Principles and Practices of Financial Management (January 2017)

These Principles and Practices of Financial Management are available on request (free of charge to with-profits policyholders). Throughout this document a distinction is drawn between **Principles** and **Practices** of Financial Management.

Principles are intended to reflect the underlying and enduring approach which the Society adopts to managing its with-profits business. Policyholders will be given three months' notice of any intended change (other than a minor one) to the Principles of Financial Management.

Practices reflect the ongoing management of the business and are expected to adapt to changes in economic conditions and the Society's business plans, whilst continuing to respect the underlying Principles. Policyholders will receive notice of any changes to the Practices of Financial Management annually.

Payments to Policyholders

Principles

The Society aims to treat its customers fairly having regard to statements made in marketing literature, in bonus notices, in past with-profits guides, in regulatory returns, and in any formal communication to members. For with-profits business, this Principle applies to both maturity payments and amounts available upon surrender.

The payments made to with-profits policyholders are intended to reflect fairly the experience of the Society (the premiums paid by members, the investment return on those premiums with an element of smoothing, the expenses incurred in servicing and administering the contracts, the effect of taxation, and the costs of providing death benefits and of meeting guaranteed benefits).

It is in the nature of with-profits business that there is a pooling of risks with other policyholders. Moreover, smoothing and distributions of the Estate may extend pooling to policyholders of a different generation. Consideration is given to the profit or loss accruing to the Society from its non-participating business.

Changes to the methods employed need to be approved by the Society's Board of Management (the "Board") having considered the advice of the With-Profits Actuary ("WPA").

The Society would not normally expect to change any historical assumptions relevant to its methods, but would review this in the event that regulatory requirements upon the Society made such a review appropriate.

Practices

The Society records and updates "asset shares" for typical with-profits contracts. The historical basis for these calculations is held electronically by the Society and its WPA. These asset shares accumulate the premiums received allowing for investment return, expenses, the effect of taxation and the cost of guarantees and risk benefits.

Different investment returns and expense levels may be allowed for short term (five year) and longer term regular premium business, for single premium business and for tax exempt products, to allow

appropriately for the effects of investment mix and taxation. Under the Monthly Savings ISA introduced in 2016, premium expenses are amortised as a recurrent charge rather than being charged at inception. Expense and guarantee charges are reviewed annually by the Board.

In performing the calculations to enable the Principles to be applied, the Society aims to keep the degree of approximation to a minimum whilst recognising that there will remain some subjective judgements in the accumulation of premiums and in the smoothing process.

The Society keeps a record of the investment returns attributed to contracts in each year. These investment returns are based upon the Society's investment experience, adjusted for the effect of taxation and, until 2011, differentiating the investment proportions in each asset class between short term and other business. Short term contracts had a higher exposure to short term bonds and a lower exposure to equities, real property and longer duration bonds than for the other classes of business but, from 2012 onwards, the same investment mix and return applies to all with-profits business.

Bonuses, both annual and final, will be adjusted where 100% of the asset share is not being paid or this target is not expected to be achieved in the next 5 years. The intention would be to make payments averaging 100% of asset share over the long term, excluding any additional sum resulting from policy guarantees.

In assessing whether targets are being met, and in determining the approximations which are acceptable in the underlying assumptions and calculation process, the Society will normally accept a tolerance level of up to 5% in aggregate.

The financial strength of the Society is also a consideration in determining benefits under with-profits contracts. To the extent that the assets of the Society exceed the amount normally required to meet policyholder benefits, these excess assets or “Estate” are a factor contributing to financial strength and enabling the Society to be able to smooth benefits, and to meet exceptionally adverse conditions. The target payments may be increased as a consequence of the Society managing its “Estate” (see below).

Its financial strength also enables the Society to formulate an investment policy which permits a higher degree of exposure to equities than would otherwise apply. The Society gives careful consideration to controlling the various risks to which it is exposed, recognising that such risks are effectively borne by the with-profits policyholders.

The Society would expect its Practices to evolve. Any change in the current methods, parameters or assumptions will be proposed to and agreed by the Board, who would have due regard to the interests of affected policyholders.

In the context of the current methods adopted, the Estate absorbs the costs of smoothing and guarantees when they apply (net of any charge made for guarantees), as well as miscellaneous sources of profit or loss such as

- taxation and expenses to the extent not modelled in the asset share calculation;
- expense contributions arising on surrendered with-profits business; and
- profits or losses from non-participating business.

