

PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT



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1. Introduction

1.1. Overview

- 1.1.1. The basis for this document was specified by the Financial Services Authority (FSA) in Policy Statement 167 and in rules and guidance set out in the relevant sections of the FSA Conduct of Business Sourcebook.
- 1.1.2. The nature of with-profits policies includes the exercise of discretion. For *the Society*, this discretion is exercised by the *Managing Board*. This document aims to explain how the *Managing Board* manages the financial aspects of *the Society's* with-profits business.
- 1.1.3. *The Society's* with-profits business is written in *the Society's* long term business fund which is referred to as the '*Life Fund*' or 'fund' in this document.
- 1.1.4. The Principles and Practices of Financial Management (PPFM) have been prepared based on current practice, past experience in managing *the Society's* with-profits business, as well as consideration of how *the Society* would expect to react to future external events such as changes to the economy.
- 1.1.5. A wide range of potential future operating conditions has been considered within the financial management framework described in the PPFM. It is difficult, if not impossible, to foresee all future possibilities. Consequently, in certain extreme conditions, it may be necessary to depart from the principles and practices described here.
- 1.1.6. Terms in *italics* are defined in the 'Definitions' in the Appendix at the end of this document.
- 1.1.7. This document was first published on 30 April 2004 following its approval by the *Managing Board*.

1.2. Principles of Financial Management

- 1.2.1. The with-profits principles are enduring statements of the overarching standards *the Society* adopts in managing the *Life Fund*.
- 1.2.2. They describe the business model used by *the Society* in meeting its duties to with-profits policyholders and in responding to longer-term changes in the business and economic environment.

1.3. Practices of Financial Management

- 1.3.1. The with-profits practices describe *the Society's* approach to managing the *Life Fund* and to responding to changes in the business and economic environment in the shorter term. Reviews will take place at least annually but may not require changes to be made.
- 1.3.2. These practices are intended to contain sufficient detail to enable a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a with-profits policy with *the Society*.

1.4. Arrangements for Change

- 1.4.1. For any change to the Principles, *the Society* will send its with-profits policyholders written notice, setting out any proposed changes to the with-profits

principles of *the Society*, three months in advance of the effective date of the proposed changes unless the Financial Services Authority has granted a waiver of this requirement.

1.4.2. *The Society's* Practices are expected to change as *the Society's* circumstances and the business environment change.

1.4.3. *The Society* would only change a Principle or Practice if it is considered 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; or
- Improve the clarity or presentation of the PPFM.

1.4.4. *The Society* will send its with-profits policyholders written notification, setting out any changes to the with-profits practices of *the Society*. This notification may be in arrears but will be within a reasonable time period from the effective date of the change.

1.4.5. Any changes to either the Principles or Practices will be approved by the *Managing Board*.

1.5. Corporate structure

1.5.1. Police Mutual Assurance Society Limited is an incorporated directive friendly society.

1.5.2. As a *mutual* organisation *the Society* has no shareholders.

1.5.3. *The Society* uses a number of subsidiary companies and *related parties* to offer additional products and services.

2. Product Structures

2.1. Policy types

2.1.1. *The Society* has the following policy types:

- *Conventional with-profits*: Ordinary Endowment, Tax-Exempt Endowment, Low Cost Endowment, Special Endowment, Minimum Low Cost Endowment and Children's Bond.
- *Unitised with-profits* pensions: Top Up Pension Plan (TUPP)
- *Unitised with-profits* lump sum: Platinum Bond and Guaranteed Investment Bond (GIB)
- *Unitised with-profits* Individual Savings Account (lump sum and regular contributions): Guaranteed ISA (GISA)
- Non-profit: mortgage protection (various versions), level term assurance (various versions), level term assurance with return (Panda), whole of life assurance (Police 4000), family income benefit, convertible term assurance, temporary annuities.
- Unit-linked: Stakeholder Pension, Child Trust Fund.

2.1.2. Only the first four categories include discretionary benefit payments and are covered by this document.

2.2. Combination policies

2.2.1. *The Society* currently has, and has had in the past, a number of 'combination' policies. These are policies that are combinations of the policy types specified above. Each component part of these policies is dealt with separately and in exactly the same way as other policies of that policy type.

3. Principles of Financial Management

3.1. The amount payable under a with-profits policy

- 3.1.1. The methods that *the Society* uses to determine the amount payable under a with-profits policy aim to reflect the *share of the Life Fund attributable to that policy*, taking into account the experience of the *Life Fund* during the lifetime of the policy. The amount paid on *maturity* and death is subject to *smoothing* and will not be lower than the guaranteed benefits.
- 3.1.2. This *share of the Life Fund attributable to a policy* makes allowance for all charges and expenses (see 3.7) and any discretionary adjustment to reflect the other business activities of *the Society* and the management of the *inherited estate* (see 3.8).
- 3.1.3. The methods used to calculate the amount payable under a with-profits policy involve a degree of approximation, for example in determining historical assumptions for which there are not detailed records. Such approximations would not significantly affect the decisions that *the Society* makes in managing its with-profits business.
- 3.1.4. Because of these approximations, historical assumptions or parameters may be changed. Such changes would usually result in a more accurate determination of the amount payable, or enable a more efficient determination of the amount without significant loss of accuracy.
- 3.1.5. If a change to the calculation method is made then the effect of the change is calculated. Any material change to the calculation would be agreed by the *Managing Board* after taking appropriate actuarial advice.

3.2. Setting regular bonus rates

- 3.2.1. Regular bonuses may be added to a with-profits policy depending on investment performance and the operating experience of the *Life Fund*.
- 3.2.2. Once added, regular bonuses cannot be removed. The aim in setting regular bonuses is to distribute that part of the investment return and profit of the *Life Fund* which is reasonably certain, whilst maintaining a reasonable margin for final bonuses. *The Society* considers both past and prospective investment returns and the solvency of the *Life Fund* when setting regular bonus rates.
- 3.2.3. Policies based on the same underlying endowment premium rates and which were effected at the same time will have the same regular bonus rate declared. Where different underlying premium rates or product structures are used, *the Society* may choose to declare a different regular bonus.
- 3.2.4. *The Society* reserves the right to introduce a new bonus series on existing premium rates, subject to obtaining actuarial advice. The investigations specified in 4.3.5 would indicate whether a new bonus series was appropriate.
- 3.2.5. Regular bonuses are reviewed once a year as part of the year end investigations. However, relevant investigations are carried out throughout the year.
- 3.2.6. *The Society* may change the interim bonus (see 4.1.1.2) during the year, and on more than one occasion, if investment conditions change significantly so that the *supportable* regular bonuses change significantly.

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- 3.2.7. Appropriate actuarial advice is taken and recommendations are made to the *Managing Board* on bonus rates. The *Managing Board* decides what regular bonus to declare.
- 3.3. Setting final bonus rates
- 3.3.1. The *share of the Life Fund attributable to a policy* is used as a guide to setting the final bonus rate or final bonus. This 'share' of the fund is subject to *smoothing*.
- 3.3.2. Conventional with-profits policies based on the same underlying endowment premium rates and which were effected at the same time for the same term will have the same set of final bonus rates. The final bonus rates depend on the duration in force at the time of a claim. As for regular bonus rates, *the Society* reserves the right to introduce a new bonus series on existing premium rates, subject to obtaining appropriate actuarial advice. Where different underlying premium rates or product structures are used, *the Society* may choose to declare different final bonus rates.
- 3.3.3. For unitised with-profits policies, the amount of final bonus added is calculated at an individual policy level and will change at the same frequency as the unit price. *The Society* reserves the right to change the final bonus system on existing premium rates, subject to obtaining appropriate actuarial advice.
- 3.3.4. No guarantees are made about the rate of final bonus or that there will be a final bonus. Although the final bonus will not be negative, on *unitised with-profits* business *the Society* is able to impose a *market value reduction* in certain circumstances. *The Society* reserves the right to change its final bonus rates and final bonuses at any time without advance notice.
- 3.3.5. For *conventional with-profits* business, final bonus rates are reviewed at least annually. However, particularly in times of significant market movements, the level of current payouts compared to asset shares will be considered; and in order to protect the solvency of the fund or to prevent payouts diverging too far from asset share, additional bonus rate declarations may be made.
- 3.3.6. For *unitised with-profits* business, final bonuses or *market value reductions* are set for each individual policy according to a prescribed formula.
- 3.3.7. Appropriate actuarial advice is taken and recommendations are made to the *Managing Board* on bonus rates. The *Managing Board* decides what final bonus rates to declare.
- 3.4. Smoothing
- 3.4.1. *The Society* takes the same approach to *smoothing* on *maturity* and death claims. A different approach is taken for surrender claims.
- 3.4.2. *The Society's* intention is that *smoothing* should be neutral over the long term for *maturity* and death claims, i.e. over the long term policyholders should receive the *share of the Life Fund attributable to those policies*, including the deduction of the charges described in section 3.7.3. *Smoothing* is intended to create neither profit nor loss to the fund in the long term.
- 3.4.3. At each bonus rate declaration and periodically in between, the cost of *smoothing* to *the Society* is calculated. There is no formal monetary limit on this cost. However, if the cost is felt to be excessively high or low then this may indicate that another bonus rate declaration is required.

