onefamily
modern family finance

Principles & Practices of Financial Management (PPFM) for the OneFamily (EM) With Profits Fund, formerly known as the 'Engage Mutual With Profits Fund'

Family Assurance Friendly Society Limited
(trading as OneFamily)

Contents

1. Introduction

The Financial Conduct Authority's Conduct of Business rules require firms to establish and maintain the Principles and Practices of Financial Management (PPFM) that it applies when managing its with profits business.

This document sets out the Principles and Practices of Financial Management that Family Assurance Friendly Society Limited applies in managing its with profits business within the OneFamily (EM) With Profits Fund ('the Fund'), also known as With-Profits Fund 1. It plays an important role in the governance of with profits business and ensuring that with profits policyholders are treated fairly.

1.1 Company Information

Family Assurance Friendly Society was established in 1975 and is incorporated under the Friendly Societies Act 1992. In April 2015, the engagements of Homeowners Friendly Society (HFS) were transferred to the Society. As part of the transfer, the Fund continues to be operated as a ring fenced sub-fund of the overall long term business fund and remains entitled to all of the surpluses arising within the Fund. The PPFM, capital framework, investment policy and expense agreements all remain materially unchanged as a result of the transfer. The legal transfer is described within the "Instrument of Transfer" (IOT) and this includes all of the provisions that were agreed when the engagements of the UK Civil Service Benefits Society (UKCSBS) were transferred to HFS in October 2003. From 1 October 2016 the OneFamily (EM) with-profits fund was closed to new business.

1.2 Purpose of the PPFM

What is a PPFM?

A PPFM is a document that defines the Principles and Practices that the Society follows when managing it's with profits business. It is approved by the Board of Directors. Each year the Board of Directors will certify that the Fund has been managed in accordance with the PPFM.

This PPFM covers all of the with profits policyholders in the OneFamily (EM) With Profits Fund.

What are Principles?

The with profits Principles describe the high level standards that the Society apply when managing the Fund. They are not expected to change often. The Principles take into account:

- the Society's duties to with profits policyholders in both current and potential future economic environments
- the policy terms and conditions
- compliance with relevant legislation, including the Instrument of Transfer
- the need to be fair to all policyholders.

What are Practices?

The with profits Practices provide more detail on the approach being taken by the Society when managing the Fund. Practices may be revised in response to changes in the regulatory, business or economic environments, and as new methods and techniques are developed in the industry and deployed by the Society.

Changes to Principles and Practices

Changes to Principles

The Board of Directors may amend the Principles if, having taken into account the advice of the With Profits Actuary, they determine that all of the following conditions are met:

- the Principles that apply prior to the amendment lead to inequity between some classes or groups of policyholders or prevent the efficient management of the Fund; and
- the Principles as amended would reduce or remove the inequity in the treatment of all classes or groups of policyholders, or, as applicable, that any inefficiency would be reduced or removed; and
- the amendments have taken into account the fair treatment of the existing policyholders at that time.

Any changes to the Principles will be notified to affected members at least three months in advance of the change coming into effect, and will be notified to the Financial Conduct Authority, as required.

Changes to Practices

To amend the Practices, the With Profits Actuary must recommend changes to the Board of Directors, stating why the changes are necessary, the extent to which they will affect policyholders, and confirm that in his opinion they are consistent with the Principles.

The Board of Directors is responsible for accepting or rejecting the With Profits Actuary's recommendations and may delegate agreement of the detail, and the implementation, of any changes to Practices, to a sub-committee of the Board.

Any changes to Practices will be notified to affected members, usually as part of the annual bonus statement communication, but in any event within 12 months of the change taking effect.

Changes to Practices will be notified to the FCA as required.

General

Regardless of any such changes, the Society will review this document at least once a year to ensure that it continues to accurately reflect the Principles and Practices that we apply.

We will only change a Principle or Practice when we consider it justified by the need to:

- respond to changes in the business or economic environment
- protect the interests of policyholders
- change a practice to better achieve a principle
- correct an error or omission in the PPFM
- improve the clarity and presentation of the PPFM

1.3 Governance Arrangements Surrounding the PPFM

It is the responsibility of the Board of Directors to ensure that the Society manages the Fund in line with the PPFM. The Board consists of both executive and non-executive directors. The Chairman of the Board is a non-executive director.

In line with the guidance from the Regulator, the Society has the following governance arrangements in place to ensure that the PPFM has been adhered to:

- the Board will produce a "Compliance with PPFM Report" on an annual basis, and this will be made available to policyholders on our website, and on request
- a With Profits Actuary has been appointed to advise the Board on its exercise of discretion in managing with profits policies. The With Profits Actuary will report annually to with profits policyholders on the Society's 'Compliance with PPFM Report'. This will be available to policyholders as an Annex to the annual report
- the Board have established a sub-committee of the Board, whose terms of reference include the management of the With Profits Sub Fund
- the composition of this Committee is the responsibility of the Board and may vary from time to time. Currently all members are Non Executive Directors. It is also attended by the Chief Executive, Chief Finance Officer, Chief Risk Officer and With Profits Actuary
- the Board considers that the Committee provides independent judgement in the assessment of compliance with the PPFM and how any conflicting and competing rights of policyholders are addressed
- the With Profits Actuary is not a member of the Board
- any changes to the PPFM will be proposed by the With Profits Actuary and approved by the Board before they are implemented.