Each of these miscellaneous items is expected to be small. If there were any extraordinary source of profit, then the Board would consider whether and how this should be reflected in its Practices.

Annual Bonuses

Principles

In setting annual bonus rates, the Society aims to take into account

- the yield on risk free assets (UK government bonds);

- the prospect that guarantee costs are or will become material;
- the financial strength of the Society; and
- an intention to change annual bonus rates in small steps.

The Society aims to keep the number of bonus series to a reasonable minimum; but there is a natural distinction between regular and single premium contracts and between tax exempt and taxable contracts. Moreover, the Monthly Savings ISA is designed so that only annual bonuses are added, not a final bonus; accordingly its annual bonus rate will more directly reflect the total return earned on investments.

Practices

The Society generally aims to keep annual bonus rates covered by risk free (UK government fixed interest) rates. Account is also taken of the financial strength of the Society; and of the extent to which a reasonable margin currently exists out of which to pay final bonuses.

There is a separate bonus series for the Monthly Savings ISA where the only bonus applied will be annual bonuses. Accordingly, the annual bonus rate for this plan will be higher than for other single/recurrent premium plans.

The Society sets the interim bonus rates for the forthcoming year at the October Board meeting. The Society reserves the right to review these rates at any point up to their declaration at the December meeting in the year to which the bonus relates. It is not expected that annual bonus rates would vary from year to year by an absolute amount exceeding 0.5% in the case of regular premium conventional with-profits business and 1% for single premium accumulating with-profits business.

Final Bonuses

Principles

In determining the final bonus scale, the Board will consider

- how payouts reflect experience, in particular on investments,
- how payouts will vary from year to year,
- the extent to which smoothing results in payouts exceeding asset share, and
- financial projections.

The financial projections consider both the development of the with-profits fund and the payouts under individual contracts. Projections of the fund would consider a variety of economic circumstances that could arise in the medium term.

Practices

For **regular premium** business, no market value reduction or equivalent applies. Generally, surrender values remain subject to the Society's discretion and are not guaranteed.

The Society sets final bonus rates with the aim of increasing the guaranteed benefits to the asset share subject to smoothing. The Society normally sets final bonuses for the following calendar year at its October Board meeting. The Board reserves the right to review final bonuses at any time for implementation as soon as practical. Such a mid-year change to bonuses would only be expected in exceptional conditions.

For policyholders surrendering their contracts after an elapsed duration of at least 6 years, the surrender value is modelled closely upon the equivalent maturity value of a policy effected in the same year, with a modest level of discounting to reflect the different cost of death benefits and to reduce the benefit of smoothing inherent in the maturity value.

All contracts surrendering usually receive at least a return of the premiums paid under the contract, except for those with an elapsed duration of less than 4 years – where a small deduction is made. At short durations, the surrender value has regard principally to the costs of writing new business and paying claims, neither of which would be truly represented in the asset share.

For **single premium** business, which is all written on a whole of life basis, the contracts provided that following an elapsed duration of 10 years, and at specified dates thereafter, the surrender value will not be less than the accumulated sum assured – the original sum assured increased by declared annual bonuses. Such guarantees were removed for new business from dates specified in the relevant Tables. Otherwise, all surrender values remain subject to the Society's discretion and are not guaranteed.

The Society generally aims to set final bonus rates to adjust the accumulated sum assured to the asset share. Such a bonus will be applied, if positive, from the third anniversary onwards.

If the accumulated sum assured were greater than the asset share, then this could result in a market value reduction being applied, unless there was a guarantee applying at the time of surrender. A market value reduction would not normally apply unless this was required to ensure that the surrender value did not exceed 105% of asset share. No market value reduction would apply to a death claim.

To the extent that the Society meets losses in this manner, including through the smoothing process, it reserves the right to target payments lower than 105% of asset share (but not below 100%) when the demand for surrender values is above normal levels.

The final bonus rates, including market value reductions, are determined on a formula basis at the start of each quarter, and would be reset during the quarter in the event of exceptionally adverse investment performance, or in response to increasing surrender demand.

Where surrender occurs in the first year of a contract, the accumulated sum assured is reduced by a charge of, currently, 3%. A market value reduction would only be applied if it exceeded the amount of this charge.

No final bonuses apply to the Monthly Savings ISA. However, market value reductions can apply as described above.