3.4.4. The degree of *smoothing* for surrender claims is less than that for *maturity* and death claims. On the surrender of all policy types, the claim value more actively reflects changes in the underlying asset values. For *unitised with-profits* policies this is done through a *market value reduction* and for *conventional with-profits* policies this is done through the surrender basis. Changes in surrender bases and in *market value reductions* reflect changes in underlying asset values but also reflect changes in other items, for example expenses.

3.5. Investment strategy

3.5.1. All the policies of *the Society*, except unit-linked policies, are invested in the *Life Fund*. The *Life Fund* is reliant on no assets outside of the Fund.

3.5.2. *The Society* operates one investment strategy for its *Life Fund*. There are no different strategies for different generations of policyholders or classes of policy.

3.5.3. *The Society's* investment strategy will have regard to the nature of the liabilities of the *Life Fund* and will seek to optimise the investment return while recognising the need to be able to meet guaranteed benefits and to safeguard the financial security of the fund. In determining the mix of assets between asset classes the investment strategy will take into account the financial strength of the fund, its ability to meet its regulatory capital requirements, and the long term expected returns anticipated for each asset category together with their volatility.

3.5.4. *The Society* operates its investment strategy in line with specified investment policies and controls. The investment policies and controls are approved by the *Managing Board*. They set out the assets in which *the Society* can invest and limits on *the Society's* exposure to different classes of asset. The investment policies also include limits on the exposure to various counterparties to reduce the risk of loss resulting from the failure of a third party.

3.5.5. *Derivatives* and other instruments may be used within limits set by the *Managing Board* for efficient portfolio management and to control and mitigate investment risk. Investments in *derivatives* are not made for speculative purposes.

3.6. Business activities and risks

3.6.1. *The Society* is a *mutual* organisation and all with-profits policies are written within the *Life Fund*. Therefore, *the Society's* with-profits policyholders share in the results of all *the Society's* business activities and risks.

3.6.2. *The Society* limits the taking on of business risk through its approval process. Before taking on any significant new business activity or risk, it must be approved by the *Managing Board* of *the Society* who would consider the costs and benefits of entering into such a venture.

3.6.3. The underlying objective of any venture would be to provide short or long term value to members or deliver a service that would, in the opinion of the *Managing Board*, be in the members' interests. This does not preclude the possibility that losses could occur.

3.6.4. Any losses or compensation costs would be borne by the *inherited estate*. However, should the *inherited estate* fall below the level required to maintain solvency of the fund as an ongoing concern (see section 3.8.2) then these losses or costs would be allowed for in the calculation of the *share of the Life Fund attributable to a policy*.

3.7. Charges and expenses

- 3.7.1. In calculating the *share of the Life Fund attributable to a policy*, an allowance is made for *the Society's* expenses. The aim is that all of *the Society's* expenses incurred in a specific year are allowed for in the calculation except where they are offset by charges made to non with-profits policies or offset by income from subsidiary companies.
- 3.7.2. Any change to the basis on which expenses are allowed for in this calculation would usually be made with the purpose of a more accurate reflection of the amount attributable to a policy.
- 3.7.3. *The Society* reserves the right to make additional charges to with-profits policies to reflect the cost of *smoothing*, the cost of guarantees, the use of capital and the management of the *inherited estate*. This will affect the *share of the Life Fund attributable to a policy*.

3.8. Management of the inherited estate

- 3.8.1. *The Society's inherited estate* is that part of the *Life Fund* not directly required to meet the liabilities and expected benefit payments (including future bonuses) for current policyholders.
- 3.8.2. The primary uses of the *inherited estate* are:
- To give investment freedom. This allows *the Society* to follow an investment strategy that should increase returns above that that would be possible without the *inherited estate*.
 - To meet statutory solvency and internal capital requirements. This allows *the Society* to demonstrate its ability to maintain solvency in adverse situations without reducing returns for policyholders.
 - To provide working capital.
 - To provide capital support for guarantees.
 - To finance other business ventures. See sections 3.6 and 4.7 for more details on this.
 - To enable *smoothing* of investment returns and payouts.
 - To meet any exceptional costs in managing the with-profits business arising as a result of legislation, taxation or other circumstances which in the opinion of the *Managing Board* should not be directly charged to policyholder benefits.
 - To meet any excess of costs over charges for business other than the conventional with-profits business.
- 3.8.3. *The Society* manages its *inherited estate* by any of the following or a combination of any of them: amending investment strategy, amending charges and by controlling the addition of regular and final bonuses, in order to ensure it is adequate to meet both the regulatory requirement and the internal assessment for capital as a buffer against adverse circumstances. The means by which the *inherited estate* is managed in any particular circumstance is determined by the *Managing Board*, based on appropriate actuarial advice.
- 3.8.4. *The Society's* intention is that the *inherited estate* should be large enough to support the activities in 3.8.2. However, *the Society* will not actively increase the size of the *inherited estate* beyond the needs of ensuring it is adequate for this purpose.

- 3.8.5. *The Society* has only one long term business fund so there is no division of the *inherited estate*. There are no constraints on *the Society's* freedom to deal with the *inherited estate* as there have been no previous dealings with it.
- 3.9. New business
- 3.9.1. Because of *the Society's* low expenses and because no commission payments are made, there is very little new business strain.
- 3.9.2. If the volume of new business was sufficiently high that the capital strain placed on the *Life Fund* threatened either the solvency of the fund or the benefit expectations of with-profits policyholders then the *Managing Board* may choose to limit the new business volumes of one or more products.
- 3.9.3. If the volume of new business was sufficiently low that the burden of expense makes a product non-viable then the Board may then choose to withdraw the product from sale.
- 3.9.4. Also, other changes may occur in, for example, the regulatory environment or taxation which would make a product non-viable. The Board may then choose to withdraw the product from sale.
- 3.9.5. In the event of a closure to significant amounts of with-profits new business, *the Society* would:
- Review its investment policy and may, for example, move assets from equities to fixed interest to more closely match liabilities.
 - Review the extent to which payments were being smoothed.
 - Review the management of the *inherited estate* to assess the appropriateness, in the opinion of the *Managing Board*, of making a distribution. If a distribution of some or all of the *inherited estate* is decided to be appropriate then the intention would be to ensure an equitable distribution to the remaining members of the Society.

