DPP) in accordance with Directive 147. The Growth Pension (2018) annuity shares:

- investment returns;
- mortality profits and losses;
- investment strategy profits and losses; and
- other sources of profits and losses (defined later in the document)

between different annuitants. There is discretion in how these proceeds are distributed to the annuitants in the bonus declaration process.

1.3 Principles

The principles:

- are enduring statements of the overarching standards that Liberty adopts in managing DPPs; and
- describe the business model used for managing the discretionary aspects of Liberty's DPPs and in responding to longer-term changes in the business and economic environment.

Liberty does not expect to change the principles often and, except with the permission of the regulator, will give at least three months' advance written notice to discretionary participation annuitants of any changes to the principles.

1.4 Practices

The practices:

- describe Liberty's current approach to managing DPPs and responding to changes in the business and economic environment in the short term; and
- are intended to contain sufficient detail to enable an understanding by a knowledgeable observer of the material risks and rewards from purchasing a DPP with Liberty.

Liberty expects to change its practices as the circumstances in the business environment change. Liberty will advise discretionary participation annuitants of any change in these practices within a reasonable period of the change becoming effective, for example via email communication within a month of the change.

1.5 Communication of the PPFM

A copy of the PPFM will be received with the Growth Pension (2018) contract. The latest version of the PPFM will also be available on the Liberty website and will be available on request to interested parties.

1.6. Compliance

The Liberty Board of Directors (the board) is responsible for the governance of *discretionary participation products*, and has tasked the Liberty Group Actuarial Committee (GAC) to monitor compliance with the PPFM on its behalf.

The PPFM may change as the economic or business environment changes. The GAC will review, approve and note for challenge to the board any change to a principle or a practice, after consultation with the *Head of Actuarial Function*.

The GAC will present to the board on its work.

2 BONUS PHILOSOPHY

2.1 Overriding Principles

2.1.1 The overriding principles will take precedence over any other principles.

2.1.2 Liberty will meet all its contractual obligations and its legal and regulatory requirements. In the event of a conflict arising between the PPFM and the policy conditions, the policy conditions will prevail.

The policy conditions include provisions that afford Liberty the ability to amend policy benefits in response to external taxation and regulatory changes. Annuitants are urged to familiarise themselves with the relevant clauses in their contracts.

2.1.3 The business will be managed having regard to policyholder reasonable benefit expectations which have arisen from original contractual entitlements as well as past practice by Liberty, industry practice and representations made to annuitants.

2.1.4 Subject to the above, Liberty aims to achieve fairness of treatment between different types and groups of discretionary participation annuitants, and between them and shareholders.

2.2 Objectives

2.2.1 The main objectives of the bonus distribution policy for the Growth Pension (2018) annuity are:

- to give each Growth Pension (2018) policyholder a fair and equitable distribution of the profits and losses in the bonus pool; and
- to smooth the distribution of the profits and losses over a defined term.

2.2.2 A fair and equitable distribution for the Growth Pension (2018) annuity is one that distributes the profits and losses in a manner that is expected to result in fair cross-subsidies between different types and groups of discretionary participation annuitants and results in no distribution of the profits and losses to shareholders.

3 FINANCIAL MANAGEMENT OF GROWTH PENSION (2018)

3.1 Background

3.1.1 For the Growth Pension (2018) annuity, bonuses are calculated based on calendar years and declared effective 1 March every year. The resultant increases are effective at each entitled policyholder's increase date. The main factor affecting the determination of the bonuses of the Growth Pension (2018) annuity is the return of the reference portfolio. In addition, bonuses are affected by variances in mortality (both past and expected future mortality) and the investment strategy.

3.2 Principles

3.2.1 The underlying bonus philosophy is that the asset share of a class of with-profit annuity annuitants will be allocated to the benefit of those annuitants over time, subject to the charges accruing to Liberty.

3.2.2 Bonuses, declared annually, are determined at the discretion of Liberty. Once an increase in annuity has been granted, the new, higher annuity is guaranteed for life.

3.2.3 The long-term solvency of the relevant class will be considered when increase declaration decisions are made.

3.2.4 The bonus philosophy aims to provide a return that is driven by the investment performance of the reference portfolio.

3.2.5 Bonuses will be smoothed over a defined period to reduce the impact of volatility on annuitants.

3.2.6 Bonuses are declared such that any profits and losses that have arisen during the year are eliminated and smoothed over a period.

3.3 Practices

3.3.1 Bonus declarations are performed once a year and are effective for the year starting 1 March in the year of declaration.

3.3.2 The bonus is fully vesting for life once granted, which means that the increased annuity cannot be reduced.

3.3.3 The annuities are priced allowing for historic returns on the reference portfolio, past variances not yet distributed to annuitants through discretionary adjustments and a minimum guaranteed interest rate. This minimum guaranteed interest rate, also known as the post-retirement interest rate (PRI), is set based on the selected trade-off between the level of the starting annuity and the annuity increase target. Consequently, annuity increases are only awarded to the extent that the declared bonuses are in excess of this minimum guaranteed interest rate.

