

# 2016 risk management supplement



# Supplement contents

Within this supplement we set out descriptions of the risks we face, how our risk management framework operates, as well as a narrative description of our appetite in relation to our main risk areas.

Understanding our risk landscape	Risk management framework	Risk appetite
<p>The risks that are inherent in our business arising from:</p> <ul style="list-style-type: none"> <li>• The products we write</li> <li>• The investments we hold to meet our obligations</li> <li>• The environment in which we operate</li> </ul>	<p><b>Our formal framework for monitoring our risk landscape and ensuring that we are only exposed to those residual risks for which we have an appetite.</b></p> <p>Our framework seeks to reinforce the parameters of acceptable risk taking, allowing business managers to make decisions that are consistent with our risk appetite.</p>	<p><b>Our quantitative and qualitative expressions for the types of risk to which we are prepared to be exposed.</b></p> <p>Alongside the minimum capital requirements that we wish to maintain and the degree of volatility of earnings we wish to avoid, we set a range of tolerances and limits for our material risk exposure.</p>

# Understanding our risk landscape

The products that we write, the investments that we hold to meet our obligations and the environment in which we operate give rise to a broad range of risks.

Our risk management framework, which is described on the adjacent page, seeks to ensure that we are only exposed to those residual risks for which we have an appetite.

## 1. The products we write

### Insurance risk

#### Longevity, mortality and morbidity

The pricing of long term life insurance business requires assumptions to be made for future trends in the life expectancy and general health of those that we insure; with the risk that actual experience may diverge to our assumptions, requiring an increase in reserves and reducing profits.

#### Life catastrophe

We also make assumptions about the likelihood of catastrophic events that could cause a widespread loss of life or disability within the pool of the lives that we insure; with the risk that future events could be more extreme to those that we have assessed in determining our reserves.

#### Weather events

In pricing household insurance products, we make assumptions about the potential level of claims that we may receive from adverse weather events; with the risk that the actual number and severity of weather events experienced may diverge from our assumptions, resulting in a higher than expected level of claims.

#### Persistency (lapse)

We're exposed to the risks that acquisition costs may not be recovered from product margins if policies lapse earlier than we anticipated within our pricing assumptions.

#### Product expenses

Our product pricing must also take account of the future costs of product servicing, with deviations in actual costs presenting the risk of reduced product profitability.

## 2. The investments we hold

### Market risks

#### Investment performance

We invest in a range of investment assets including equities, bonds and property to meet the obligations from our insurance products; however, there is a risk that the income and value of these investment assets may under-perform relative to required targets.

#### Interest rates and inflation

Interest rates and inflation can impact the value of the investment assets we hold to meet our obligations, as well as the value of the obligations themselves, impacting profitability.

#### Currency

Fluctuations in exchange rates can vary both the value and income from investment assets denominated in foreign currencies, as well as the sterling profits and value of our overseas businesses.

#### Property

Lifetime mortgages include a no-negative equity guarantee which transfers to L&G an exposure to loss should house price inflation fall below expectations

### Credit risks

#### Bond default

We hold a significant portfolio of corporate bonds to back our annuity business. The portfolio is diversified across a range of sectors and geographies, but inherently is exposed to the risk of default resulting in financial loss.

#### Property direct lending

We also hold property lending and sale and leaseback investments and are inherently exposed to the risk of default by a borrower or tenant, although we seek to protect our interests by taking security over underlying property.

#### Banks and the issuers of financial instruments

Banking and money market counterparties, the issuers of financial instruments and the providers of settlement and custody services may default on their obligations to us, resulting in financial loss.

#### Reinsurance counterparties

Although not directly an investment risk, in using reinsurance in our annuity and protection businesses, we are also exposed to the risk that a reinsurer may default, impacting the payment of claims to us and other obligations, and requiring us to either seek alternative reinsurance arrangements, potentially on less advantageous terms or bear the reinsured risks directly.

## 3. Environment we operate in

### Operational risk

#### People, process, systems and external events

Our business processes can be complex, with significant reliance placed upon a combination of IT systems and manual processes. We also rely upon the knowledge and expert judgement of our people. Weakness or failure in our systems and processes, the loss of key personnel, or errors and omissions, could result in financial loss or adversely affect our customers and reputation. Where we directly engage in housebuilding, we may also be exposed to construction risk.

#### Regulation and legislation

The markets in which we operate are highly regulated. Changes in regulation or legislation can require changes to our products or business processes. A breach of legislative or regulatory requirements may expose us to financial penalties, remediation costs and damage to our reputation.

