Scottish Friendly Assurance Society Ltd

Principles and Practices of Financial Management for Conventional With Profits Business

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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”) apply in managing the Conventional With-Profits Business that was written directly through Scottish Friendly or transferred into the Main Fund of Scottish Friendly. The PPFM are not intended to alter the rights and obligations we have under any policy documents we have issued to policyholders. Should there be any conflict between this PPFM and what is stated in any such policy document then the policy document will prevail.

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 (and its assets) is owned by its members, whether they are with-profits policyholders or non-profit policyholders. 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 For certain classes of business that have been transferred to us from another society we maintain separate notional internal funds. These funds are managed in accordance with the conditions upon which the transfers were agreed. Separate PPFM are maintained for each of these internal funds and explain how the relevant transferred business is managed. With this exception we maintain only one pool of assets in respect of our non-linked business. This is the Main Fund. We manage our overall financial position taking into account the Industrial Branch and Ordinary Branch in aggregate. (Industrial Branch is business where home service agents originally collected the policy premiums in cash).

1.6 This PPFM document covers the operation of the Conventional With-Profits Business including the business transferred from Pioneer Life and Royal Standard; separate documents cover each of the classes of transferred business mentioned above and the Unitised Ordinary Branch With-Profits Business within the Main Fund.

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 polices 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.

3. Overriding Principles

3.1 Scottish Friendly has three overriding principles that can be regarded as overriding the principles and practices contained elsewhere in this document 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 For most classes of with-profits business, payouts will be determined having regard to asset shares to endeavour to ensure that fairness is maintained between different groups and generations of policies. Asset shares represent the accumulated value of a policy using the actual experience of Scottish Friendly in terms of net investment return, mortality, expenses, and other charges. For classes of business where asset shares do not represent an equitable guide to payouts, payouts will be determined by other appropriate methods.

4.1.3 Our method of determining the amount payable to a with-profits policyholder aims to ensure that, on average over the longer term, the amount paid out on maturity and surrender claims is 100% of the asset share. This is subject to meeting a minimum payment equal to the guaranteed benefits and to maintaining the solvency position of Scottish Friendly. 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 100% of asset shares. This ‘smoothing policy’ is described in more detail in Section 6 below.

4.1.4 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.

4.1.5 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 For most classes of with-profits business payouts will be determined having regard to asset shares (see below) 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. For classes of business where asset share does not represent an equitable guide to payouts, such as whole life policies, payouts will be determined using other methods.

4.2.2 Asset shares are determined for all policy classes as:

Asset share at the start of the period
Plus premiums received
Plus investment return (which can be negative) on the underlying assets
Minus cost of death or other risk benefits
Minus Charges for expenses, tax and guarantees

4.2.3 Asset shares are calculated on a policy-by-policy basis. 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 The investment returns allocated to asset shares are based on the investment returns attributed to the Main Fund, following a hypothecation process. Fixed interest securities are notionally allocated to non-profit business. Within the Main Fund a different investment strategy may be adopted for different classes of with-profits policy. A different investment strategy may also be adopted in respect of the assets supporting the policy asset shares; the cost of any additional policy guarantees or the estate. This will normally be reflected in different asset allocations for the different classes of business. The investment return allocated to asset shares for each class of business will reflect the returns on the assets underlying the asset shares for each class of business.

4.2.5 The investment return credited to the asset shares may be adjusted to take account of profits (or losses) arising from other business risks borne by the Main Fund. The With Profits Actuary will consider the appropriateness of such an adjustment each year as part of the bonus recommendation considered by the Board. This will take into account the profits and losses from:

- the subsidiary companies;
- the expense margins arising from the sub-funds;
- the non-profit business of the Main Fund (included business that has transferred into the Main Fund); and
- any other miscellaneous sources.

The charge for tax is calculated using the basis appropriate for mutual life insurance, which is equivalent to the policies (and so asset shares) being taxed as standalone policies.

4.2.6 Our current practice is that any excess of the actual expenses and costs of providing guarantees over the charges deducted from asset shares is met by the estate and not included as a miscellaneous profit in the calculation of asset shares for the remaining policies. The current charge for guarantees is 0.25% p.a, which is deducted from the investment return.

4.2.7 At such time as the estate falls outside the boundaries of our target range then, on the advice of our With-Profits Actuary, an enhancement (or reduction) to asset shares will be considered to bring the estate back within the target range.

4.2.8 Surrender values are set to give a fair return to policyholders reflecting the premiums paid, the expenses incurred and the investment return earned.

4.2.9 Asset shares are not appropriate as a basis for calculating payouts on death under whole life contracts, where the cost of future life cover is significant. Such payouts are therefore based on similar bonus scales to with-profits endowments.

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 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 – for example, to avoid excessive costs of collecting very small premiums for Industrial Business, surplus has in the past been used to make policies fully paid up; in addition, an advance of the surplus arising from the switch of payment method from home collection to direct debit was used to incentivise policyholders to switch.

