

Scottish Friendly Assurance Society Ltd

**Principles and Practices of Financial Management
for With-Profits Business Transferred from Rational
Shelley**

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1. Introduction

- 1.1 The Conduct of Business sourcebook of the Financial Conduct Authority ('FCA') requires firms to establish and maintain 'Principles and Practices of Financial Management' ('PPFM') to govern their conduct of their with-profits business.
- 1.2 This document sets out the PPFM that Scottish Friendly Assurance Society Limited ("Scottish Friendly", "we" or "us") applies in managing the with-profits business transferred from Rational Shelley Friendly Society Ltd ('RS') on 31 December 2005 and in ensuring that customers are treated fairly. The PPFM are not intended to alter the rights and obligations we have under the scheme of transfer from RS or any policy documents that have been issued to policyholders.
- 1.3 Scottish Friendly was established as a friendly society in 1862 and is incorporated under the Friendly Societies Act 1992. We are a mutual society and so have no shareholders. Scottish Friendly has a Board of Directors, which is the ultimate governing body for Scottish Friendly, and distribution of surplus and bonuses is determined by the Board upon the advice of the With-Profits Actuary.
- 1.4 We have established procedures to ensure that the Directors can satisfy themselves at regular intervals that the with-profits business is being managed in accordance with the PPFM; these procedures include formal reports from the With-Profits Actuary and an Independent Person appointed to review PPFM compliance to the Board.
- 1.5 We operate one pool of assets (the Main Fund) for our (non-linked) business, including both conventional and unitised with-profits. We manage our overall financial position taking into account both funds in aggregate. Special investment arrangements have been agreed as regards RS business (detailed in Section 7 below). We will operate a Notional RS Business Fund in order to provide an orderly run-off of the business over a 15 year period. The opening fund comprises the assets and liabilities of Rational Shelley, less any costs and contingencies associated with the transfer, as at the transfer date of 31 December 2005.
- 1.6 This PPFM document covers the operation of the Rational Shelley With-Profits Business. Separate PPFM documents cover Scottish Friendly's other with-profits business.
- 1.7 The Principles are high-level statements that reflect the general approach adopted in managing the with-profits business and are not expected to change often. If the Directors decide that a Principle should be changed, the procedures that will be followed are set out in Section 12.
- 1.8 The Practices are statements of specific practice employed in managing the with-profits business. They reflect the current approaches given the particular circumstances and economic conditions. Practices are likely to be revised in response to changes in the regulatory, business and economic environment and as new methods and techniques are developed in the life and pensions industry. However, the different Practices would still need to conform to the Principles. The procedures for changing Practices are set out in Section 12.

2. With-Profits Policies

- 2.1 Conventional with-profits policies have a guaranteed amount of cash (Basic Sum Assured) to which bonuses are added. The guaranteed amount is payable on a specified event or date stated in the policy document provided all premiums under the policy are paid when due. Bonuses are additions to the benefits payable on with-profits policies and usually take one of two forms: annual (or regular or reversionary) bonuses which are added throughout the policy term and final (or terminal) bonuses which (if payable) are only added at the date of a payout. Annual bonuses are declared as a percentage of the guaranteed amount and a percentage of the previously declared annual bonuses and are added yearly; final bonus is expressed as a percentage of the sum assured and total annual bonuses added to the date of the claim and depends on the duration of the policy at the date of the claim. Final bonus is not explicitly paid on the surrender of a conventional with-profits policy but for these types of policy the surrender value makes some implicit allowance for final bonus.
- 2.2 Special bonuses also apply to many policies relating to additional amounts guaranteed on the transfer of the RS business to Scottish Friendly, and on previous business transfers.

3. Overriding Principles

3.1 Scottish Friendly has three overriding principles that can be regarded as overriding the principles and practices contained elsewhere herein if they come into conflict. These are:

- (a) We will manage our business in accordance with all legal and regulatory requirements.
- (b) We will manage our business in a sound and prudent manner with due regard to the interests of our policyholders and with a view to treating all policyholders fairly.
- (c) We will aim to manage our business in order to ensure that all guaranteed benefits can be paid as they fall due.