2. The amount payable under a with-profits policy

This section describes the Principles and Practices to determine the amount payable for a with-profits policy before any additional payment that may be made from the Free Assets in the Fund (see section 6 of this report for more information on the Free Assets).

2.1 Amount Payable Principles

Principles

- The Society aims to treat all with profits policyholders fairly having regard to statements made in marketing literature, contracts and communications to policyholders (including any documents associated with the Transfer of Engagements)
- The overall aim is to pay out amounts which are broadly equitable to those policyholders leaving, by way of death, maturity or surrender, and those policyholders remaining in the Fund
- For conventional with profits policies, the amount payable on maturity or death will be the initial guaranteed benefits plus bonuses constituting a fair share of the distributable surplus earned by the Fund over the period of the investment, subject to the terms and conditions of the policy conditions, which take precedence
- For all regular premium unitised with profits policies, single premium unitised with profits policies taken out before the transfer of engagements from UKCSBS to HFS and Easybond single premium unitised with profits policies, the amount payable on death will be the guaranteed benefits plus bonuses constituting a fair share of the distributable surplus earned by the Fund over the period of the investment, subject to the terms and conditions of the policy conditions, which take precedence
- For Protected Investment Bond policies the amount payable on death will be based on the value of the units at the date of death, subject to any minimum amount that applies
- With the exception of Protected Investment Bond policies, where a with profits policy is eligible for a surrender value, the amount paid on surrender will have regard to the guaranteed benefits and bonuses, adjusted to avoid surrenders causing a strain on the Fund for continuing policyholders, but subject to the terms and conditions of the policy, which take precedence
- For Protected Investment Bond policies the surrender value will be based on the value of the units at the date of surrender, using either the pure or average price of units, whichever is applicable, adjusted for any surrender penalties that apply
- Where applicable, common bonus rates are used for appropriate groupings of policies reflecting an element of cross subsidy and pooling of risks for policies with similar characteristics. A single group may contain policies of different type, age, year of entry, tax status, size and premium history
- In order to provide an element of stability in the returns to policyholders, smoothing may be applied to payouts. It is intended that the long term cost of smoothing is broadly neutral across generations of policyholders
- The payout policy aims to provide a fair return to policyholders by taking into account asset shares. Equivalent measures are used for minor classes of policies where insufficient information is available to calculate reliable asset shares
- The Board on the advice of the With Profits Actuary may determine changes to the approach to calculating payouts
- The Board, on the advice of the With Profits Actuary may determine changes to historic assumptions, or parameters, used to calculate payouts.

Practices

Where possible, asset shares are used as a guide to determining bonus rates and the amounts payable to with profits policyholders. The asset share methodology is described in section 2.2. Payouts to policyholders are smoothed. The smoothing is applied in two ways:

- Implicit Smoothing
  - > by grouping policies together for the purposes of determining final bonus rates, MVRs and Surrender Values
  - > by limiting the number of different bonus scales, so that minor product classes share the experience of the major classes
  - > by holding final bonus rates, MVRs and Surrender Value Factors unchanged between review dates.

  Implicit smoothing may apply to all policy payouts.
- Explicit Smoothing

  This type of smoothing only applies to certain types of claim and is described in the sections below.

Conventional With Profits: Maturities

The long term aim in determining final bonus rates is to return to maturing with profits policies, as a group, on average 100% of asset shares. The amounts payable in any year, or to any particular policyholder, may be more or less than 100%, due to the effects of guarantees, smoothing and the grouping of policies.

Current practice in deciding final bonus rates is to group together maturing policies according to product type and calendar year of commencement and then target an average payment on maturity (i.e. final bonus) for each group equal to asset share, subject to the smoothing process. This final bonus is expressed as a percentage of existing regular bonuses.

Final bonus rates are smoothed so that the full extent of changes in the market value of assets is not always immediately reflected in claims payments. In normal circumstances, the aim of the current smoothing policy is to ensure that changes in maturity payouts on comparable policies from year to year are limited to no more than 10%. In more volatile market conditions this may increase to 20%, and possibly higher in exceptional circumstances.

The aim is that in normal circumstances the cost of smoothing will be broadly neutral over the long term. There is no specific overall limit to the accumulated cost, or surplus, of smoothing beyond the principle of maintaining regulatory solvency at an appropriate level. The maturity payout for an individual policy, when scaled up or down according to the amount of the guaranteed benefits in relation to the average guaranteed benefits for the group of policies to which it belongs, should normally fall in the range 80% to 120% of the average asset share for the group. The aim is to ensure that at least 90% of all claims fall within this range.

Conventional With Profits: Deaths

For with profits endowment policies the final bonus rate on death is the same as the final bonus rate that would have been payable had the policy matured on the date of death.

For whole of life with profit policies, where there is no fixed maturity date, separate final bonus rates are determined by grouping whole of life policies together by product type and calendar year of commencement, and targeting average payouts at the average asset share for each group. This final bonus is expressed as a percentage of existing regular bonuses.