4. Practices of Financial Management

4.1. Product structures

4.1.1. Conventional with-profits

- 4.1.1.1. An initial guaranteed amount is given, the endowment sum assured. This is the minimum amount that will be paid on *maturity* or earlier death.
- 4.1.1.2. Regular bonuses may be added to the endowment sum assured each year depending on investment performance and the operating experience of the *Life Fund*. Regular bonuses are added on the policy anniversary. However, the bonus does not become guaranteed until the bonus declaration for that calendar year. Until a bonus becomes guaranteed it is called an interim bonus. Regular bonuses and interim bonuses are only paid on *maturity* or death.
- 4.1.1.3. *The Society* currently uses a super-compound bonus system. This means that the regular bonus consists of two parts. The first is a percentage of the endowment sum assured and the second is a percentage of the regular bonuses already accrued.
- 4.1.1.4. Because of the different bases for calculating endowment sums assured, different bonus series are used for Minimum Low Cost Endowments, Children's Bonds and then all other policy types.
- 4.1.1.5. At *maturity* or on death, a final bonus may be paid in addition to the endowment sum assured, regular bonuses and interim bonuses.
- 4.1.1.6. There is a separate final bonus for each policy term. There are separate final bonus scales for Minimum Low Cost Endowments, Children's Bonds and then all other policy types.
- 4.1.1.7. The final bonus is expressed as a percentage of the endowment sum assured plus regular bonuses plus interim bonuses.
- 4.1.1.8. On surrender no guarantees apply either to the amount paid or the method used to determine the surrender value.

4.1.2. Unitised with-profits

- 4.1.2.1. This category includes the Top Up Pension Plan (TUPP), Platinum Bond, Guaranteed Investment Bond (GIB) and Guaranteed ISA (GISA). The details of these policies differ but the underlying structure is the same.
- 4.1.2.2. Each payment buys both Guaranteed units and Shadow units, giving a Guaranteed Fund and a Shadow Fund for each policy. For TUPP, Shadow units are bought at the unsmoothed Shadow Fund Unit Price. For Platinum Bond, GIB and GISA, Shadow units are bought at the smoothed Shadow Fund unit price; however in some unusual conditions we may choose to use a 'Special' price for the GIB and the GISA (see section 4.1.2.12 for further details). The smoothed and unsmoothed Shadow Fund Unit Prices are discussed below in sections 4.1.2.3 and 4.1.2.4.
- 4.1.2.3. The price of Shadow units changes in line with changes in the underlying asset values of the *Life Fund*. The Shadow Fund Unit Price is calculated each week. For the Platinum Bond and GIB, a deduction is made for the tax

expected to be paid by the fund in respect of the investment return attributed to these policies. This is the unsmoothed Shadow Fund Unit Price. When multiplied by the number of units held it gives the unsmoothed Shadow Fund.

- 4.1.2.4. A smoothed Shadow Fund Unit Price is also calculated. This price is the average unsmoothed price over the last 26 weeks, multiplied by an interest adjustment and an asset share factor (see section 4.5.3 for details). Multiplying the number of units held by this price gives the smoothed Shadow Fund.
- 4.1.2.5. Units are cancelled from the Shadow Fund to cover the following charges: Initial Charge, Renewal Charge (taken monthly) and Alteration Charge (if applicable, TUPP only). For TUPP, Shadow units are cancelled at the unsmoothed Shadow Fund Unit Price. For Platinum Bond, GIB and GISA, Shadow units are cancelled at the smoothed Shadow Fund unit price; however, in some unusual circumstances, a 'Special' price may be used for GIB and GISA (see section 4.1.2.12 for further details).
- 4.1.2.6. Regular bonuses may be added to the Platinum Bond and TUPP depending on investment performance and the operating experience of the *Life Fund*. For Platinum Bond, the Guaranteed Fund is increased each week in line with the declared regular bonus rate by increasing the Guaranteed Fund Unit Price. For TUPP, the Guaranteed Fund is increased each month in line with the declared regular bonus rate by creating additional units of equal value. The GIB and the GISA have no regular bonuses.
- 4.1.2.7. For the TUPP, units are cancelled from the Guaranteed Fund to cover an initial charge, a renewal charge (taken monthly) and an alteration charge (if applicable). Charges are not deducted from the Guaranteed Fund of the Platinum Bond but a surrender penalty is applied on surrender within the first five years. No charges are taken from the Guaranteed Fund of GIB or GISA.
- 4.1.2.8. For TUPP units bought prior to 1 May 2003, there is a guarantee that the regular bonus rate will be at least 3.5% each year. For other units there is no minimum guaranteed rate of bonus.
- 4.1.2.9. In certain circumstances the Shadow Fund may be lower than the Guaranteed Fund. The difference between these two values is called a *market value reduction* or *MVR*. If the *MVR* switch is turned on, then in these circumstances certain claim values will be subject to a minimum of the Shadow Fund, i.e. the *MVR* will be applied. If the *MVR* switch is turned off, then in these circumstances certain claim values will be subject to a minimum of the Guaranteed Fund, i.e. the *MVR* will not be applied. It is anticipated that the *MVR* switch will usually be turned on. See sections 4.1.2.10 and 4.1.2.11 for further details of when a *market value reduction* is applied to claim values.
- 4.1.2.10. For certain claims, the claim value is subject to a minimum of the Guaranteed Fund (i.e. no *market value reduction (MVR)* will be applied). These claims are:
- For Platinum Bond, on surrender on tenth (or subsequent quinquennial) anniversary;
 - For Platinum Bond, partial withdrawals up to 7½% of the initial investment each year;
 - For GIB, on surrender on fifth (or subsequent quinquennial) anniversary;
 - For GISA, on surrender/transfer out at guarantee points. A guarantee point occurs five years after the end of the tax year in which payments are made and at subsequent quinquennial points thereafter (i.e. payments

made during each tax year, as measured at 5th April are guaranteed on 6th April in five years' time and every five years thereafter);

- For TUPP, on retirement from main scheme or at the specified age; and
- For all four products, on death (on Platinum Bond, GIB and GISA the death value paid is 101% of the value of the policy).

Any final bonus will be calculated by reference to the smoothed Shadow Fund. However for GIB and GISA, in some unusual circumstances, the value of the Shadow Fund may be calculated using a 'Special' unit price (see section 4.1.2.12 for further details), so that a final bonus is calculated with reference to the unsmoothed Shadow Fund. See section 4.4.3 for details of the final bonus calculation and section 4.5.3 for details of the *smoothing* practices.

4.1.2.11. On other claims, if the smoothed Shadow Fund is greater than the Guaranteed Fund then the smoothed Shadow Fund is used to determine a final bonus for the policy. However, in some unusual circumstances, a 'Special' unit price may be used for GIB and GISA (see section 4.1.2.12 for further details), so that a final bonus is calculated with reference to the unsmoothed Shadow Fund.

- On Platinum Bond surrenders where a final bonus is payable, if the smoothed Shadow Fund is greater than the Guaranteed Fund then the smoothed Shadow Fund will be used to determine a final bonus for the policy.
- On TUPP transfers where a final bonus is payable, the greater of the smoothed Shadow Fund and unsmoothed Shadow Fund is used with reference to the Guaranteed Fund to determine a final bonus for the policy.
- For Platinum Bond surrenders where an *MVR* is applied, if the smoothed Shadow Fund is less than the Guaranteed Fund then the unsmoothed Shadow Fund will be used to determine a *market value reduction*.
- For TUPP transfers where an *MVR* is applied, the minimum of the smoothed Shadow Fund and unsmoothed Shadow Fund is used with reference to the Guaranteed Fund to determine a *market value reduction*.
- For GIB and GISA surrenders where an *MVR* is applied, if the smoothed Shadow Fund is less than the Guaranteed Fund then the smoothed Shadow Fund will be used to determine a *market value reduction*. However, in some unusual circumstances, a 'Special' unit price may be used for GIB and GISA (see section 4.1.2.12 for further details), so that an *MVR* is calculated with reference to the unsmoothed Shadow Fund.
- For Platinum Bond surrenders where an *MVR* is not applied and there is no final bonus, the Guaranteed Fund is paid subject to any surrender penalty. For Platinum Bond surrenders in the first five years, a surrender penalty or an *MVR* may be applied but not both. See section 4.4.3 for details of the final bonus calculation and section 4.5.3 for details of the *smoothing* practices.