### Liquidity risk

#### Contingent events

Low probability and typically extreme events that if not adequately planned for, may result in unanticipated requirements for liquidity.

#### Collateral

Failure to hold sufficient cash or suitable liquid assets to meet collateral requirements for financial instruments, may result in unplanned disposals of assets at excessive cost.

#### Investment liquidity

Exposure to liquidity risk may also arise if the profile of investment assets held to meet obligations to policyholders is not aligned with the maturity profile of policies, or the profile does not adequately take account of the rights of policyholders to exercise options or guarantees; although we manage the risk by ensuring that an appropriate proportion of our funds are held in cash or other readily realisable assets to meet maturities and anticipated early withdrawals as they fall due.

There are potentially material correlations between all the above risks, with a single event leading to losses on multiple risk types. These correlations are difficult to estimate though they would tend to be more acute as the underlying risk scenarios become more extreme.

An assessment of the principal risks and uncertainties that may impact our business strategy, earnings or profitability are set out on page 44 and 45 of the 2016 Annual Report and Accounts. Note 8 ('asset risk') and 18 ('insurance risk') to the financial statements further describe how the above risks relate to our businesses and the control techniques that we apply to manage them.

# Risk management framework

Our risk framework is designed to enable the Group Board to draw assurance that risks are being appropriately identified and managed in line with our risk appetite.

We deploy a 'three lines of defence' risk governance model, whereby business divisions are responsible for risk taking within the parameters of our risk appetite and accountable for managing risks in line with our risk policies; risk functions led by the group chief risk officer provide objective challenge and guidance on risk matters; with Group Internal Audit providing independent assurance on the effectiveness of business risk management and the overall operation of the risk framework. The core elements of our risk framework are set out below.

## Risk appetite

The group's risk appetite statement sets out our overall attitude to risk, and the ranges and limits of acceptable risk taking. The Group Board's Risk Committee leads an annual review of the group's risk appetite, assessing the continued appropriateness of our key measures and tolerances relative to the risk exposures of the group. Additionally, as part of the annual planning cycle, assessment is made of the level of risk taking proposed in the group plan and the capacity for risk taking within the overall appetite framework.

The group's risk appetite is approved by the Group Board on the recommendation of the Group Risk Committee and the group chief executive. The regular management information received by Group Board and Group Risk Committee includes our risk appetite dashboard setting out actual positions relative to the key targets and limits set in our risk appetite.

## Risk taking authorities

We cascade the parameters of our risk appetite to our business managers through 'Risk and Capital Mandates', empowering managers to make decisions that are consistent with our appetite for risk.

Our mandates articulate the product types and features that may be written; the assets classes that may be held; the target capital positions and ranges of earnings volatility within which the overall profile of risks should be managed; and tolerances for specific risk exposures. Activities that would result in a business operating outside agreed parameters require formal approval from the group centre.

## Risk policies

### Risk control

We set formal policies for the management of market, insurance, credit, liquidity and operational risks. The policies specify our overall strategies for ensuring each risk type is managed in line with our risk appetite and the minimum control standards that should be applied in managing our significant risk exposures.

### Risk mitigation

We deploy a range of risk management techniques to manage and mitigate risks, so as to control risk exposures in line with our risk limits. For example, we use derivative instruments to hedge unrewarded risks as part of our asset liability management activity; and reinsurance programmes to transfer significant aggregations and concentrations of insurance risk exposures. Our framework of controls includes documented underwriting policies and structured delegated pricing and underwriting authorities. It also includes investment policies which take into account the nature of our liabilities, guarantees and other embedded options given to policyholders.

## Risk identification and assessment

### Review process

We operate a risk identification and assessment process under which all our businesses regularly consider changes in the profile of existing and emerging risks. The assessment process evaluates the risks that are inherent in our products as well as those that are presented from changes in the environments that we operate in.

### Scenario planning

We undertake scenario analysis of emerging and uncertain future events to assess possible outcomes and to develop proactive management responses.

### Own risk solvency assessment

Our risk identification and assessment process forms part of our broader 'own risk and solvency assessment' process, our ongoing assessment of the risks to which Legal & General is exposed and an evaluation of the sufficiency of resources to sustain the business strategy over the horizon of the group plan.

## Risk management information

Our risk management information framework is structured to report and support the review of ongoing and emerging risks and assess actual risk positions relative to the risk limits and targets that we set.