The death payout for an individual policy, when scaled up or down according to the amount of the guaranteed benefits in relation to the average guaranteed benefits for the group of policies to which it belongs, should normally fall in the range 80% to 120% of the average asset share for the group.

The aim is to ensure that at least 90% of all claims fall within this range.

There is no specific smoothing policy for death payouts.

Conventional With Profits: Surrenders

The overall aim is to target average payouts for groups of policies at 100% of average asset shares, subject to policy conditions.

Current practice is to apply a Surrender Adjustment factor to the guaranteed benefits after they have been adjusted according to the length of time the policy has been in force in relation to the original policy term, and any premium arrears.

The surrender factors are determined by grouping policies together according to product type, calendar year of entry, policy term and age, and then comparing policy asset shares with guaranteed benefits (adjusted according to the length of time the policy has been in force in relation to its original policy term). Surrender factors are set so that average surrender payouts for each group are targeted at 100% of average asset share.

The surrender payout for an individual policy, when scaled up or down according to the size of annualised premium in relation to the average annualised premium for the group of policies to which it belongs, should normally fall in the range 80% to 120% of the average asset share for the group.

The aim is to ensure that at least 90% of all claims fall within this range.

There is no specific smoothing policy for surrender payouts.

The surrender value factors are reviewed on a regular basis, and may be adjusted specifically to reflect movements in asset values. At any one time we may pay more or less than target mainly as a result of accommodating short term market fluctuations.

Regular premium unitised with profits policies, single premium unitised with profits policies taken out before the transfer of engagements from UKCSBS to HFS and Easybond single premium unitised with profits policies: Surrenders and Deaths.

All unitised with profits policies are written on a whole of life basis and therefore do not have a fixed maturity date.

The long term aim in determining the amount of final bonus on surrender or death is to return to surrendering with profits policies, as a group, on average 100% of asset shares. The amounts payable in any year, or to any particular policyholder, may be more or less than 100%, due to the effects of guarantees, the grouping of policies and changes in investment conditions.

Current practice in deciding final bonus rates is to group together policies according to product type and calendar quarter of commencement and then target an average payment on surrender or death for each group equal to 100%

of average asset share.

If asset shares are greater than guaranteed benefits a final bonus will normally be added. However, if asset shares are less than guaranteed benefits then a Market Value Reduction (MVR) may be applied (see section 2.4). MVRs are not applied on death claims or on surrender claims on an MVR free date.

The final bonus and MVR, are expressed as a percentage of existing guaranteed benefits.

The surrender or death payout for an individual policy, when scaled up or down according to the amount of the guaranteed benefits in relation to the average guaranteed benefits for the group of policies to which it belongs, should normally fall in the range 80% to 120% of the average asset share for the group. The aim is to ensure that at least 90% of all claims fall within this range.

There is no specific smoothing policy for surrender or death payouts.

The final bonus rates and Market Value Reduction factors are reviewed on a regular basis, and may be adjusted specifically to reflect movements in asset values. At any one time we may pay more or less than target mainly as a result of accommodating short term market fluctuations.

Protected Investment Bond policies: Surrenders and Deaths

All unitised with profits policies are written on a whole of life basis and therefore do not have a fixed maturity date.

On surrender on the 5th, 10th and each subsequent 10 year anniversary the original investment, less any withdrawals made, is guaranteed.

Units are allocated to the bond when the investment commences. The number of units allocated depends on the 'pure price' (see below) of units at the date of investment, the amount the investor is investing and the initial allocation rate that applies.

Each week the Society will change the pure price of the units to reflect:

- the performance of the underlying investments
- the annual management charge and the charge for the cost of guarantees
- any miscellaneous sources of profit or loss allocated from the overall Fund
- and to provide for tax.

The pure price will be used to value the bond for the first 26 weeks of the policy. After that the 'averaged price' will be used to value the bond. The averaged price is the average of the pure price over the previous 26 weeks.

After 26 weeks, on surrender, the amount paid out will be based on the averaged price. Prior to this the pure price will be used.

The only exception to the above is when the pure price is less than 90% of the averaged price (e.g. in the event of a sudden market fall). In this situation, to protect the remaining members of the With Profits Fund, any surrenders or partial withdrawals will be based on the pure price.

Early surrender penalties may be applied on surrender or partial withdrawal in the first 5 years.

The amount payable on death will be 101% of the value of the units at the date of death, subject to a minimum amount of 101% of the initial single premium less any withdrawals that have been taken from the policy.

The surrender or death payout for an individual policy should normally fall in the range 80% to 120% of asset share (as defined in section 2.2). In exceptional market circumstances, where markets are rapidly rising and the pure price significantly exceeds the average price, surrender payouts may be less than 80% of asset share. The aim is to ensure that at least 90% of all claims fall within the range 80-120%.

General

Supporting documentation of systems, methods and assumptions are maintained. Any minor changes to assumptions would normally be authorised by the With Profits Actuary. More significant changes in assumptions and changes in methodology would be agreed with the With Profits Actuary and reviewed by the Board With Profits Committee, before formal approval by the Board of Directors.