4. Methods of determining claim values

4.1 Principles

- 4.1.1 We will use appropriate models, methods and techniques to manage the with-profits business and determine payouts.
- 4.1.2 In the case of business transferred from RS no appropriate records are available to allow meaningful asset share investigations to be carried out. Payouts are therefore determined by means of a bonus reserve valuation.
- 4.1.3 The amount payable to policyholders depends on our bonus policy which is described in Section 5 below. We aim to distribute the surplus fairly and equitably between each policyholder, each class of policyholder and each generation of policyholder by using a combination of annual bonuses and final bonuses.
- 4.1.4 Surrender values are set to give a fair return to policyholders reflecting the premiums paid, the expenses incurred and the investment return earned.
- 4.1.5 Any approximations which are used should not materially affect resulting payouts or bonuses compared to the result of more precise methods which could practicably have been used at a reasonable cost.

4.2 Practices

- 4.2.1 Payouts will be determined using a bonus reserve calculation to endeavour that fairness is maintained between different groups and generations of policies. Approximate methods may be used for minor lines of business and when insufficient data precludes the use of more precise methods.
- 4.2.2 The bonus reserve valuation discounts future cash flows on a realistic basis taking into account the rate of return on gilts, with appropriate explicit allowance for future expenses.
- 4.2.3 The methods, parameters and assumptions underlying these calculations are documented each year and signed off by the With-Profits Actuary. Any changes to current methods, parameters or assumptions relevant to a particular method have to be approved by the With-Profits Actuary and reported to the Board.
- 4.2.4 Surrender values are calculated by using appropriate factors to convert the sum assured into a paid up value and discounting the result to give the surrender value.

5. Bonus Policy

5.1 Principles

5.1.1 The distribution of surplus and bonuses is determined by the Board upon the advice of the With-Profits Actuary. In giving the advice the With-Profits Actuary will take into account:

- the need to ensure that Scottish Friendly is able to meet its statutory liabilities;
- the current and possible future capital needs of Scottish Friendly;
- the scheme of transfer of the RS business;
- the investment strategy (see Section 7 below);
- the bonus policy (described in Sections 4, 5 and 6);
- regulatory requirements about protecting with-profits policyholders; and
- the need for an appropriate level of security for policyholders' benefits.

5.1.2 We aim to distribute the surplus fairly and equitably between each policyholder, each class of policyholder and each generation of policyholder by using a combination of annual bonuses and final bonuses. The amount payable on death or maturity is determined by the sum assured, annual bonus and final bonus that apply on the date of claim. Where appropriate in the circumstances, and on the advice of the With-Profits Actuary, surplus may also be 'distributed' in different ways (such as waiving future premiums where it is uneconomic to collect them).

5.1.3 Part of the surplus is allocated to a with-profits policy each year in terms of a reversionary or annual bonus added to the sum assured. Provided the policy is maintained in force until maturity (or death) then, once declared, this annual bonus is guaranteed. Annual bonuses will be added when appropriate to provide policyholders with additional guaranteed benefits; rates of annual bonuses are changed relatively slowly. Where necessary however the Directors will restrict annual bonus rates in order to protect the solvency of Scottish Friendly or to ensure the maintenance of a reasonable balance between the guaranteed benefits and final bonuses payable at maturity (or death).

5.1.4 The bonus policy will be regularly reviewed to ensure it remains appropriate. Any changes made to the bonus policy will be communicated to policyholders in a timely and appropriate manner, and the reasons for the changes will be explained.

5.1.5 The rate of final bonus will be set based on the results of the bonus reserve valuation which quantifies the liabilities assuming the maintenance of current bonus rates; this then leads on to consideration of whether the assets are sufficient to increase (or reduce) bonuses, accepting some surplus (or deficit) will result from smoothing bonus changes (see 6.2).