4.1.2.12. For GIB and GISA, in some unusual circumstances, the unsmoothed unit price (i.e. a 'Special' price) may be used for the Shadow Fund at the discretion of the Society. This would be triggered by the unsmoothed Shadow Fund Unit Price varying significantly from the smoothed Shadow Fund Unit Price (in either direction). The level of variance is kept under review. Our current practice is that if the unsmoothed price fell to such an extent that it was more than 5% below or increased to such an extent that it was more than 5% above the smoothed price we could decide to use the unsmoothed price (i.e. the 'Special' price), until such time as it was decided that we no longer wished to make this adjustment. The "trigger point" at which a move to the unsmoothed price is made (and the point at which a move is made back to the smoothed price) will depend on several factors including the level of

investments and claims, and the volatility of investment markets, and is at the discretion of the Society.

- 4.1.2.13. For GIB, payment of an amount equal to at least the initial investment is guaranteed on the fifth anniversary and on subsequent quinquennial anniversaries thereafter (reduced if any income is taken). If the value of the Shadow Fund is less than the Guaranteed Fund at any of these guarantee points, the Shadow Fund will be increased up to the level of the Guaranteed Fund. This will be done by creating more Shadow Fund units on the policy. If the value of the Shadow Fund is greater than the Guaranteed Fund at any of these guarantee points, the Guaranteed Fund will be increased up to the level of the Shadow Fund. This will be done by creating more Guaranteed Fund units on the policy, effectively resetting the guaranteed amount to this new higher level.
- 4.1.2.14. For GISA, payment of an amount equal to at least the amount invested is guaranteed five years after the end of the tax year in which payments are made and at subsequent quinquennial points thereafter (reduced if any withdrawals/transfers out are made). If the value of the Shadow Fund relating to payments made during a particular tax year is less than the Guaranteed Fund relating to the same tax year at any of these guarantee points, the Shadow Fund will be increased up to the level of the Guaranteed Fund. This will be done by creating more Shadow Fund units on the policy. If the value of the Shadow Fund relating to payments made during a particular tax year is greater than the Guaranteed Fund relating to the same tax year at any of these guarantee points, the Guaranteed Fund will be increased up to the level of the Shadow Fund. This will be done by creating more Guaranteed Fund units on the policy, effectively resetting the guaranteed amount to this new higher level.

4.2. The amount payable under a with-profits policy

4.2.1. General

- 4.2.1.1. The current methods used by *the Society* to determine the amount payable under a with-profits policy are approved by the *Managing Board*. The detail of these methods is documented internally. The PPFM provides an overview of those methods.
- 4.2.1.2. The internal documentation includes the details of the historical assumptions used and of the computer model used in the calculations.
- 4.2.1.3. The documentation and practices below refer to *the Society's* current approach. Calculations may have been done differently or more approximately in the past.
- 4.2.1.4. Changes in the methods, parameters and assumptions for calculating the amount payable under a with-profits policy are approved by the *Managing Board*, after taking appropriate actuarial advice.
- 4.2.1.5. *The Society* makes no allocation of assets (notional or otherwise) to particular classes of business when recognising investment return. The total investment return on the fund is attributed to all policies. The investment return on a particular subset of the total assets is therefore irrelevant to the calculation.
- 4.2.1.6. The same approach to determining the amount payable is used for all the *conventional with-profits* policies. A different approach is used for the *unitised with-profits* products. Both approaches are covered here.

4.2.2. Conventional with-profits

- 4.2.2.1. *The Society* uses *asset share* as the starting point for determining the amount payable under a policy. In normal circumstances, the *asset share* is calculated once a year as part of the year end valuation of the *Life Fund*. If an additional final bonus declaration is to be made then additional calculations will be done.
- 4.2.2.2. A policy's *asset share* is calculated as:
 - premiums paid accumulated with investment returns
 - less allowance for expenses
 - less allowance for the cost of life cover
 - adjusted for tax (if applicable).
- 4.2.2.3. The investment return of the *Life Fund* is the actual investment return reduced by an amount to reflect the cost of guarantees. This reduced return is used to accumulate the premiums paid.
- 4.2.2.4. The *asset share* may be adjusted to allow for other items (e.g. profits/losses from other sources and management of the *inherited estate*). This adjusted asset share is the *share of the Life Fund attributable to a policy*. It is subject to *smoothing*.
- 4.2.2.5. Our current practice is that surrender values are based on 95% of the *share of the Life Fund attributable to a policy*. The surrender factors used are usually calculated once a year. In times of significant market movements, calculations may be more frequent. For this purpose *shares of the Life Fund attributable to policies* are averaged over all policies issued in a particular

year for a particular term. Some limited *smoothing* of the surrender value factors is done, in that surrender values are normally calculated just once a year. Surrender values are calculated using factors that reflect the *share of the Life fund attributable to a policy*; there is no final bonus explicitly calculated for surrenders.

4.2.2.6. For *maturity* and death claims, the *share of the Life Fund attributable to a policy* is the basis for determining a final bonus scale. See section 4.4.2 for details of the calculation of final bonuses.

4.2.2.7. The table below details the main assumptions and parameters used in the *asset share* calculation. It also shows how these assumptions are derived. This is the current derivation, calculations may have been done differently or more approximately in the past.

4.2.2.8. Most of the assumptions are historical. However, some assumptions are required to project the *asset share* forward over the following year. This is necessary because the *asset share* calculations used to set bonus rates for policies becoming claims during the following year are carried out at the previous year end. Future assumptions are made acting on appropriate actuarial advice.

4.2.2.9.

ASSUMPTION/PARAMETER	DERIVATION
Historical investment returns	Based on the achieved investment returns of the <i>Life Fund</i>
Future investment returns	Current economic experience and economic forecasts
Historical expenses	Based on the expense apportionment exercise (see section 4.8)
Future expenses	Based on most recent expense apportionment exercise and budgeted expenses for the coming year
Historical tax rates	History of tax rates
Future tax rates	Based on current tax rates and known changes
Historical mortality experience	Industry mortality tables adjusted for actual Society experience
Expected mortality experience	Based on industry wide mortality investigations and <i>the Society's</i> own annual investigation
Historical inflation	Historical inflation records
Future inflation	Current economic experience

4.2.2.10. In calculating the *asset share* a number of approximations are made. These include: annual calculations of *asset shares*, using tax rates rather than apportioning the actual tax paid in any one year and deducting the same expense amounts from all policies irrespective of size and policy type.

4.2.2.11. Some of *the Society's* expenses are attributed to its subsidiary companies, unit-linked business, *unitised with-profits* business and non-profit business. Where expenses are not covered by the products or subsidiaries to which they are apportioned (i.e. where the charges collected are less than the expenses attributed) the excess is borne by the *inherited estate*. Where the charges exceed the expenses the excess enhances the *inherited estate*. The remaining expenses are apportioned between the *conventional with-profits* products and allowed for in their *asset share* calculations.

4.2.2.12. The tax in the *asset share* calculation is based on the historical investment returns, expenses and tax rates. Tax deducted from *asset shares* is compared

with the total tax payable which is attributable to the with-profits business. Where the two are significantly different an adjustment may be made to *asset shares*. There is no tax deducted from *asset share* for Tax-Exempt Endowment and Children's Bond policies.

4.2.2.13. Where gross investment return on the *Life Fund* in any year is negative the corresponding net investment return is likely to be greater (i.e. less negative). In these circumstances, the *Society* reserves the right to apply the gross investment return to *asset shares* for both tax exempt and taxable business. Any tax asset that is created as a result of negative investment returns may then not be credited to *asset shares* until such time as the tax asset is then realised. This is our current practice and may change in the future, subject to actuarial advice.

4.2.2.14. *The Society* reserves the right to make a charge to *asset share* to cover the following items:

- the cost of *smoothing*,
- use of capital and
- management of the *inherited estate*.

As described in section 4.2.2.4, the *Society* may also decide to make discretionary credit adjustments to *asset shares*, e.g. for profits from other sources, or deductions from *asset shares*, e.g. for losses from other sources. The resulting adjusted asset share is the *share of the Life Fund attributable to the policy*. See sections 4.8 and 4.9 for further details.