The same assumptions may be applied across different types of policies, and across different generations of policies, where the experience of different groups is likely to be similar, or where the experience of different groups is not separately available.

2.2 Asset Share Methodology

Principles

Asset shares are used as a guide to determine the amounts payable under a policy and will reflect the sources of profit or loss of the Fund.

Practices

In establishing the asset share accumulation basis, any minor changes to assumptions would normally be authorised by the With Profits Actuary. More significant changes in assumptions and changes in methodology would be agreed with the With Profits Actuary and reviewed by the Board With Profits Committee, before formal approval by the Board of Directors.

With Profits Policies Commencing Prior to 1st November 2003

Individual policy asset shares for policies commencing prior to 1st November 2003 were calculated as part of the Transfer of Engagements (from UKCSBS to HFS). For some small amounts of historic business, data was not available in sufficient detail to determine individual policy asset shares, and other approximate methods were used to determine an appropriate fair share for each policy.

Asset shares are currently calculated and maintained at individual policy level on a quarterly basis. In general they are the accumulation of:

Premiums paid

plus an allocation of investment return

plus an allocation of miscellaneous profits/losses from the Fund

minus the costs of administering the business (or for unitised with profits business the charges on the policy), the costs of managing the Fund, and the costs of investment management

minus the cost of providing life assurance benefits or for some policies the cost of providing ill health benefits

minus an allowance for the expected tax charge levied on the Fund

minus any partial withdrawals taken from the policy

minus a charge for the cost of providing guaranteed benefits

minus a charge for the use of capital support provided to the Fund

minus any charges for any risk transfers and reassurance from the Fund.

The approach is described in more detail below:

Premiums Paid

The asset share accumulation assumes that all premiums are paid. Any missed premiums or premium arrears for an individual policy are deducted at the time of claim.

Investment Return

The investment return used in asset share calculations is based on the assets backing the with profits policies. The current practice is to group policies together according to product type and the time period until the next guarantee date. An asset mix is then determined for each group of policies, based on the amount of guarantees in relation to asset shares, and the time period until the next guarantee date. The investment return earned by the assets that have been notionally allocated to each group of policies is then used in the asset share calculations.

Allocation of Miscellaneous Profits/Losses

With profits policies currently participate in profits, or losses, arising from non profit business written in the Fund, and other miscellaneous sources of profit and loss. Asset shares may be adjusted periodically by making an approximate allowance via an additional allocation (or deduction) to asset shares, reflecting any miscellaneous profits (or losses) arising in the Fund.

Expenses

The expenses associated with the ongoing administration of with profits policies is covered by an expense agreement with the Non Profit Fund. This is covered in Section 5. Current practice is to calculate the total amount of expenses charged to the Fund (excluding investment expenses) on a quarterly basis.

Investment expenses are charged to asset shares and are based on the fees charged under the investment management agreement with our investment Fund Managers.

The charges in relation to premium paying conventional with profits policies are charged to asset shares, and expressed as a percentage of premiums payable.

The charges in relation to paid up and non-premium paying conventional with profits policies are charged to asset shares, and expressed as a percentage of sum assured.

The charges in relation to non profit policies are attributable to the inherited estate. The difference between expenses incurred and the product charges for unitised with profits policies are attributable to the inherited estate. Project costs and any exceptional costs will also be charged to the inherited estate unless there is a clear rationale for allocating them to any particular product group, as agreed by the With Profits Actuary.

Cost of Life Assurance and Other Risk Benefits

Mortality costs, and for some policies the costs of providing ill health benefits are charged to asset shares using realistic assumptions, derived from experience and approved by the With Profits Actuary. Any difference between the claims experience of the Fund and the aggregate mortality allowances within asset share accumulations are attributable to the inherited estate.

Taxation

As agreed within the Instrument of Transfer, for taxation purposes the With Profits Sub Fund is considered on a stand alone basis, irrespective of the overall tax position of Family Assurance Friendly Society (see section 5 for further details).

For policies that are subject to tax, in the accumulation of asset shares, an allowance for income and capital gains tax is made in the investment return, and allowance is made for tax relief on expenses.

Any difference between the tax attributable to the Fund and the aggregate tax allowances within asset share accumulations are attributable to the inherited estate.

Other Charges

Whilst there is provision to make charges to asset shares for the cost of guaranteed benefits, capital support and risk transfer (e.g. reassurance), no charges are currently made to asset shares for these costs.

The cost of providing guaranteed benefits is currently met from the inherited estate. If the inherited estate, after meeting other business risks and capital requirements approved by the Board, is not sufficient to cover the cost of providing guaranteed benefits appropriate charges would be made to policy asset shares. This would be subject to approval by the With Profits Actuary and the Board of Directors.

Regular premium unitised with profits policies and Easybond single premium unitised with profits policies commencing on or after 1st November 2003

All with profits policies are unitised with profits policies with explicit charges to cover expense costs, mortality costs and the cost of providing guarantees.

Asset shares are currently calculated and maintained at individual policy level on a quarterly basis.

Under normal circumstances asset shares are based on the shadow value of units. Premiums less charges purchase notional units in the Fund. The shadow price of these units then increases (or decreases) over time to reflect the actual investment return earned by these policies (determined in the same way as policies commencing prior to 1st November 2003), net of any tax that may be deducted (depending on the type of policy) and the annual management charges that apply to these policies. Units are also adjusted to allow for any partial withdrawals taken from the policy.