5.1.3 Part of the surplus is allocated to a with-profits policy each year in terms of a 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; the aim in setting annual bonus rates is to increase policy values in line with the average redemption yield on medium to long term government bonds less a margin to cover the charges for expenses and guarantees at a level considered sustainable in the long term. 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 so that payouts on maturity will be close to the asset share of the policy, but not reflecting day to day fluctuations in asset share due to market volatility. The limits on the maximum changes in payouts from one year to the next will be set in line with the Smoothing Policy described below (see 6.2).

5.2 Practices

5.2.1 Our current approach is to review the level of annual bonus rates once a year. In reviewing annual bonus rates we first consider the sustainability of rates that do not depart significantly from those declared in recent years. This reflects the expectation that, in normal circumstances, rates will change relatively infrequently.

5.2.2 Policy Asset Shares are projected forward under different economic scenarios and using current rates of annual bonus, to determine the level of final bonus (if any) that would be payable to ensure maturity values equated to the Asset Shares. The aim is to establish if current rates of annual bonus (taking a long-term view) allow for an appropriate proportion of bonus and payout to be paid in final (non-guaranteed) form under reasonably foreseeable economic and demographic experience.

5.2.3 As a guide, Scottish Friendly's aim, over the long term, is to pay Final Bonus rates in the range of 15% to 30% of the guaranteed sum assured and declared annual bonuses for policies at a 10 year term and 40% to 65% for policies at a 25 year term, consistent with maintaining an appropriate free asset position and appropriate investment freedom. Where projected Final Bonus rates on "best estimate" assumptions lie generally within these ranges, then current annual bonus rates would be regarded as supportable.

5.2.4 Where projections assuming current annual bonus rates do not produce acceptable results, alternative bonus rate assumptions are tested to determine the most appropriate rates to be declared. Should it be necessary to reduce annual bonus rates, Scottish Friendly would seek to avoid large reductions (beyond 0.50% per annum) subject, however, to Scottish Friendly's free asset and solvency position being satisfactory.

5.2.5 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.

5.2.6 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. We aim to target maturity payouts at 100% of asset shares, subject to the smoothing policy described in Section 6 below. The target is for at least 90% of maturity payments to fall within the range 80% to 120% of the unsmoothed asset share (for Ordinary Branch Business) or 75% to 200% of the unsmoothed asset share (for Industrial Branch Business).

5.2.7 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.

5.2.8 With-profits whole of life policies receive final bonus rates paid on death based on those paid at the maturity of with-profits endowment policies with the same duration in force.

5.2.9 As described above, surrender values are calculated by blending in the relevant asset share to the current scale of maturity values including any final bonus. We aim to target surrender payouts at 100% of asset shares, subject to the smoothing policy described in Section 6 below. However, regular premium policies are surrendered for no value if less than 2 years premiums have been paid in recognition of the expenses of selling and setting up the policy. The target is for at least 90% of surrender payments to fall within the range 80% to 120% of the unsmoothed asset share (for Ordinary Branch Business) or 75% to 200% of the unsmoothed asset share (for Industrial Branch Business).

5.2.10 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 approximations for conventional with-profits policies are the use of sample policies to represent the whole population, and in the use of a single formula for the final bonus at each duration.

6. Smoothing Policy

6.1 Principles

6.1.1 Our smoothing policy aims to operate so that under and overpayments to the underlying asset share will be balanced out over time. The aim over the longer term is to share out all the surplus earned on the fund.

6.1.2 The extent of smoothing will be constrained so that the cost of smoothing to the fund is broadly neutral over the long term.

6.1.3 The extent of smoothing applied on surrender values will be such as to blend in the relevant surrender value to the current scale of maturity values including any final bonus.

6.2 Practices

6.2.1 We aim to target maturity payouts at 100% of asset shares, subject to, in normal market conditions, a maximum change in the payouts on policies of the same original term maturing from one review to the next of 10% (upwards or downwards). This smoothing policy applies to all conventional with-profits business maturing at the same time.

6.2.2 However, the extent of smoothing will be constrained by ensuring that the expected cost of any overpayments when compared with projected asset shares over the next 3 years can be supported by the estate. If that is not the case, i.e. normal market conditions do not apply, then more significant changes to payouts might be required.

6.2.3 As described above, surrender values are calculated by blending in the relevant asset share to the current scale of maturity values including any final bonus. However, regular premium policies are surrendered for no value if less than 2 years premiums have been paid in recognition of the expenses of selling and setting up the policy.

7. Investment Strategy

7.1 Principles

7.1.1 The aim of the investment strategy of the Main Fund is to maximise the returns to with-profits investors while preserving the ability of the fund to meet its commitments to policyholders. In determining the mix of assets between different asset classes, the investment strategy will take account the financial strength of the fund, its ability to meet its regulatory capital requirements, and the long term expected returns available in each asset category and their volatility.

7.1.2 In considering the range of assets in which to invest, the 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 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.

7.1.3 In determining the investment strategy of the Main Fund, no reliance is placed on other assets of Scottish Friendly outside the fund.

7.1.4 Where any class of policy has a materially different profile of guarantees to other policies invested in the Main Fund, a different investment strategy may be adopted for this business. This may be implemented by the adoption of a differential asset allocation policy or by using an appropriate hedging strategy.