4.2.3. Unitised with-profits

4.2.3.1. *The Society* uses a Shadow Fund value as the starting point for determining the amount payable under a *unitised with-profits policy* (TUPP, Platinum Bond, GIB or GISA).

4.2.3.2. This value is calculated separately for each policy.

4.2.3.3. The Shadow Fund calculation is:

$$\begin{aligned} \text{Fund in month } n+1 \\ = & \text{Fund in month } n + \text{premiums paid} + \text{investment return} \\ & - \text{initial charge (if relevant)} - \text{alteration charge (if relevant)} - \\ & \text{monthly renewal charge} \end{aligned}$$

- Investment return is allowed for by changes in the Shadow Fund unit price. For the TUPP and GISA, the price used is the actual (gross) investment performance of the *Life Fund* less a charge for the cost of guarantees. For the Platinum Bond and GIB, the price used is the actual investment performance of the *Life Fund*, after adjustment for tax and a charge for the cost of guarantees.
- Charges are taken by cancelling units of equal value. For the TUPP it is possible that the cancellation of units could make the Shadow Fund negative.
- The initial charge is only taken at the start of the policy and an alteration charge is only made when the policy is amended (e.g. lump sum added, regular premiums increased). There is no alteration charge for the Platinum Bond, GIB or GISA.
- Details of the calculation of charges and attribution of expenses are in section 4.8.
- The calculation reflects the prevailing tax regime. As the TUPP is a pension product and because GISA is an ISA, there is currently no allowance for tax in the calculation of TUPP and GISA values. For the Platinum Bond and GIB, tax is allowed for in the conversion of the gross unit price to a net unit price.

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- There is a two week lag between the calculation of the unit price that is used for the TUPP and the unit prices that are used for the Platinum Bond, GIB and GISA.
 - As described in section 4.2.2.4, the *Society* may also decide to make a discretionary credit adjustment to a policy by creating additional units in the *Shadow Fund* equal in value to the credit adjustment.
- 4.2.3.4. Where gross investment return on the *Life Fund* in any year is negative the corresponding net investment return is likely to be greater (i.e. less negative). In these circumstances, the *Society* reserves the right to apply the gross investment return in the calculation of the Shadow Fund unit price for both tax exempt and taxable business. Any tax asset that is created as a result of negative investment returns may then not be credited to *asset shares* until such time as the tax asset is then realised. This is our current practice and may change in the future, subject to actuarial advice.
- 4.2.3.5. *The Society* reserves the right to make a charge to *asset share* to cover the following items:
- the cost of *smoothing*,
 - use of capital and
 - management of the *inherited estate*.
- As described in section 4.2.2.4, the *Society* may also decide to make discretionary credit adjustments to *asset shares*, e.g. for profits from other sources, or deductions from *asset shares*, e.g. for losses from other sources. The resulting adjusted asset share is the *share of the Life Fund attributable to the policy*. See section 4.8 for further details.
- 4.2.3.6. The charges and credits for these items could be applied explicitly in the Shadow Fund calculations or implicitly by changing the asset share factor. The asset share factor is discussed in section 4.5.3.
- 4.2.3.7. The value of the Shadow Fund can be calculated using either the unsmoothed Shadow Fund unit price or the smoothed Shadow Fund unit price (see sections 4.1.2.9 and 4.1.2.11). See section 4.5.3 for the calculation of the smoothed Shadow Fund unit price.
- 4.2.3.8. See sections 4.1.2.9 to 4.1.2.13 for further details of the amounts payable under a unitised with-profits policy.

4.3. Setting regular bonus rates

- 4.3.1. It is not *the Society's* intention to frequently change the rate of regular bonus to reflect short term movements in investment market conditions. Given this, unless various investigations (see section 4.3.5) show that there is a need to change regular bonus rates, regular bonus rates remain the same.
- 4.3.2. The same investigations are carried out for all products but the results are looked at separately for different bonus series. Different conclusions may be reached and different bonus rates may be declared.
- 4.3.3. The following products have their own bonus series:
- Minimum Low Cost Endowment,
 - Children's Bond,
 - TUPP, and
 - Platinum Bond.
- All other endowments have the same regular bonus rates. There is no regular bonus rate for GIB or GISA.
- 4.3.4. This is because the calculation of premiums and benefits for these products are significantly different. For all other endowments, the same basic endowment premiums underlie the premium and benefit calculations.
- 4.3.5. For policies that are a combination of Taxable and Tax-Exempt Endowment, the regular bonus rate applied to each contract will be the same. In these circumstances the payout will still be the same whether the policy is a single contract policy or a multiple contract policy.
- 4.3.6. The investigations and factors considered include:
- Results of previous year's investigations;
 - *Bonus earning power investigations* for new and existing business;
 - Current investment and economic conditions;
 - Investment performance over the last year;
 - Prospects for future investment and economic performance;
 - Investigations into future solvency and payout levels; and
 - The cost of guarantees associated with the current and proposed regular bonus rates.
- 4.3.7. The *bonus earning power investigations* look at whether current bonus rates are *supportable* over the long term based on prudent current expectations of future investment returns and the scope that this leaves for final bonuses. The scope for final bonus is not a specified amount as it will depend on the product type, term of the policy and the current economic environment.
- 4.3.8. Where it is decided that a change in the regular bonus is required, the aim is for the change in bonus percentage to be no more than 1% each year in either direction.
- 4.3.9. For the *unitised with-profits* products the regular bonus is declared in advance so there are no interim bonuses.
- 4.3.10. For *conventional with-profits* policies, the regular bonus declared is for the previous calendar year. For example, on the bonus declaration date in 2003, the bonuses added in 2002 become guaranteed at the declared rate. The declared rate may be different to the interim bonus rate that had been used. All claims paid before the bonus declaration date will include interim bonuses calculated at the latest declared rate.

- 4.3.11. Our current practice is that interim bonuses are added at the same rate as the latest declared regular bonus. They are added when a policy anniversary is reached.

4.4. Setting final bonus rates

4.4.1. General

- 4.4.1.1. The final bonus is calculated differently for the *conventional with-profits* products and the *unitised with-profits* products.
- 4.4.1.2. The sections below describe *the Society's* current approach to setting final bonus rates and final bonuses. Recent economic experience is reflected in the calculations to the extent that it affects the calculation of *asset shares* and Shadow Funds.

4.4.2. Conventional with-profits

- 4.4.2.1. Final bonus rates do not directly influence the surrender values that are paid. However, if the amount paid on surrender is less than the *share of the Life Fund attributable to a policy*, this is an item of profit which increases the *inherited estate*. Indirectly, through the management of the *inherited estate*, this may be allowed for in determining the *share of the Life Fund attributable to a policy*.
- 4.4.2.2. The *asset share* is the starting point for the calculation of *maturity* proceeds. The *asset share* is calculated for each policy as specified in section 4.2.2.2. The *asset shares* are then grouped by each *maturity* year and term combination.
- 4.4.2.3. The *asset share* calculations give the total amount attributable to each policy term. This covers all the policy types in this category. These amounts are then adjusted as set out in sections 4.2.2.4 and 4.5.2 to determine the actual final bonus scale.
- 4.4.2.4. For the Children's Bond and Minimum Low Cost Endowment, the same method is used but then payouts are compared with those for other endowments and adjustments may be made to ensure consistency. If adjustments are made then they would reflect our current expectation that a Children's Bond policy should yield more than an equivalent endowment because of its more favourable tax treatment and that a Minimum Low Cost Endowment should yield less than equivalent Low Cost Endowment because of its greater level of life cover. Future experience (e.g. taxation changes) and the effect of guarantees could change these expectations.
- 4.4.2.5. The Children's Bond is a whole of life policy with a limited premium paying term. The final bonus is added to the policy at the end of the premium paying term. Thereafter, if the proceeds are not claimed then they will grow in line with average monthly bank rates.
- 4.4.2.6. For Children's Bond policies, no final bonus is paid on death. The death benefit is the endowment sum assured plus accrued regular and interim bonuses (or the surrender value if this is greater).
- 4.4.2.7. For policies that are a combination of Taxable and Tax-Exempt Endowment, the final bonus rate applied to each contract will be the same. In these circumstances the payout will still be the same whether the policy is a single contract policy or a multiple contract policy.