Any difference between the claims, tax and expense experience for these policies, and the aggregate allowances within asset share accumulations, are attributable to the inherited estate. If these differences are significant and in the view of the With Profits Actuary are likely to cause inequity within the Fund, then payouts can be based on asset shares accumulated using the actual expense and claims experience incurred.

Asset shares may be adjusted periodically by making an approximate allowance via an additional allocation (or deduction) to asset shares, reflecting any miscellaneous profits (or losses) arising in the Fund.

Protected Investment Bond policies

All policies are single premium unitised with profits policies with explicit charges to cover expense costs and the cost of providing guarantees.

Individual policy asset shares are maintained by calculating the value of the units each week at the pure price. This takes into account investment growth, policy charges, taxation and any allocation of miscellaneous surplus or loss.

Under certain circumstances it may be more appropriate to allocate miscellaneous surplus or loss via an adjustment to the number of units rather than the unit price.

Any difference between the claims, tax and expense experience for these policies, and the aggregate allowances within asset share accumulations, are attributable to the inherited estate. If these differences are significant, then any surplus or profit arising may be re-attributed to policyholders as miscellaneous surplus or loss.

If the underlying investments under perform their expected levels, or investment conditions change, such that the expected cost of providing the guarantees exceeds the guarantee charge, in the interests of protecting all members in the With Profits Fund, the following actions may be taken, subject to the approval of the Board on the advice of the With Profits Actuary:

- increase the charge for providing the guarantees
- change the investment mix of the underlying assets so that a larger proportion is held in more secure assets such as government bonds or cash.

2.3 Bonus Philosophy

This section does not apply to Protected Investment Bond policies.

Principles

- The Board, taking into account the advice of the With Profits Actuary determines bonus policy.
- Bonus is distributed by means of regular additions to guaranteed benefits ("regular bonus") and by a sum added to guaranteed benefits, typically when a claim arises ("final bonus").
- Regular bonuses are set with the aim of providing a gradual build up of guaranteed benefits over the lifetime of the contract.
- Regular bonus rates may be changed to reflect circumstances, including past and expected future investment returns, the levels of guaranteed benefits on the policies to which they apply and the overall financial strength of the Fund.
- Different bonus rates may apply to different types of policy, for example, to reflect significant differences in policy types, guarantees, premiums rates and investment mix.
- A new bonus series may be determined, for classes of new business, to give effect to the payout policy, and the other Principles and Practices that may apply.
- Final bonus rates are set with the overall aim of distributing the balance of the distributable surplus earned over the lifetime of the policy, to the extent that such profits have not already been distributed by way of regular bonuses.
- Final bonus rates may be smoothed, although there is no limitation on the amount of change in the rate of bonus at successive declarations.
- The Board may alter conditions for payment of final bonuses or cease paying final bonuses at any time without notice. Factors which might lead to a change include changes in the financial circumstances of the Fund, and anticipated future experience of an exceptional nature.

Practices

The paragraphs below describe how bonus rates are currently determined and smoothed in normal circumstances. The Society may change these arrangements in exceptional circumstances, for example, a prolonged period of depressed asset values, substantial business losses in the Fund, regulatory solvency issues or substantially higher volumes of surrenders.

Regular Bonus

Regular bonus rates are reviewed at least once a year. The amount of regular bonus may depend on:

- the profits earned by the Fund in recent years
- the investment return we expect in the long run
- the levels of guaranteed benefits compared to asset shares
- the current and projected regulatory solvency position of the Fund
- the interaction between regular bonus, final bonus and any market value adjustments.

The current aim is to pay a regular bonus if the Fund is able to afford it. The amount of regular bonus is set at a rate that is expected to be sustainable over the remaining policy duration. This is achieved by projecting asset shares for groups of policies, and comparing these to projected guaranteed benefits.

Regular bonus rates may be smoothed to limit the changes in the rates from year to year. Uniform regular bonuses will be declared if the overall payout policy is not compromised as a result.

For conventional with profits policies, regular bonus is declared in respect of complete calendar years. A regular bonus is not declared for the part calendar year when the policy is set up. Instead, a regular bonus, or interim bonus where appropriate, is payable based on a full calendar year when the policy becomes a claim. Interim bonus rates, where appropriate, are determined having regard to the estimates of the level of regular bonus expected to be declared at the next declaration.

For unitised with profits business, regular bonus is added via a monthly or weekly increase in the unit price.

Final Bonus

Final bonus rates are reviewed at least once a year, and may be reviewed more frequently in volatile market conditions, or if required to protect the financial position of the Fund.

Final bonus rates are set to give effect to the payout and smoothing policy that was described in section 2.1.

Final bonus rates are currently based on calendar year of entry for conventional with profits business and calendar quarter of entry for unitised with profits business.

Final bonus, where applicable, is payable on all claims arising on death or maturity, and for all surrender or partial surrender claims for unitised with profits policies. Explicit final bonus rates are not applied to surrenders for conventional with profits policies.