5.2 Practices

- 5.2.1 Our current approach is to set annual bonus rates once a year. We aim to change annual bonus rates relatively infrequently, and only if gilt yields change significantly (by more than 1%).
- 5.2.2 However annual bonuses may fall to zero in some extreme market conditions and will only be declared if the Board is satisfied that the solvency of the fund will not be detrimentally affected over the short or long term. Interim bonuses would normally be payable at the same rate as the last declared bonus in the event of death or maturity before the next bonus declaration.
- 5.2.3 Final (or terminal) bonuses are only payable at the time of a claim, and reflect more closely the performance of the fund at that time; they are not guaranteed and tend to fluctuate.
- 5.2.4 Final Bonuses may fall to zero in some circumstances such as significant falls in the values of the fund's assets. Our current approach, which may change in the future, is to set final bonuses once a year although more frequent changes will be made in volatile market conditions.
- 5.2.5 As described above, surrender values are calculated by converting the sums assured to a paid-up value and discounting the result to give the surrender value.
- 5.2.6 The effect of any approximations used in setting bonus rates is intended to be neutral, both within each class or generation of policyholders and in aggregate. In the majority of cases, the most significant approximation for conventional with-profits policies is in the use of a single rate for the final bonus.

6. Smoothing Policy

6.1 Principles

6.1.1 Scottish Friendly aims for a smooth progression in returns by varying the annual bonus rates relatively infrequently and making gradual adjustments to the final bonus rates on an annual basis.

6.2 Practices

6.2.1 Final bonus rates will be applied to the sum assured and existing annual (not special) bonuses and set according to the supported rate (derived from the bonus reserve valuation) by splitting the difference between the current rate and the latest calculated rate each year.

6.2.2 The supported rate will change in response to any change in the annual bonus rate, in which case consideration will be given to smoothing the change in final bonus rate more gradually.

7. Investment Strategy

7.1 Principles

- 7.1.1 The investment strategy of the Notional RS Business Fund was agreed as part of the scheme of transfer. The aim of the investment strategy of this notional sub-fund of the with-profits fund is to provide an orderly run-off of the transferred RS business while preserving the ability of the notional RS fund to meet its commitments to policyholders.
- 7.1.2 In determining the mix of assets between different asset classes, the investment strategy will take account the maturity of the business, the financial strength of the Notional RS Business Fund, its ability to meet its regulatory capital requirements, and the long term expected returns available in each asset category and their volatility.
- 7.1.3 In considering the range of assets in which to invest, the with-profits fund may use derivatives and other financial instruments, within limits determined by the Board, to help manage risk or to aid efficient portfolio management. The with-profits fund may also include assets that are not normally traded to support the operation of the business provided that the fund also holds sufficient liquid assets to meet its requirements.
- 7.1.4 In determining the investment strategy of the Notional RS Business Fund, no reliance is placed on other assets of Scottish Friendly outside the Notional RS Business Fund.
- 7.1.5 Within the Notional RS Business Fund there are currently no constraints on the investment strategy between different classes or generations of policyholders.
- 7.1.6 Parameters for counterparty exposure have been set by the Board on the advice of the With-Profits Actuary taking into account regulatory requirements regarding admissibility and are monitored by the Board; the fund does not currently invest in derivatives but were it to do so appropriate constraints on counterparty exposures would be established.

7.2 Practices

- 7.2.1 At the date of transfer the Notional RS Business Fund was initially invested in gilts and equities in the ratio 60:40%. From the end of 2006, each year the assets backing asset share will be progressively switched from equities into gilts at a rate of 2% p.a. as follows: 62:38, 64:36, ..., to 90:10 (after 15 years).

8. Exposure to business risk

8.1 Principles

8.1.1 As members of a mutual society, with-profits policyholders ultimately bear the risks and rewards of all business undertaken by Scottish Friendly. However, wherever possible, any such risks not arising from the RS business itself will not be borne by the transferred RS policyholders.

8.1.2 Any significant additional business risks to be undertaken by Scottish Friendly require the approval of the Board and Executive, acting on the advice of the With-Profits Actuary, and would be based on expectations of achieving appropriate returns for the with-profits policyholders commensurate to the risks borne; such returns would be compared to commercially available alternative investments. Due account may also be taken of the strategic implications of any new development. The Risk Committee of the Board is responsible for the effective risk management of Scottish Friendly, including consideration of the business risks being borne.

8.1.3 The notional RS business fund will bear the risks associated with guarantees provided on the RS transferred with-profits policies. The estate of the Notional RS Business Fund will normally bear the costs of meeting these guarantees but if the level of the estate falls below the level required to operate the smoothing policy and provide working capital, the costs of meeting guarantees may lead to more than a gradual change in the annual and final bonus rates.