4.4.3. Unitised with-profits

- 4.4.3.1. The final bonus for each individual policy (TUPP, Platinum Bond, GIB or GISA) is set weekly according to a prescribed formula. The member receives the value of their units based on a smoothed Shadow Fund Unit Price (or the Guaranteed Fund if this is higher and no *MVR* is applicable on the claim). However, in some unusual circumstances, a 'Special' unit price may be used to value the Shadow Fund for GIB and GISA (see section 4.1.2.12 for further details). See section 4.5 for details of the *smoothing* formula used.
- 4.4.3.2. A unitised with-profits policy can only have a final bonus or an *MVR* applied. It cannot have both at the same time.
- 4.4.3.3. Final bonuses paid on other unitised with-profits policies do not influence the surrender/transfer value calculation. A final bonus may be paid on surrender/transfer.

4.5. Smoothing

4.5.1. General

- 4.5.1.1. The aim is to ensure that on average over the longer term the collective amount paid out on *maturity* and surrender claims is the *share of the Life Fund attributable to those policies*, subject to a minimum of the guaranteed benefits. This average is taken over all policies becoming claims over a number of years, so that in any one year the amounts paid out on claims may be more or less than the share of the *Life Fund* attributable to those claims.
- 4.5.1.2. Maturity payouts should normally fall in the range 80% to 120% of the *share of the Life Fund attributable to the policy*. In cases where the guaranteed benefit is higher than the *share of the Life Fund attributable to a policy*, the guaranteed value will be paid and the payment may be outside this range.
- 4.5.1.3. *The Society* does not operate an overall limit on the accumulated cost of/excess from *smoothing*. However, the extent of *smoothing* will be constrained if the *Managing Board* believes that the solvency of the fund will be detrimentally affected over the short or long term or if the Board believe that the *inherited estate* is being built up to a level that is deemed to be unnecessarily high.

4.5.2. Conventional with-profits

- 4.5.2.1. *The Society* has different *smoothing* strategies for its *conventional with-profits* policies and its *unitised with-profits* policies. *The Society* does not apply different strategies to new entrants to the *Life Fund*.
- 4.5.2.2. *Smoothing* strategies do not directly influence the surrender values that are paid. Surrender values are calculated using factors that reflect the *share of the Life Fund attributable to a policy*. Some limited *smoothing* of the surrender value factors is done, in that surrender values are normally calculated just once a year. *Smoothing* is also applied by grouping policies of the same term and year of entry where they would belong to the same bonus series when calculating the factors.
- 4.5.2.3. Our current practice is that surrender values are based on 95% of the *share of the Life Fund attributable to a policy*. Surrender payouts should normally fall in the range 75% to 115% of the *share of the Life Fund*.
- 4.5.2.4. The most significant factor in determining the final bonuses is the *share of the Life Fund attributable to a policy* (including all charges and credits, if applicable). It is used as a benchmark in determining the level and shape of final bonus scales.
- 4.5.2.5. In determining the actual payout scale to be declared, the following factors are considered:
- Adjustments to *asset share* to allow for other items (e.g. management of the *inherited estate*) see section 4.2.2.4;
 - The resulting percentage of the *share of the Life Fund* being paid at each term and in aggregate;
 - How this compares to the percentage paid at the previous declaration and to *the Society's* long term target for percentage of the *share of the Life Fund attributable to a policy*;
 - Yield at each term, how this progresses from one term to the next and how it compares to the previous year;

- Cost of *smoothing*;
- Change in payouts by other companies and how absolute payouts compare at 10 and 25 years.
- Projected future *asset shares* and *shares of the Life Fund*.

4.5.2.6. *The Society* operates no maximum change in payouts from one bonus declaration to the next.

4.5.2.7. In addition to the explicit smoothing described in 4.5.2.5, the Society also smoothes implicitly by grouping together all policies that have the same term and year of entry where they belong to the same bonus series, by holding final bonus rates unchanged between declaration dates and by limiting the number of different bonus scales so that minor product classes share the experience of the major classes.

4.5.2.8. *Smoothing* is operated across all *conventional with-profits* policies. *Unitised with-profits* policies are smoothed differently because claim values are determined differently.

4.5.3. Unitised with-profits

4.5.3.1. If a claim is made, on Platinum Bond or TUPP, that is subject to an *MVR* then no *smoothing* is applied to the benefit value. If a claim is made, on GIB or GISA, that is subject to an *MVR* then *smoothing* will be applied to the benefit value (unless, however, a 'Special' unit price is used to value the Shadow Fund in some unusual circumstances - see section 4.1.2.12 for further details).

4.5.3.2. For other claims, benefits are determined by reference to a smoothed Shadow Fund price. This price is the average unsmoothed price over the last 26 weeks, multiplied by an interest adjustment and an asset share factor. For GIB and GISA, in some unusual circumstances, a 'Special' price may be used for the Shadow Fund at the discretion of the Society. This would be triggered by the unsmoothed Shadow Fund unit price varying significantly from the smoothed Shadow Fund unit price (in either direction). See section 4.1.2.12 for further details.

4.5.3.3. The interest adjustment compensates for the time lag introduced by this *smoothing* process. It is set with reference to an appropriate interest rate. The adjustment is currently reviewed once a year.

4.5.3.4. The asset share factor reflects discretionary adjustments to the *asset share* calculation to allow for other charges, credits and profits from other sources, see sections 4.8.4 and 4.9. The asset share factor is currently reviewed once a year.

4.5.3.5. The *smoothing* formula may be revised in severe stock market conditions.

4.5.3.6. The same formula is used for all *unitised with-profits* policies. There are no differences for different generations or new entrants.

4.5.3.7. Under the Platinum Bond, up to 7½% of the initial investment can be withdrawn in each policy year without penalty (either *MVR* or surrender penalty). This means that partial surrenders within this limit do not reduce the Guaranteed Fund by more than the amount withdrawn. The Shadow Fund is reduced by the same proportion.

- 4.5.3.8. Under the GIB and GISA, there are no *MVR* free withdrawals. This means any partial surrender will reduce the Guaranteed Fund and the Shadow Fund by the same proportion.

4.6. Investment strategy

4.6.1. General

- 4.6.1.1. All the policies covered by this document (*conventional with-profits* and *unitised with-profits*) are invested in *the Society's Life Fund*. All other policies issued by *the Society*, except unit-linked policies, are also invested in this fund.
- 4.6.1.2. The investment strategy of the *Life Fund* is in line with investment policies and controls approved by the *Managing Board*. These policies and controls may be amended only with the consent of the *Managing Board*.
- 4.6.1.3. *The Society's* investment strategy is formally reviewed each year. Investment performance and activities are reviewed by the *Investment Committee* quarterly.

4.6.2. Matching

- 4.6.2.1. *The Society's* fixed liabilities (e.g. sums assured and declared bonuses) are best matched by sterling fixed interest assets and cash. The financial analysis work of *the Society* includes reviewing the proportion of the *Life Fund* required to be held in fixed interest and cash.
- 4.6.2.2. *The Society's* requirement for a *Life Fund* core holding of sterling fixed interest assets and cash imposes a minimum rather than a maximum limit on these types of asset. There may often be valid investment reasons to hold more than the minimum level.
- 4.6.2.3. The *Life Fund's* core holding of sterling fixed interest assets and cash reflects the average term of the *Life Fund* liabilities. This is also set as part of the annual financial analysis work of *the Society*.
- 4.6.2.4. Subject to solvency constraints, provided that the minimum proportions allocated to fixed interest and cash are not breached and that the investment policies and controls are followed, then it is the decision of the *Investment Committee* as to the appropriate investment balance of the *Life Fund*. We would normally expect between 30% and 60% of assets to be invested in equities and property. Subject to solvency constraints, we would generally aim to be at the higher end of this range.