The Society may occasionally add special bonuses in order to reduce costs, e.g. to enable it to consolidate contracts fairly. Such bonuses have the effect of increasing guarantees but the associated cost may be balanced by administrative savings.

Smoothing

Principles

Smoothing is intended to be neutral in effect on the Society's finances over the long term. The Society does not set any short term limit on the cost of smoothing, but would generally wish to establish that in the medium term any smoothing costs are likely to disappear other than those due to paying out guaranteed benefits (sums assured and declared annual bonuses). Market value reductions (or negative final bonuses) only apply to surrendering single premium business, and only then to recoup at most the underlying asset losses on the relevant contract.

Practices

There is a single smoothing strategy applicable to all generations, sizes and types of with-profits policy, except for the Monthly Savings ISA.

The Society operates smoothing to the extent that payouts would not normally vary by more than 10% from year to year, and usually by less for policies of less than 20 years' duration. Also, the final bonus scale would itself be smoothed.

Under the Monthly Savings ISA, the Society will set the variable annual bonus rate to target pay-outs within 5% of asset share. Where this is achieved without the need for market value reductions, it will normally pool contracts in successive tax years which are on a variable bonus rate and thereafter manage the combined years.

It is intended that the above practices will normally result in most maturity and longer-term surrender values falling within the range 90% to 110% of asset share. This target range would be monitored and the Board would consider how to address any material breach and over what period.

Any formulae used to smooth pay-outs may be adapted from time to time to respect the above principles and practices.

Investment Strategy

Principles

The investment strategy is determined having regard to the ability of the Society to withstand adverse investment scenarios. The main asset classes that may be held by the Society are short-term deposits, government and corporate bonds, equities and real property. Pooled funds may be held. Some of these funds fall outside the requirements of the EU "UCITS" directive (*Undertakings for Collective Investment in Transferable Securities*). On direct holdings, including any managed by third parties, the Board sets and monitors the controls on derivatives and on counterparty risk. Derivatives may only be held for the purpose of efficient portfolio management.

Practices

The Society's investment strategy is reviewed annually by the Board. Plans to implement the strategy are regularly considered by the Risk & Investment Committee.

Each quarter, the Society reviews the matching of the investments to the accrued liabilities (the sums assured earned to date plus declared annual bonuses). Investment proportions are chosen so that the accrued guaranteed benefits are largely covered by cash and fixed interest assets including the rental element of property investment. Although the Society aims for a close degree of investment matching, a slightly mismatched position may be accepted by the Board, following consideration of the associated risk.

Liquidity is principally considered to be an issue for investment in real property, where the Society aims for a diverse portfolio with individual pooled property funds not exceeding 3% of total assets individually or 15% in total. The Society does not invest directly in real property. Non-UCITS funds (such as funds of hedge funds) and cash deposited for more than 6 months are also considered illiquid; no more than 20% of the total assets would be invested in illiquid assets in aggregate.

The Society sets limits on any pooled fund in which it invests. Any new fund manager or new type of investment instrument, including directly held derivatives, would only be considered by the Society after prior approval had been given by the Board.

The Society normally places a limit of 3% of assets on the counterparty risk assumed from cash holdings with any one banking group. The Board has increased this to 5% for the Society's main current account, and may approve a higher limit on a temporary basis to facilitate investment transactions.

Business Risks

Principles

The Society may consider issuing insurance contracts other than with-profits contracts within the with-profits fund, or establishing subsidiaries to facilitate offering other types of product. It will consider each case with a view to balancing the risks of and potential rewards from undertaking such business, and in order to provide its membership with a more complete range of products and service. Such risks and rewards are effectively borne entirely by the with-profits fund.

Practices

Business risk for non-participating (i.e. other than with-profits) business is material for protection contracts issued by the Society. These risks are often covered by reinsurance contracts, and the Society reviews the credit rating of reinsurance counterparties at least annually. In addition the short-term (5 year) savings plan is a fully guaranteed non-participating product and the Society bears all the risks thereon including those from fluctuations in interest rates.

In launching any new non-participating product, the Society considers the likely maximum exposure to which it could be subject if business volumes were good, and the losses to which it will be subject if business volumes do not recoup development costs. In particular, the Board would consider an analysis of the impact on its with-profits business.

Profits or losses from non-participating policies are monitored annually. Such profits or losses are currently small and are attributed to the Estate.