## Risk oversight

The group chief risk officer and his team, who are independent of the business line, support the Group Board and its Risk Committee in articulating acceptable risk taking and ensuring the effective operation of our risk and capital framework. This includes ongoing assessment of the group's capital requirements to confirm that they meet regulatory solvency requirements.

The group chief risk officer also provides objective challenge and guidance on a range of risk matters to business managers, including the risks implicit in product developments, business transactions and new asset classes, and strategies for managing risks in line with the group's overall risk appetite.

## Risk committees

The Group Board has ultimate responsibility for the group's risk management framework. The Group Board's Risk Committee supported by the group chief risk officer, serves as the focal point for risk management activities. Details of the operation of the Group Risk Committee are set out in the full 2016 annual report.

Beneath the Group Risk Committee is a structure of formal risk oversight committees providing more focused review and challenge of specific risks to the group, and reviewing the effectiveness of frameworks in place to manage those risks.

# Risk appetite

Our risk appetite sets the ranges and limits of acceptable risk taking for the group as a whole (see page 42 of the Annual Report).

We further define our appetite to the specific risks to which we are exposed as follows.

## Market risk

We have an appetite for market risk within our annuities and with-profits businesses, and our shareholder funds, where we are rewarded for taking exposure to the risk. In particular, we have an appetite for selected risks associated with equity, bond and property investments as the asset class may provide higher investment returns relative to the risk free rate over the medium term and enable the optimisation of risk adjusted returns.

We have limited tolerance, however for significant losses or volatility from these market risks and so we seek to set clear investment risk limits which must be adhered to by group businesses. We also have limited tolerance for significant mismatches in interest rates where asset outgoes are expected to cover liability outgoes over a long time horizon, and risks arising from fluctuations in inflation. Where hedging instruments exist, we seek to remove both these risks. Similarly, we have a limited tolerance for developed country currency risk relative to the base currency of our investment assets and will selectively hedge these currency risks.

## Credit risk

We have an appetite for selected credit risk to the extent that accepting this risk enables us to optimise policyholder and group risk-adjusted returns.

In particular, default risk is an inherent factor in bond investments. However, we have limited tolerance for significant losses from single or interrelated counterparty failures, and therefore set credit rating based exposure limits for investment portfolios as well as limits on exposures to specific sectors and single counterparties, and trade out positions if appropriate.

We also have an appetite for property lending counterparty risk where we can assess the risk of default on loan repayments and the taking of the risk enables us to optimise group risk adjusted returns, including those derived through a diversification of credit risk. We have limited tolerance, however, for significant loss from the failure of property lending counterparties and require that all lending is subject to formal underwriting and secured on physical property assets.

We recognise that there is an inherent risk of reinsurer default. However, we have limited tolerance for significant financial loss or operational disruption from a reinsurer default event and we will seek to set and monitor credit risk derived exposure limits for each reinsurance counterparty with which we do business.

We have limited tolerance for the risk of default by banking and money market counterparties, the issuers of derivative financial instruments, or the providers of settlement and custody services, and will seek to actively manage all such exposures against our defined counterparty exposure limits.

## Insurance risk

We have an appetite for longevity, mortality and morbidity risk together with selected household insurance risks where we expect to add value by accepting such risks, and have the capability to assess, price for and monitor trends in the risks assumed.

We have a low tolerance for not achieving our target reward for risk as a result of policies lapsing at a faster rate than that anticipated. Similarly we have a low tolerance for negative variances on product expense assumptions. We seek to manage both these risks by investigations and monitoring experience and reflect the conclusions in our product design and reserving strategies.

We have limited tolerance for an accumulation of catastrophe risk by geographic location and will seek to use a combination of underwriting, geographic concentration limits and reinsurance to manage such exposures. Similarly, we have limited tolerance for exposure to weather events and will seek to purchase excess of loss reinsurance to protect against this risk.

## Operational risk

We accept a degree of exposure to operational risk where exposures arise as a result of core strategic activity, however, we have very limited appetite for large operational losses due to the likely customer impact, reputational damage and opportunity costs.

We aim to implement effective controls to reduce operational risk exposures except where the costs of such controls exceed the expected benefits.

## Liquidity risk

We do not seek exposure to liquidity risk, but accept that a degree of exposure will arise as a consequence of the markets in which we operate, the products that we write and through the execution of investment management strategies. We seek to ensure that we meet our obligations as they fall due and avoid incurring material losses on forced asset sales in order to meet those obligations.

We seek to maintain at a group level sufficient liquid assets and standby facilities to meet a prudent estimate of the group's cash outflows, as identified through annual planning processes.

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