8.1.4 The Notional RS Business Fund is exposed to the risk arising from maintaining non-profit policies. Any profits or losses arising from these risks, including any costs of compensation, accrue in the first instance to the estate of the RS business fund but if the level of the estate falls below the level required to operate the smoothing policy and provide working capital, any losses may be funded by reducing the annual and final bonus rates.

8.2 Practices

8.2.1 The Notional RS Business Fund does contain non-profit policies. The scale of the non-profit business is currently around 10% by reserves.

8.2.2 The Notional RS Business Fund does not have any subsidiaries.

8.2.3 Any profits or losses arising from business risks arising in the Notional RS Business Fund are currently borne by the estate of the Notional RS Business Fund and are taken into account in operating the smoothing policy (see Section 6). However, if the level of the estate falls below the level required to operate the smoothing policy and provide working capital, any losses may be deducted from asset shares, pooled across all with-profits policies.

9. Charges and Expenses

9.1 Principles

9.1.1 The charges applied to the RS business are as agreed in the scheme of transfer.

9.2 Practices

9.2.1 The expenses to be charged to the RS business are as follows:

- 0.5% p.a. of Notional RS Business Funds;
- 15% of premiums in respect of RS business;
- £30 per premium paying and £15 per paid up policy p.a. in 2006, increasing at RPI+1% p.a.

9.2.2 The RPI increase used to determine the expenses in subsequent year will be based on the increase in RPI from January 2006 to January of the business year.

9.2.3 These expenses will be charged to the Notional RS Business Fund assets each year and will also be used for future expenses in the bonus reserve valuation calculation.

9.2.4 A contingency reserve for unclaimed policies will be maintained until the fund is wound-up (see section 10). Appropriate efforts will be made to maintain contact with the Notional RS Business Fund members. To the extent that contact with members had been lost at the date of transfer, any reserve for unclaimed policies on winding up will not exceed the claims incurred on such contracts in the 3 years prior to winding up.

10. Management of the Estate

10.1 Principles

10.1.1 The estate of each of the notional RS Business Fund will be managed in accordance with its own PPFM. However, in circumstances where solvency is threatened the Main Fund may be supported by the notional RS Business Fund. Similarly, should the notional RS Business Fund be unable to support the relevant transferred business the Main Fund would be required to support the benefits.

10.1.2 The estate means the excess of the assets of the fund over the liabilities under the bonus reserve valuation. Part of the estate was distributed by means of special merger bonuses at the time of the transfer from RS.

10.1.3 At the end of 2020, or if the Notional RS Business Fund falls below £5 million or if less than 500 policies remain premium-paying, the estate will be distributed to the remaining policies, by freezing the current rates of reversionary and final bonus. Scottish Friendly shall be entitled to defer winding up the Notional RS Business Fund, and will be required to do so if the rate of reversionary bonus has been reduced in the preceding 3 years, in which case the PPFM will continue to apply,

10.1.4 In the meantime the primary uses of the estate include:

- a) Promoting the ongoing corporate purposes of Scottish Friendly including current and future generations of members;
- b) Supporting the smoothing of benefits paid to with-profits policyholders;
- c) Providing statutory capital to meet reserving requirements in excess of the liabilities given by the bonus reserve valuation method;
- d) Providing working capital to cover any mismatch in timing between the receipt of charges applied to policies in the fund and the actual expenses incurred in the maintenance of those policies;
- e) Providing capital support to cover the costs of meeting guarantees; and
- f) Meeting 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 Board should not be charged to policyholder benefits.

10.1.5 No target range has been set for the estate – rather it will be distributed by means of the smoothing process as described in Section 6.

10.1.6 If required by the solvency of the fund, we will restrict the investment policy of the fund and/or the smoothing of benefits to existing policyholders.

10.2 Practices

10.2.1 Currently, the estate is being used to manage the smoothing process as described in Section 6.

10.2.2 The investment strategy of the estate may differ from the rest of the Notional RS Business Fund. It would be expected that the proportion of equities invested in the estate would be no more than 10% higher or lower (in

absolute terms) than the proportion of equities for assets backing asset shares.