The final bonus rate could be zero.

In addition, a Market Value Reduction (for unitised with profits) or a Surrender Adjustment (for conventional with profits) may be applied on surrender. This is covered in the section below.

2.4 Market Value Reduction and Surrender Adjustments

Principles

- For all regular premium unitised with profits policies, single premium unitised with profits policies taken out before the transfer of engagements (from UKCSBS to HFS) and Easybond single premium unitised with profits policies a Market Value Reduction (MVR) may be used whenever it is necessary to protect the Fund from losses arising from unit cancellations. The application of an MVR is based on a comparison of asset share and the credited return from the application of regular and final bonuses.
- For Protected Investment Bond policies the surrender value will be based on the value of the units at the date of surrender, based on either the pure or average price of units, whichever is applicable, adjusted for any surrender penalties that apply.
- For conventional with profits policies a Surrender Adjustment will be applied to the guaranteed benefits on early surrender. The application of a Surrender Adjustment is based on a comparison of asset shares and the guaranteed benefits (adjusted according to the length of time the policy has been in force in relation to its original policy term).

Practices

Market Value Reduction (all regular premium unitised with profits policies, single premium unitised with profits policies taken out before the transfer of engagements (from UKCSBS to HFS) and Easybond single premium unitised with profits policies).

Market Value Reduction (MVR) factors for unitised with profits policies are determined to give effect to the payout policy described in section 2.1.

An MVR may be applied when the asset share is less than the policy value based on the credited return from the application of regular and final bonuses, subject to policy conditions.

MVRs are not applied on death, or on surrender on an MVR free date. MVRs are currently not applied on withdrawals of less than 10% of the original investment.

In deciding on the size and application of an MVR the Society may take into account the following factors:

- the differential between asset shares and the policy value based on the credited return from the application of regular and final bonuses
- the number and level of surrenders being experienced
- the policy conditions, together with policyholders reasonable expectations as established by statements made in marketing literature, contracts and communications to policyholders (including any documents associated with the Transfer of Engagements)
- the current and projected regulatory solvency position of the Fund.

Surrender Adjustment (Conventional With Profits Business)

Surrender Adjustment factors for conventional with profits policies are determined to give effect to the payout policy described in section 2.1.

The Surrender Adjustment is applied to the guaranteed benefits, after they have been adjusted according to the length of time the policy has been in force in relation to the original policy term, and any premium arrears.

Depending on the level of asset shares, the Surrender Adjustment may increase or decrease the adjusted guaranteed benefits.

Surrender Adjustments (Protected Investment Bond policies)

On surrender during the first 26 weeks, the amount paid out will be based on the pure price.

After this the average price will be used. The only exception is when the pure price is less than 90% of the average price. In this situation, to protect the remaining members of the With Profits Fund, any surrenders or partial withdrawals will be based on the pure price. Early surrender penalties, as set out in the Key Features document, may be applied on surrender, or partial withdrawal, in the first 5 years. No other surrender adjustments will be applied.

3. Investment strategy

Principles

- The investment policy of the Fund will be determined by the Board, taking into account the advice of the WP Actuary.
- The investment policy will have regard to the nature and term of the liabilities of the business, fair treatment of each class and generation of policyholder.
- The investment policy will seek to optimise the investment return, while recognising the guarantees provided, smoothing and the need to meet regulatory solvency requirements.
- The equity content of the assets underlying the with profits business will reflect the Society's current and projected regulatory solvency position, the level and duration of guaranteed benefits, intended future bonus policy, surrender value bases and the application of MVRs.
- Derivative investments may be used for the purposes of Efficient Portfolio Management, to help match liabilities and, at certain times, to protect the solvency of the Fund and the security of policyholders' benefits.
- Counterparty exposure is limited, as required, in the interests of the prospective financial position of the Fund.
- Investments that are not normally tradable e.g. premises owned and occupied, may be held by the Fund.
- In normal circumstances, the investment strategy for the Fund will be determined according to the composition of the Fund alone.

Practices

Whilst the Board is ultimately responsible for the investment strategy, the Executive Investment Committee is appointed to review investment strategy and asset mix, and monitor the ongoing investment performance of the assets. The asset mix and investment performance is subject to regular review by the Executive.

The assets of the Fund are currently managed by Legal & General Investment Managers.

The method currently used to determine asset allocation is as follows:

1) **Determine the investment policy for the assets backing the asset shares**

Asset allocations are established for the assets that are assumed to back policy asset shares. The asset allocations are reviewed on a regular basis and will change depending on the overall financial position of the Fund and taking into account the needs of the Fund whilst it is in run-off. The asset allocations may differ by product groups, which consider the product type and length of time until the next guarantee date.

2) **Determine the investment policy for the remainder of the Fund**

The Board, through the Executive Investment Committee, decides on the asset mix for the remainder of the Fund. This investment mix depends on the level of the remaining assets, and what the remaining assets are likely to be required for, as well as the investment outlook for different asset classes. For example, assets required to cover non-profit policy liabilities, the cost of providing guarantees, or business risks are likely to be held in more secure assets e.g. fixed interest securities. The surplus assets of the Fund may be invested in assets expected to generate higher returns, to maximize long term returns for the Fund and more secure assets to reduce the volatility of the Fund as it runs off.

