Principles and Practices of Financial Management (1 January 2023)

These Principles and Practices of Financial Management ("PPFM") 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 previous PPFMs, 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 members. Moreover, smoothing and distributions of the Estate may extend pooling to members 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 and the With-Profits Arrangement ("WPAA").

The Society does not expect to change any historical assumptions relevant to its methods, but will review this if regulatory requirements made such a review appropriate or if errors are found.

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, the cost of guarantees and risk benefits and enhancements from past distribution of the Estate.

Different investment returns and expense levels may be allowed for taxable and tax-exempt products, to allow appropriately for taxation. Under Monthly Savings ISA policies issued between 6th April 2015 and 5th April 2020, premium expenses are amortised as a recurrent charge rather than being charged at inception. Expense and guarantee charges for all products are reviewed at least once a year 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 are net of investment management fees.

Bonuses, annual and/or final, will be adjusted if 100% of the asset share is not being paid or if this target is not expected to be achieved in the next 5 years. The intention is to make payments averaging 100% of smoothed 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 normally accepts a tolerance level of up to 10% 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" contribute to financial strength and enable the Society 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 risk assets 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 expects its Practices to evolve. Any change in the current methods, parameters or assumptions will be agreed by the Board, who will 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 or loss, 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 minimum; but there is a natural distinction between regular and single premium contracts and between tax exempt and taxable contracts.

Monthly Savings ISA policies issued between 6th April 2015 and 5th April 2020 were 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. Monthly Savings ISA policies issued from 6th April 2020 have both annual and final bonuses.

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, its expenses and of the extent to which a margin currently exists out of which to pay final bonuses.

There is a separate bonus series for Monthly Savings ISA policies issued between 6th April 2015 and 5th April 2020 where the only bonus applied will be annual bonuses. Accordingly, the annual bonus rate for this plan will normally be higher than for other single/recurrent premium plans. The Society currently guarantees the rate of annual bonus for this plan during the year of subscription and for 12 months afterwards and no market reduction applies during this period. The investment surplus in the 12 months after the year of subscription is shared equally with the member.

Monthly Savings ISA policies issued from 6th April 2020 have the same annual and final bonus rates as the Lump Sum ISA.

For Lifetime ISA and Monthly Savings ISA policies issued after 6th April 2020 the Society currently guarantees the rate of annual bonus during the year of subscription and no market value reduction applies during this period.

For ISAs the subscription year ends on 5th April and for Flexible Savings Plans the subscription year ends on 31st December.

The Society normally sets the interim bonus rates for the forthcoming year at a Board meeting during the 4th quarter of the calendar year.

The Society reserves the right to review these rates at any point up to their declaration at the December Board meeting in the year to which the bonus relates. It is not expected that annual bonus rates will vary from year to year by an absolute amount exceeding 0.5% p.a. in the case of regular premium conventional with-profits business and 1% p.a. for single/recurrent premium accumulating with-profits business, or 1.5% p.a. in the case of the Monthly Savings ISA policies issued between 6th April 2015 and 5th April March 2020.

Final Bonuses

Principles
In determining the final bonus scale, the Board considers:
•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 consider a variety of economic circumstances that could arise in the medium term.

Practices
For regular premium conventional with-profits 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 Autumn Board meeting. The Board reserves the right to review final bonuses at any time and to implement changes as soon as practical. 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** accumulating with-profits business, which is all written on a whole of life basis and includes business written on recurrent premiums, the contracts initially 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.

These guarantees were removed for new business from dates specified in the relevant Tables, and no policies issued after 5th April 2013 have any such guarantees. Otherwise, all surrender values remain subject to the Society's discretion and are not guaranteed.

The Society 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. Final bonuses do not apply to the Monthly Savings ISA policies issued between 6th April 2015 and 5th April 2020 (Tables 29 and 30).

Final bonuses do apply to Monthly Savings ISA policies issued from 6th April 2020 (Tables 32 and 33). For business written on recurrent premiums (including regular premium ISAs issued before 1st January 2016 under Tables 25 & 28, Flexible Savings Plans issued under Table 27, regular premiums into a Lifetime ISA issued under Table 31 and Monthly Savings ISA policies under Tables 32 and 33), the period qualifying for final bonus commences at the end of the year of subscription. The Society therefore assumes the investment risk during the year of subscription.

If the accumulated sum assured is 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. The Society offers a market value reduction subsidy for all policies issued up to 31 December 2019, such that 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.

This market value reduction subsidy does not apply for policies written with effect from 1 January 2020.