11. Volume of new business

11.1 Principles

11.1.1 The fund is closed to new business.

11.2 Practices

11.2.1 The fund is closed to new business.

12. Amendment of the Principles and Practices

12.1 Principles

12.1.1 The Board may amend the Principles in this document but only upon the advice of the With-Profits Actuary; the Independent Person appointed to review PPFM compliance will be consulted before any changes are made to the Principles.

12.1.2 If the With-Profits Actuary believes that any proposed amendment to the Principles will or may have a material effect upon the rights or reasonable expectations of policyholders he shall give notice of such proposed amendment to the FCA.

12.1.3 Policyholders will be provided with three months' notice prior to the effective date of any change to the Principles.

12.2 Practices

12.2.1 The Board may amend the Practices in this document on the advice of the With-Profits Actuary, who will provide his written opinion on whether the proposed changes are consistent with the Principles.

12.2.2 Policyholders (and if appropriate the FCA) will be notified of changes to Practices. Details will be displayed on Scottish Friendly's website within 14 days of their implementation and policyholders will be advised of the nature of any changes in their next regular mailing from Scottish Friendly.

12.3 Minor Changes

12.3.1 Notwithstanding the above, the Board may amend the PPFM if that change:

- is necessary to correct an error or omission in the PPFM, or
- would improve the clarity or presentation of the PPFM without materially affecting its substance; or
- is immaterial.

12.4 Compliance and Record Keeping

12.4.1 The Independent Person appointed to review PPFM compliance will assist the Board in ensuring compliance with the PPFM and the maintenance of governance arrangements to achieve this.

12.4.2 Whenever the PPFM document is changed, Scottish Friendly will:

- Document the changes and keep previous versions of the PPFM for at least 6 years;
- Ensure that revised procedures and systems are properly documented; and
- Ensure the implementation of the change(s) is properly managed with appropriate change controls.

13. Glossary

Annual bonus

Bonus that is added yearly.

Asset Share

The accumulation of premiums less charges for expenses, tax, guarantees and the cost of life assurance and cost of other risk benefits plus the investment return on the underlying assets.

Bonus reserve valuation

A method of determining the value of future liabilities under a life insurance contract. Future benefits, including guaranteed benefits, annual bonuses, final bonuses, where appropriate, plus future expenses and less future premiums are discounted at a rate of interest usually based on current market conditions.

Conventional with-profits policy

Policy that has a guaranteed minimum cash sum (the basic sum assured) to which bonuses are added.

Derivative

A financial instrument usually including an option to trade in securities at a fixed price at some future date.

Final Bonus

Bonus added when there is a claim

Estate

The difference between the market value of assets and the asset share and provision for guarantees.

Industrial Branch Business

Business where home service agents originally collected the policy premiums in cash.

Main Fund

The main fund of Scottish Friendly comprising its Industrial Branch and Ordinary Branch with profits business, related non-profit business and Estate (but excluding any notional funds in respect of Transferred Business).

Notional Fund

A notional sub-fund of the with-profits fund covering Transferred Business.

Notional RS Business Fund

The notional sub-fund of the with-profits fund covering the Rational Shelley business transferred to Scottish Friendly

Scottish Friendly Life Index Benchmark

This index compares Scottish Friendly's mix of asset classes against a pool of other insurance companies mix of asset classes.

Smoothing

A means by which long term returns on with-profits policies are adjusted to even out the short term high and low investment returns.

Surplus

The excess of premiums and investment return over claims, expenses, taxation and the increase in liabilities calculated as required by the Regulations.

Surrender value

The claim value paid when a policy is voluntarily discontinued by the policyholder before the maturity date.

Transferred Business

Business that has been transferred from another Society or Insurance company where the terms of the transfer have provided for a separate notional fund to be established. The fund being earmarked to support the benefits of the transferred policies.

Unitised with-profits policy

Policy that has units allocated to which bonuses are added in the form of an increased unit price.

With-Profits Actuary

An actuary is a person with a professional qualification specialising in financial risk and particularly insurance risk. The term 'With-Profits Actuary' in the PPFM relates to the actuary with overall responsibility for advising the Board on how to apply the PPFM.