The underlying investment funds reflect differing risk / reward profiles which are used to manage the Fund's investment strategy and the external investment manager is responsible for selecting the specific assets to meet the aims of the funds.

The current range of material investment funds are as follows:

Legal & General UK Index Trust – this fund aims to provide growth and track the performance of the FTSE All-Share Index. It invests in a broad spread of UK-listed companies, ranging from very large to smaller companies.

LGIM Sterling Liquidity Fund – this fund aims to provide capital stability, liquidity and diversification while providing a competitive level of return. It invests in high quality short-term sterling fixed income and variable rate securities and diversifies risk across a range of financial institutions, sovereign and corporate issuers. It seeks to maintain a AAA rating, which is the highest fund rating available.

Legal & General Sterling Corporate Bond Index Fund – this fund aims to provide income and to track the return of the iBoxx Sterling Non-Gilts ex-BBB Index. It invests in sterling corporate bonds rated AAA, AA or A, deemed to be higher quality than lower-rated bonds.

Legal & General Short Dated Sterling Corporate Bond Index Fund – this fund aims to provide income and capital growth and to track the return of the iBoxx Sterling Corporates 1-5 Index. It invests in 'short-dated' corporate bonds, which tend to be less sensitive to interest rate risk than longer-dated bonds.

Legal & General All Stocks Gilt Index Trust – the objective of this fund is to provide a combination of growth and income. The fund aims to track the return of the FTSE Actuaries UK Conventional Gilts All Stocks Index. It invests in government bonds issued by the UK government.

In addition, there are also investments in the Insight Global Absolute Return Fund and Insight Diversified Protector fund backing the unitised with profits business, such as the Protected Investment Bond.

Other investment funds and directly held assets may be invested in if these better meet the requirements of the Fund.

The investment strategy and investment performance are reviewed on a quarterly basis by the Executive Investment Committee.

4. Business Risk

Principles

- The Board is responsible for the size and type of business risks accepted, taking into account existing business risks and the financial condition of the Fund.
- The Board, on the advice of the With Profits Actuary, is responsible for ensuring that profits, or losses, arising from exposure to business risks is allocated fairly to all policyholders having regard to the source of the miscellaneous sources of profits or losses.
- Profits and losses on any non profit business within the Fund and any other liabilities (including compensation) which are identified in relation to any of the business allocated to the Fund will be borne by the assets of the Fund.
- The Fund may make investments in accordance with applicable legal and regulatory requirements.
- The Fund may provide financial support to other long term business funds or subsidiary companies within the Society, subject to the approval of the Board, on the advice of the With Profits Actuary.
- Control of existing business risks is managed through the Society's risk management practices which include regular monitoring of all significant business risks. Processes are established to determine the impact of the various business risks, for example insurance, market, credit, liquidity, operational, on the financial position of the Fund, and to identify and where necessary implement appropriate mitigating actions.

Practices

General

In general, when considering whether to accept a business risk the Board will consider:

- potential rewards to policyholders in relation to the rewards from other alternatives, including risk free investments
- the size and extent of existing business risks
- the size of the business risk being considered, and the potential impact on the Fund and the inherited estate.

Financial Support to Connected Parties

The Fund may provide financial support to other long term business funds or subsidiary companies of the Society, subject to the approval of the Board, on the advice of the With Profits Actuary. In considering whether the Fund can make a loan, or investment, the Board and With Profits Actuary will need to be satisfied that:

- the extent and terms of the loan, or investment, are on a commercial basis, and are no more favourable than would be the case than if the loan, or investment, was to an unrelated company
- the loan or investment is appropriate for the Fund
- the reasonable benefit expectations of policyholders will not be impaired as a result.

Risk Management

The Board regularly reviews risks to which the Fund is subject. It carries out a full review of such risks each year, including a recalculation of the Funds regulatory solvency position under a variety of risk scenarios. As a result of this process the Board may implement measures to reduce or limit risk. These may include changing investment strategy, reinsurance of mortality risks, changes to regular and final bonus policy, amending MVRs and surrender factors, or changing the Fund's smoothing policy.

Distribution of Miscellaneous Profits or Losses

Miscellaneous profits or losses will be reflected in the asset share accumulation bases of different classes and generations of policies in a manner judged by the Board, taking into account the advice of the With Profits Actuary, to be fair and equitable. In giving this advice the With Profits Actuary will have regard to the source of those miscellaneous profits or losses, any appropriate smoothing of these items and situations where these items are insufficiently material to be recognised.

There is no specific level of profit or loss from business risks before the Fund will treat them as a determinant of the amounts payable to with profits policyholders.

5. Charges and expenses

Principles

- The Board, on the advice of the With Profits Actuary, are required to agree that expenses and tax charges allocated to the Fund are reasonable, and are in line with any Expense Agreements in operation.
- As described in the Instrument of Transfer, the tax charge to be levied on the Fund will be calculated as a best estimate of the position assuming the business was the sole long term business of an independent mutual friendly society.