For ISA business written on recurrent premiums, a new policy is issued for each tax year, which means that the market value reduction subsidy does not apply to any contributions made to these ISA policies from the 2020/21 tax year onwards, 6th April 2020. Policies without a market value reduction subsidy normally have a lower guarantee charge applied to asset shares to reflect the lower cost of guarantees associated with these products. No market value reduction applies 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 (measured from the end of the year of subscription for recurrent premiums), 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.

For the Lifetime ISA the 3% charge is waived for a qualifying house purchase.

For surrenders of recurrent premium contracts during the year of subscription, the surrender charge is one month's premium for Monthly Savings ISA policies issued on or before 6th April 2020, 5% of total premiums in the case of the Lifetime ISA (reduced to 2% for qualifying house purchase).

For Monthly Savings ISA policies issued from 6th April 2020 there are charges applied where surrender occurs in the first two years of a contract. The charge is currently 5% of the accumulated sum assured where surrender occurs in the first year of a plan and 3% where surrender occurs in the second year of a plan.

No final bonuses apply to Monthly Savings ISA policies issued between 6th April 2015 and 5th April 2020. 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 expects that over the medium term any smoothing costs will be zero, excluding costs due to paying out guaranteed benefits (sums assured and declared annual bonuses). Market value reductions (or negative final bonuses) only apply to surrendering single/recurrent 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 Monthly Savings ISA policies issued between 6th April 2015 and 5th April 2020.

The Society operates smoothing normally to limit payouts varying to less than 10% from year to year, and usually by a lower percentage for policies of less than 20 years' duration. Also, the final bonus scale is itself smoothed.

Under Monthly Savings ISA policies issued between 6th April 2015 and 5th April 2020, the Society will set the variable annual bonus rate to target pay-outs normally within 10% of asset share.

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 unsmoothed asset share. This target range is monitored and the Board will consider how, and over what period, to address any material breach.

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, commodities, and real property – normally within pooled funds. Some of these funds may 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.

The Board has set a minimal appetite to invest into areas that will have a detrimental effect on the Society, its members, or the wider environment as a result of climate change. This principle continues to mature as the Society progresses to bring its appetite into practice within its investment strategy.

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

At least every 6 months (aligned to the Society's actuarial valuation dates), the Society reviews the matching of its investments to its guaranteed liabilities (the sums assured earned to date plus declared annual bonuses), allowing for the circumstances in which the guarantees are payable at a minimum (such as the guarantees comprising minimum guaranteed death benefits). Investment proportions are chosen so that the guaranteed benefits are largely covered by cash and fixed interest assets. Although the Society aims for a close degree of investment matching in respect of guaranteed liabilities, 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 5% of total assets individually or 15% in total. The Society does not invest directly in real property. Non-UCITS funds (such as Insurance Linked Security 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.

Any new fund manager or new type of investment instrument, including directly held derivatives, will 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 when considered appropriate.

Business Risks

Principles
The Society may consider issuing insurance contracts other than with-profits contracts in the with-profits fund, or establishing subsidiaries to facilitate offering other types of products in order to provide its membership with a more complete range of products and services. It will consider each case with a view to balancing the risks of and potential rewards from undertaking such business. 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 considers 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 policyholders.

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 including the market value reduction subsidy on with-profits contracts written up to 31 December 2019. The charge made in a normal year will be 0.25% for policies qualifying for the MVR subsidy and 0.15% for those policies written from 1 January 2020 for which the MVR subsidy no longer applies. The Society intends to apply a higher charge when the recent performance of investment markets has been poor.

Charges and Expenses

Principles
The Society aims to apportion charges and expenses 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.

The Board considers whether certain costs are exceptional and should be met from the Estate rather than charged to asset shares.

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 Monthly Savings ISA policies issued between 6th April 2015 and 5th April 2020, such expenses are met by an annual charge.

Normally 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. Where applicable, this annual charge includes an allowance for the cost of any market value reduction subsidy applying to business written up to 31 December 2019. This charge 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 (including the MVR subsidy, if applicable), 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.

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 might develop over the

medium term, and how the Society's free assets would respond to adverse movements in investment values.

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 risk assets are fully assigned to the asset shares.

The Society considers whether changing business volumes or other factors require a higher or lower target figure for the Estate, taking into consideration the Society's 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 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 allocated to various years. The Society last implemented a distribution of this nature with effect from January 2017.

New Business

Principles
The Society generally aims to write as much business as it can within the constraints of generating acceptable new business expense levels and not wishing to oversell to its members. It reviews the 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 at least annually.

In the event that the Society were to close to new business, it would need to consider courses of action to safeguard members' interests. 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
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.