4.6.3. Limits on Asset Classes

4.6.3.1. The table below summarises the limits for certain asset classes:

Limit applies to:	Limit
Sterling fixed interest securities and cash deposits	No maximum
Non-sterling investments	Maximum 15% of fund assets in total Maximum 5% of fund assets in single currency other than £, Euro, US \$
Equities + debt with a single issuer (including connected companies)	Maximum 5% of fund assets (except if issuer is UK Government or Bank of England)
Property	Maximum 15% of fund assets in total Maximum 2½% of fund assets in single property
Policy loans	Maximum 1% of fund assets in total

4.6.3.2. This is subject to the following:

- Investment in debt not issued by the UK Government or *supranationals* should not exceed 50% of the sterling fixed interest portfolio.
- A minimum of 25% of the sterling fixed interest portfolio should be invested in debt issued by the UK Government.
- The value of short term deposits with any approved credit institution should not exceed 10% of the fund assets.

4.6.4. Credit Risk and Liquidity

- 4.6.4.1. Investment in sterling and non-sterling cash deposits and debt with an outstanding *maturity* of not more than one year may only be made with institutions that have a short term *credit rating* of F1 or F1+ from Fitch-IBCA (or an equivalent rating from another recognised credit rating agency). No agency may have placed the institution on a downward credit watch.
- 4.6.4.2. Investment in sterling fixed interest securities may only be made in stocks that have been rated between AAA and BBB inclusive by Standard & Poors (or equivalently by other recognised credit rating agencies). No agency may have placed any stocks rated BBB on a downward credit watch.
- 4.6.4.3. Procedures are in place to deal with an existing holding whose *credit rating* falls below that required. These cover the timescales in which the stock will be sold.
- 4.6.4.4. Dealings in *derivatives* are restricted to the use of strategies which serve to promote efficient portfolio management or for the control and mitigation of risk. The use of derivatives will be in accordance with the FSA's Handbook.
- 4.6.4.5. Apart from assets that would not normally be traded (see section 4.6.6) and any property investments, the assets held in the *Life Fund* are very liquid. There are no specific liquidity constraints on the *Life Fund*.

4.6.5. Changes in Asset Allocation

- 4.6.5.1. Subject to solvency constraints (see section 4.6.2.1), provided that the minimum proportions allocated to fixed interest and cash are not breached, then it is the decision of the *Investment Committee* to change the asset

allocation of the *Life Fund*. This will be decided after considering the investment outlook for the various asset classes which is carried out quarterly.

- 4.6.5.2. The Investments team may not invest in asset classes not covered by the investment policies or controls unless the appropriate due diligence has been carried out and approved by the *Managing Board* and an appropriate section has been added to the policies and controls.
- 4.6.5.3. The Investments team considers social, environmental and ethical issues to the extent that they believe will benefit performance and/or reduce risk. They will also not invest in any way that is likely to damage *the Society's* reputation.

4.6.6. Assets that would not normally be traded

- 4.6.6.1. *The Society* holds a number of assets that would not normally be traded because of their importance to *the Society*. These are:
- The head office buildings;
 - *Seed capital*, share capital and/or loans to *related parties* (see section 4.7.5 for further details); and
 - *Seed capital*, share capital and/or loans to subsidiary companies (see section 4.7.5 for further details).
- 4.6.6.2. The *Life Fund* owns property in Lichfield that is occupied by *the Society*. This property is held because, in the opinion of the *Managing Board*, this is the most efficient way of operating business premises for *the Society*. The property is treated as an investment asset for accounting purposes and does not place any restraint on investment freedom. It would affect the payouts on with-profits policies because any change in property value affects the investment return of the *Life Fund*. As this property is occupied by *the Society* and relocation would be a significant event, there is no formal review procedure for this investment.
- 4.6.6.3. *The Society* invests in subsidiary companies and other *related parties* in order to increase the range of products and services available to its members. The pricing philosophy for the products will set out whether they are being offered for tactical reasons, on a cost neutral basis or to make a profit for with-profits policyholders.
- 4.6.6.4. *The Society* reviews the operations of its subsidiary companies and *related parties* periodically through board meetings of those companies, their reports and accounts and feedback to the *Managing Board* of *the Society*.
- 4.6.6.5. Investments in assets that would not normally be traded are restricted in line with other investments. Head office buildings are restricted to 2½% of fund assets. Investments in any one subsidiary or *related party* are restricted to 2½% of fund assets. There is no aggregate limit on the amount invested in assets that would not normally be traded.
- 4.6.6.6. The out-turn from investment in these assets will impact on the amounts payable to with-profits policyholders. The value of head office property together with *seed capital*, share capital and loans in *related parties* or the subsidiaries are included in the calculation of the investment return on the *Life Fund*.

- 4.6.6.7. As these assets would not normally be traded no credit or liquidity requirements are placed on them.
- 4.6.6.8. Investments in assets that would not normally be traded are not a significant proportion of the *Life Fund* and do not place constraints on investment freedom.

4.7. Business Activities and Risks

- 4.7.1. As a *mutual* organisation with all with-profits policies written within the *Life Fund*, *the Society's* with-profits policyholders share in the results of all *the Society's* business activities and risks. All with-profits policyholders bear *the Society's* business risks equally.
- 4.7.2. The exposure of the *Life Fund* to business risks arising from the application of charges and the apportionment of expenses in relation to with-profits business is described in section 4.8. Any excess of the actual expenses over the charges applied to policies (including *asset shares*) will be borne by the *inherited estate*. However, management of the *inherited estate* (see section 4.9) may result in a discretionary adjustment to the amount paid on a policy.
- 4.7.3. The *Life Fund* bears the risks associated with guarantees provided on with-profits policies. A charge for meeting these guarantees is made (see section 4.8.4).
- 4.7.4. See comments in section 4.10 on the new business strain involved in acquiring new with-profits and non-profit policies.
- 4.7.5. *The Society* has currently entered into a number of investments in subsidiary companies and *related parties*. Where the subsidiaries or *related parties* are limited companies, *the Society* may invest share capital in them. *The Society* may also invest *seed capital* in subsidiaries or *related parties*; or make loans to them. Details of *the Society's* subsidiary companies and the size of *the Society's* investments in them are included in the annual Report and Accounts for the PMAS group of companies.
- 4.7.6. Before taking on any significant new business activity or risk, it must be approved by the *Managing Board of the Society* who would consider the costs, benefits and risks of entering into such a venture. The Board assessment will include an estimate of the projected profits or losses; this calculation will use a risk discount rate which reflects the alternative use of the capital required. The *Managing Board* also considers reports on the ongoing management of risk on a regular basis.
- 4.7.7. *The Society* limits the business risks that it takes on by means of the restriction on the capital investment in subsidiary companies. Business risk is also restricted by using subsidiary companies, *related parties* or third parties to offer certain product lines.
- 4.7.8. *The Society* does not specifically attribute the rewards or losses from business activities to the *asset share* calculation (and therefore the amount payable under a with-profits policy). There is no minimum value which they must exceed before contributing to the calculation. Rewards and losses contribute to the *inherited estate* and the management of this will affect the benefits payable under a with-profits policy (see section 4.9 for details).
- 4.7.9. *The Society* does not smooth any profits or losses arising from business activities.

4.8. Charges and expenses

4.8.1. Allowance for expenses incurred: General

- 4.8.1.1. The total expenses of *the Society* are split into the following categories: acquisition, investment, maintenance and claim. These categories are then sub-divided into products.
- 4.8.1.2. Wherever possible, expenses are attributed directly to the different product types, e.g. costs of printing specific literature and advertising. Non-product specific expenses are apportioned using ratios relevant to the type of expense incurred, e.g. departmental headcounts, time apportionment.
- 4.8.1.3. All expenses are attributed to one of the four main categories and to a product type. There are no 'miscellaneous' or 'other' expenses.
- 4.8.1.4. All expenses are charged at cost to the Life Fund.
- 4.8.1.5. *The Society* uses a number of out-source services. The contract for any such arrangement includes a review period (typically 3 or 5 years). The terms under which *the Society* would be able to terminate these arrangements are set out in the agreements.
- 4.8.1.6. *The Society* has only one long term business fund and no shareholders. Therefore, no judgements are needed about how to apply charges and apportion expenses between entities.
- 4.8.1.7. Expenses attributed to the *conventional with-profits* business of *the Society* are allowed for in the *asset share* calculation as detailed. For other classes of business (e.g. *unitised with-profits*, unit-linked) charges are made to the products which are added to the *inherited estate*. Where the expenses attributable to those classes of business are larger than the charges then the excess is met by the *inherited estate*. The management of the *inherited estate* (see section 4.9) will determine how these expenses affect the *share of the Life Fund attributable to a policy* calculations.