Practices

The expenses charged to the Fund are covered by an expense agreement with the Non Profit Fund. The expense agreement is reviewed and approved by the Board With Profits Committee on an annual basis. The main provisions within the agreement are as follows:

All direct sales costs for new business activities, including commission, direct marketing and product literature are charged directly to the Fund.

The provision of sales support costs including overheads are charged directly to the Fund, and the amount to be charged each year is determined as part of an annual expense investigation.

A per policy maintenance cost is charged to the Fund to cover the expected administration and financial management costs, including overheads, in the following calendar year. This is based on the costs identified by an annual expense investigation and the expected number of policies in force.

The costs of investment management of the Fund's assets and pension scheme expenses are charged directly to the Fund.

Project or other exceptional costs required to support the activities of the Fund are charged directly to the Fund. These costs can include changes to products, administration, financial management or investment management arrangements, and may be driven by regulatory changes, external change or other changes that will benefit members of the Fund. Any project costs are identified as part of an annual expense investigation.

With the exception of the above, no other costs are charged to the Fund.

On an annual basis, a statement of all costs charged to the Fund will be prepared, to explain the nature and reasons for the charges. This statement is reviewed and approved by the Board With Profits Committee and the With Profits Actuary.

6. Management of the Free Assets in the Fund

The free assets, or inherited estate, are the excess of assets held within the Fund, over and above the amount required to meet the liabilities. The liabilities, for this purpose, include those that arise from the regulatory duty to treat customers fairly in setting discretionary benefits, such as final bonuses.

Principles

- The Fund's inherited estate may be used, at the Board's discretion to:
  - > provide investment flexibility by enabling a higher proportion of the Fund to be invested in potentially higher reward but higher risk assets, than would otherwise be the case
  - > provide additional security against unexpected adverse events
  - > meet the cost of paying out guaranteed benefits in excess of asset shares
  - > permit flexibility in the smoothing of claims payouts for with profits purposes
  - > meet unexpected costs, or exceptional items of expenditure, including compensation costs
  - > meet such other purpose as permitted by law and consistent with the Society's regulatory duty to maintain adequate financial resources.
- Bonus rates and investment policy will be managed in order to keep the size of the inherited estate at a level, which in the opinion of the Board, on the advice of the With Profits Actuary, is appropriate for the level of risk accepted by the business. There is no predetermined target size for the inherited estate within the Fund.

Practices

The Society deploys appropriate practices to assess the realistic and statutory solvency positions of the Fund to determine the size of the inherited estate.

The inherited estate will be distributed fairly to existing with profits policyholders, by augmenting claim values by an appropriate amount, so that the inherited estate is distributed gradually, as existing with profits policies become claims. The inherited estate is currently meeting the following specific costs, and will continue to do so in the foreseeable future:

- the cost of meeting payments in excess of asset share for conventional with profits maturity or death claims
- the cost of meeting MVR free guarantees on unitised with profits policies
- exceptional expenses not charged to asset shares.

Once a year the Board will consider the size of the inherited estate, and whether any part of the inherited estate is not required to meet the above costs. If this was to be the case, the Board may consider how some of the inherited estate could be used to improve payouts to existing policyholders.

The inherited estate is used to improve claims payouts to with profits policyholders, subject to the following criteria:

- asset shares will be enhanced by an agreed uplift rate when determining final bonus rates, market value reductions and surrender factors
- the uplift rate to be applied to asset shares will be reviewed at least annually, and will be approved by the Board, taking into account the advice of the With Profits Actuary
- the uplift rate can be amended at any time depending on the financial strength of the Fund
- the future uplift rate will depend on the overall financial strength of the Fund
- for those policies where guaranteed benefits are higher than asset shares after the uplift has been applied, the guaranteed benefits will be paid out.

From time to time, it may be that the Fund requires additional financial support from the assets of the Society's other long term business funds. Such support will only be provided if the judgement of the Board is that the support is financially desirable in the overall context of the Society, or that it is necessary to meet statutory requirements.

Where such support is provided then at the Board's discretion a suitable charge (but not exceeding 2% of such support per annum – as defined in the Instrument of Transfer), in addition to the investment return achieved on that capital whilst supporting the with profits business, will be made to the Fund. The actual charge levied shall reflect the normal commercial terms for any market transactions of a similar nature and degree of risk for the capital involved, and the opinion of the With Profits Actuary as to a fair level of charge

The provision of the additional capital support will be reflected in the asset share accumulation bases of different classes and generations of policy. This will be agreed by the With Profits Actuary.

Once the Fund has been closed, the run-off of the business will be managed in a sound and prudent manner until the size of the Fund falls below a minimum threshold criterion. This minimum threshold criterion is reached when the total assets within the Fund fall below £25 million (as at 31 December 2003) increased each year in line with the change in Average Earnings Index, or if the number of contracts falls below 12,000, whichever occurs first.

At the point that the business falls below this threshold, or as soon as the Board deems to be appropriate thereafter, the policies then remaining will be converted to guaranteed bonus business on a fair and equitable basis.

In managing the with profits business up to the point of such conversion, in determining bonus policy and in determining the terms of the conversion to guaranteed bonus business, the Board will take into account the reasonable interests of the various policyholders in the Fund, and any external capital support that may have been provided to the Fund.

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