3.3.4 Increases are determined as follows:

$$Max\left[0\,,\frac{1+B-c}{1+PRI}-1\right]$$

Where:
$\mathrm{B} = \text{bonus (includes return, discretionary adjustment and longevity impacts where applicable)}$
$c = \text{fee levied by Liberty (the fee levied is dependent on the level of PRI)}$
$PRI = \text{post-retirement interest rate}$

The purpose of the formula is to provide an element of transparency and objectivity in the increase declarations.

3.3.5 B is determined using the 5 year smoothed return of the reference portfolio adjusted upwards or downwards for longevity profits and losses (where applicable) and other profits and losses such as investment strategy profits and losses.

3.3.6 The reference portfolio return and discretionary adjustments are smoothed over a period of time. The smoothing formula and period of smoothing will be reviewed and adjusted when necessary to ensure that they continue to meet the objectives of the Growth Pension (2018) annuity.

3.4 Longevity

3.4.1 Section 3.4 relates only to annuitants that are in the Growth Pensions 2018 product options that share in longevity profits and losses.

3.4.2 Growth Pension (2018) uses a number of assumptions when pricing (i.e. determining the premium for a new annuitant's starting income) and the subsequent annual increases in annuitants' incomes.

3.4.3 An important assumption is how long annuitants are expected to live on average, i.e. their longevity. This will determine the total annuity to be paid over the annuitants' expected lifetimes. This is referred to as the longevity assumption. There is also a long-term trend for people to, on average, live longer, referred to as longevity improvement. Liberty is required to make an assumption in its pricing regarding what the future longevity improvement will be for Growth Pension (2018) annuitants.

3.4.4 A simple, flat longevity improvement assumption was chosen as it is transparent and simple to understand. The assumption may be adjusted in future based on the actual longevity experience of annuitants. The Growth Pension (2018) starting annuity is priced assuming a flat longevity improvement assumption of 1% p.a. across all ages. This means that, compared to a higher assumption (e.g. 2%), annuitants receive a higher starting income. Conversely, compared to a lower assumption (e.g. 0.5%) the starting income is lower.

3.4.5 Actual longevity experience will almost certainly be different from the assumption used in pricing. This will result in longevity profits or losses. A profit arises when annuitant longevity is shorter than assumed as annuity payments are made for a shorter period of time than assumed when pricing.

3.4.6 Annuitants will share in these profits and losses which arise as a result of the overall actual longevity experience. This has an impact on the bonuses declared, which can either be increased or decreased depending on the extent to which actual longevity experience is different from that assumed when pricing.

3.4.7 For example, an annuitant who shares in longevity profits and losses may expect to receive a bonus of 8% based on market returns. If actual annuitant longevity is shorter than assumed in the pricing basis, the bonus may be increased to above 8%.

Conversely, if annuitant longevity experience is longer than assumed in the pricing basis, the bonus may be decreased to below 8%.

3.4.8 The above example illustrates that bonuses are influenced by the actual longevity experience. The size of the adjustment related to the longevity experience is dependent on the extent to which longevity experience differs from the longevity assumption in the pricing basis, and hence the size of the consequent profit or loss.

3.4.9 The pricing assumptions will be reviewed and adjusted if and when necessary as part of the ongoing sound financial management of the Growth Pension (2018) product. Any change in the longevity assumption in the pricing basis will result in longevity profits or losses and hence affect the bonuses of annuitants sharing in longevity profits and losses.

3.5 Investment strategy

3.5.1 The Growth Pension (2018) product was designed so that the underlying asset mix aims to achieve

- long-term real returns to enable competitive annuity increases to be awarded.
- a reasonable match for the minimum guaranteed annuities in payment.
- a reasonable match for the expected annuity increases.

3.5.2 Derivatives can be used to reduce risk and improve the investment management of the portfolio.

3.5.3 The investment strategy will be reviewed and adjusted when necessary to ensure that they continue to meet the objectives of the Growth Pension (2018) annuity.

3.6 New bonus classes

3.6.1 The Growth Pension (2018) has its own bonus class. Liberty reserves the right to create different bonus pools for Growth Pension (2018) in the future where deemed appropriate. The new bonus series will be merged with the original bonus series where Liberty deems this to be appropriate and fair.

3.6.2 In the event that other types of DPP business were to be written by Liberty, this business will not belong to the same bonus class as Growth Pension (2018).

3.7 Principles regarding cancellation and transfer of policies

3.7.1 Liberty endeavours to process cancellations and transfer of policies, where applicable, such that there is no adverse effect on continuing policies.

3.8 Glossary

3.8.1 **Asset share** refers to the liability held in respect of the Growth Pension (2018) product. This equals the premium paid less upfront charges, less any annuity payments made and ongoing fees charged, plus any investment return attributed to the asset share.

3.8.2 **Discretionary adjustment** refers to adjustments made (due to longevity and investment strategy variances) to arrive at the declared bonus.

3.8.3 **Reference portfolio** refers to the portfolio selected, the returns of which are used in determining the increase targeted on the annuity.