4.8.2. Allowance for expenses incurred: Conventional with-profits

- 4.8.2.1. Average acquisition, investment, maintenance and claim expenses are calculated across the *conventional with-profits* product categories, i.e. the same monetary amounts are used for all *conventional with-profits* policies.
- 4.8.2.2. These average expenses are charged to the *asset share* calculations:
 - Initial acquisition expense deducted at outset
 - Renewal investment plus maintenance expense charged monthly
 - Claim claim expense deducted on *maturity*, death or surrender.
- 4.8.2.3. For *conventional with-profits* policies that have more than one contract, the expenses will be deducted from each contract. The payout will still be the same whether the policy is a single contract policy or a multiple contract policy.

4.8.3. Allowance for expenses incurred: Unitised with-profits

- 4.8.3.1. Units are cancelled from the Shadow Fund to cover initial, renewal (taken monthly) and alteration (if applicable) charges. There is no charge on claim.

- 4.8.3.2. For the TUPP, these charges are reviewed each year. The review looks at the expenses increased in line with inflation and the results of the expense analysis.
- 4.8.3.3. For the Platinum Bond, GIB and GISA, these charges are defined as a proportion of the amount invested (initial charge) and a proportion of the bond/ISA value (renewal charge). The proportions were specified when the products were launched. There are no procedures for the review of these charges.

4.8.4. Other charges to asset shares

- 4.8.4.1. A charge is also made to the *asset share* to cover the costs (including potential costs) of guarantees on with-profits policies. This charge is made by reducing the investment return attributed to the calculated *asset share* by an annual percentage dependent on the policy type. The level of charge to be applied is reviewed annually.
- 4.8.4.2. *The Society* may also make a charge to the *asset shares* to cover the cost of *smoothing*, the use of capital and/or the management of the *inherited estate*. The *Managing Board* will consider making such charges if the *inherited estate* is not of a sufficient size for the uses stated in 3.8.2.

4.9. Management of the inherited estate

- 4.9.1. The FSA definition of *inherited estate* is shown in the Appendix.
- 4.9.2. *The Society's inherited estate* is used to help the running of all of *the Society's* business, including with-profits. It is not used to meet any specific costs or benefit payments.
- 4.9.3. The *inherited estate* is being used:
- To give investment freedom;
 - To meet statutory solvency and internal capital requirements;
 - To provide working capital;
 - To provide capital support for guarantees;
 - To finance other business ventures (see section 4.7 for more details on this);
 - To enable *smoothing* of investment returns and payouts; and
 - To meet any excess of costs over charges for business other than *conventional with-profits business*.
- 4.9.4. *The Society's* investment strategy for the *inherited estate* is currently the same as that for the rest of the *Life Fund*. However, *the Society* reserves the right to change this in the future.
- 4.9.5. *The Society* aims to maintain the *inherited estate* at a level adequate to achieve the aims in 4.9.3. The level of *inherited estate* required for this will depend on the environment at any given point in time and the appropriate level will be reviewed from time to time by the *Managing Board* on actuarial advice.
- 4.9.6. The size of the *inherited estate* is assessed regularly as part of the financial management of the fund. If the *inherited estate* is larger/smaller than the adequate level then it is reduced/increased back to the adequate level over a specified period. The specified period will depend on the size of the adjustment to be made. In addition, changes may be made to charges and investment mix. *The Society* manages the size of its *inherited estate* by any of the following or a combination of any of them: amending investment strategy, amending charges and by controlling the addition of regular and final bonuses.

4.10. New business

- 4.10.1. Each year as part of the routine financial investigations, *the Society* investigates the effect of writing various levels of new business on the financial position of *the Society*.
- 4.10.2. Because of *the Society's* low expenses and because no commission payments are made, there is very little new business strain. Because of this there are currently no practical limits on the volume of new business (with-profits or other) that *the Society* can sustain.
- 4.10.3. If the proportion and scale of with-profits new business falls to such a level that the solvency of the fund was threatened or the benefit expectations of with-profits policyholders were threatened then the *Managing Board* may choose to close the *Life Fund* to new business.

Appendix: Definitions

Phrase	Definition
Asset share	premiums paid accumulated with investment returns less allowance for expenses less allowance for the cost of life cover adjusted for tax (if applicable)
Bonus earning power investigation	An investigation to assess the level of regular bonus rates that could be paid given assumptions about future investment returns
Conventional with-profits	A with-profits policy that has a guaranteed benefit at maturity (the endowment sum assured). Regular and final bonuses may be added to this amount on maturity depending on investment performance and the operating experience of the Life Fund
Credit rating	An evaluation of a company's ability to repay its financial obligations or its likelihood of not defaulting on debts
Derivatives	Financial instruments that can be used to mitigate risk or to speculate on price movements without having to own the underlying asset. The most common derivatives are futures, options, warrants and convertible bonds
Inherited estate	That part of the Life Fund not directly required to meet the liabilities and expected benefit payments (including future bonuses) for current policyholders. The FSA define this as an amount representing the fair market value of the with-profits assets less the realistic value of the liabilities of a with-profits fund
Investment Committee	A sub-committee of the Managing Board who provide assistance in the discharge of the Managing Board's investment responsibilities
Life Fund	Also called 'the fund'. This is the Society's long term business fund

Phrase	Definition
Managing Board	This group is made up of the Chief Executive, Executive Directors and Non-Executive Directors. It develops and implements the strategic direction of the Society and ensures that it operates in accordance with its legal and regulatory responsibilities
Market value reduction (MVR)	A charge applied to the Guaranteed Investment Bond, Guaranteed ISA, Platinum Bond and Top Up Pension Plan in certain specified circumstances if the Shadow Fund is lower than the Guaranteed Fund. It is the difference between the Shadow Fund and the Guaranteed Fund, i.e. if an MVR is applied then the claim value is the Shadow Fund
Maturity	For conventional with-profits policies of specified term, maturity is the end of the specified term For Children's Bonds, maturity is the end of the premium paying period For Top Up Pension Plans, maturity is retirement For Platinum Bonds, Guaranteed Investment Bonds and Guaranteed ISAs, maturity is encashment on an MVR free date
Mutual	An organisation set up and owned by its members and run for their benefit. Friendly societies are mutuals. They have no shareholders
Related party	A company over which the Society has some influence or control
Seed capital	Start up capital for related party or subsidiary
Share of the Life Fund attributable to a policy	Asset share adjusted by charges and credits. These include: Cost of smoothing Use of capital Management of inherited estate Discretionary credit adjustments or deductions (e.g. for profits/losses from other sources)
Smoothing	The act of reducing the impact of changes in the value of the underlying assets on payouts

Phrase	Definition
Supportable [regular bonus rates]	Regular bonus rates are supportable if the projected asset share based on prudent current expectations of future investment returns is greater than the guaranteed claim value including future regular bonuses
Supranationals	These are approved or credit risk scenario exempt institutions
The Society	Police Mutual Assurance Society Limited
Unitised with-profits	A with-profits policy where premiums have been used to purchase units. Regular and final bonuses may be added to the Top Up Pension Plan or Platinum Bond policies depending on investment performance and the operating experience of the Life Fund. The Guaranteed Investment Bond and the Guaranteed ISA have no regular bonuses, but policies may have a final bonus added depending on investment performance and the operating experience of the Life Fund.