There are also business risks associated with the guarantees under with-profits contracts. In practice, the costs of meeting guarantees must fall on all with-profits policyholders, and this business is managed to keep the cost of such guarantees to a minimum consistent with the fair treatment of those policyholders. Consideration of new business volumes is a factor in managing these risks. Losses arising from guarantees are effectively attributed to the Estate as they arise. A deduction will be made from the investment return applied to asset shares in order to cover the expected cost of guarantees on with-profits contracts. The charge made in a normal year will be 0.25%, but the Society intends to apply a higher charge when the recent performance of equity markets has been poor. In 2013, the additional cost of guarantees on 5 year savings plans was recognised, and an additional annual charge of 0.5% was introduced for these plans.

Charges and Expenses

Principles

The Society aims to apportion charges fairly to all contracts including with-profits policies and to reflect these where material in the asset share process.

Practices

The Society will consider annually, following an analysis of its expenses for the previous year, whether the apportionment of expenses to with-profits policies needs to be changed. All expense allowances include an element for mortality costs and a deduction for taxation where applicable. New business and claims expenses are normally attributed to premiums, and these are amortised over the life of a contract for regular premium business. In the case of the Monthly Savings ISA, such expenses are met by an annual charge. The asset shares are intended to reflect actual expense levels without any material subsidy.

As indicated above, the Society also levies an annual charge for the cost of guarantees. This is generally set by the Board in the final quarter of the year.

Management of the “Inherited” Estate

Principles

The Society assesses its Estate as the total of its assets in excess of the total of the asset shares attributable to the contracts making due allowance for other policy and non-policy liabilities covered by those assets. Where material, this definition may encompass anticipated assets (e.g. the value in non-participating business), and liabilities (e.g. future guarantees).

The Estate is available to support the fund including the immediate cost of smoothing and meeting guarantees, as well as generally to meet any other risks not directly associated with with-profits contracts.

The Society aims to maintain its Estate at a stable level over the long term having regard to the investment return which is earned on that Estate. This respects the concept that the Estate has been “Inherited” from past generations of business, but that it is not acceptable to levy the current generation without good cause.

The Society's with-profits policies benefit from the Estate, in that it enables the Society to gain a larger exposure to equity type investments.

These Principles confer a benefit on policyholders. In return, the Estate may be managed on occasion with a view to other business needs, for example to ensure adequate capital is held.

Practices

The Society uses the Estate to meet guarantees and smoothing costs although, over the longer term, the net cost is intended to be small. In doing so, it also pays attention to the financial strength of the Society. This includes an assessment of how the finances of the Society will develop over the medium term, and how the Society’s free assets would respond to adverse movements in investment values.

The Board considers whether certain costs are exceptional and should be met from the Estate rather than charged to asset shares. Currently, some business development costs are dealt with in this way.

The investments backing with-profits contracts are determined after hypothecating appropriate (lower risk) assets to the Estate and to the non-participating business. In consequence, the Society’s holdings in equities and real property are fully assigned to the asset shares.

The Society would consider whether changing business volumes or other factors required a higher or lower target figure for the Estate, but again this would be principally driven by considerations of financial strength.

If the Society’s financial strength is revealed to be excessive in the context of the above tests, its investment strategy and its new business plans, then the Board will formally consider proposals to distribute part of the Estate so as to redress the balance.

Such distributions have taken place in the past and have generally taken the form of an increase in the historic investment return. The Society has implemented a further distribution of this nature which takes effect from January 2017.

New Business

Principles

The Society generally aims to write as much business as it can within the constraints of acceptable new business expenses and not wishing to oversell to its members. In particular, it would review any potential risks in any non-participating business written in the with-profits fund, the investment risk associated with single premium business, and any other risks to the capital position of the Society.

In the event that the Society were to close to new business, it would need to consider various alternatives whereby its members' interests could be safeguarded. Subject to that, it would then need to determine an equitable way of distributing the Estate (or most of it) to the membership as the business ran off.

Practices

The amount of business which the Society writes is generally stable from year to year. Lump sum business has grown in recent years, and the Society has adopted terms and conditions, for new business of this type, which limit the risk arising from guarantees.

Were business levels to deteriorate for any reason, and in particular if expenses were also to rise, then the natural course would be for the Society to carefully consider its future role and activity, including the way in which the Estate is managed.