7.1.5 The investment strategy for the estate will be determined separately from the rest of the Main Fund and will be designed to make the most efficient use of Scottish Friendly's capital in mitigating its business risks.

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 The investment strategy of the Main Fund, and the mix of assets between different classes of asset are subject to formal review each year and more frequently in volatile market conditions. In doing so, the mix of assets will vary according to the financial strength of the fund – the weaker the fund, the less that will be invested in equities and property.

7.2.2 High level checks are completed on a regular basis to ensure that the assets held by the fund continue to remain suitable taking due account of the nature and term of the policy liabilities calculated on a realistic basis. In particular, detailed consideration is given to the impact that any potential adverse market conditions may have on the solvency of Scottish Friendly .

7.2.3 Cash flows are monitored at a high level and various cash flow projections (updated at least annually) are available to help ensure the fund maintains sufficient liquidity.

7.2.4 The amount of equity and property content (the equity backing ratio) is closely monitored as returns from such investments are generally more volatile than those from a fixed interest portfolio, and the equity backing ratio would be reduced if necessary to ensure the solvency position of the fund was not compromised by an unsuitable asset mix.

7.2.5 We would expect the future equity backing ratio in respect of the assets supporting policy asset shares of with-profits policies in the Main Fund to normally be in the range of 20% to 70%.

7.2.6 Due regard for security and diversification is also given within each asset class. The core (at least 80%) of the equity holdings are to be index trackers with the remainder in aggressive actively managed funds. No move away from these provisions can be made without the sanction of the Board following advice from the Investment Committee and the agreement of the With-Profits Actuary.

7.2.7 The Investment Committee meets regularly and monitors performance, strategy and compliance with the investment mandates of the fund; the Executive, with the permission of the Chairman, has the authority to vary these guidelines to permit investment between Committee Meetings. The above counterparty guidelines apply to all counterparties, approved or otherwise.

7.2.8 At present the Main Fund invests in corporate bonds via a unit trust which takes due account of their credit quality, with a minimum Standard & Poor's rating of CCC; total corporate bond exposure will comprise no more than 50% of the fixed interest portfolio.

7.2.9 The Main Fund does not currently invest in derivatives but were it to do so Board approval would be required for their use either as part of efficient portfolio management or to help manage risk by matching specific liabilities or to protect solvency.

7.2.10 The Main Fund currently includes Scottish Friendly's head office as a property investment; this currently represents less than 1% of Scottish Friendly's total assets and is considered a more efficient use of capital than leasing office property.

7.2.11 The assets of Scottish Friendly, and the Main Fund, also include two subsidiaries, Scottish Friendly Asset Managers Limited and Scottish Friendly Insurance Services Limited, which provide additional services to Scottish Friendly's members as allowed under the Friendly Societies Act 1992. The principles applying to such investments are described in Section 8.1 below.

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 risks arising in respect of business that has been transferred into a notional fund will not be borne by the Main Fund. Similarly any risks arising in respect of the Main Fund will not normally be borne by a notional fund.

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 Main Fund bears the risks associated with guarantees provided on with-profit policies that are held within this fund. The estate of the Main 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 in excess of any charges already deducted from asset shares may be deducted from asset shares.

8.1.4 The limits on accepting new with-profits business containing guarantees are included in Section 11 below. While no further Industrial Branch business is sold the fund remains exposed to the risks associated with acquiring new Ordinary Branch business.

8.1.5 The Main Fund is exposed to the risk arising from acquiring and maintaining non-profit policies. It will only do so if the potential rewards from this risk are greater than the rewards available from investment in the asset portfolio by a margin that allows for the nature of the risks undertaken or if there are synergistic benefits to the fund (such as offering a funding method for regular savings policies or representing an option for a maturing pension policy).

8.1.6 Any profits or losses arising from these risks, including any costs of compensation, accrue in the first instance to the estate of the Main 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 deducted from asset shares. Equally profits arising from these risks may be used to enhance asset shares.

8.1.7 The limits on accepting new non-profit business are included in Section 11.

8.1.8 The Main Fund may invest in non-quoted group companies provided that the expected return on those investments is no worse than the return that would be expected on an investment in similar quoted companies or if there are synergistic benefits to the fund (such as an extension of the product range).

8.2 Practices

8.2.1 At present (though this may change in the future), limits in relation to business risk from acquiring and maintaining with-profits policies are those set out in Section 11 on limits to new business.

8.2.2 The Main Fund does contain non-profit policies, including unit-linked and protection business.

8.2.3 The Main Fund is also exposed to the risk arising from the transfer of insurance business from other societies and insurance companies. Transfers of such businesses will only be done when the cost of running the acquired business is expected to be lower than the fees and charges paid by the acquired business to Scottish Friendly.

8.2.4 The Main Fund does operate two subsidiaries both of which are considered strategically important to Scottish Friendly-Scottish Friendly Asset Managers Ltd, a subsidiary which undertakes CTF and ISA management, and Scottish Friendly Insurance Services Ltd, a subsidiary which undertakes third party administration. Both of these subsidiaries provide Scottish Friendly's members with additional financial services products outside the constraints of the friendly society.

8.2.5 Any profits or losses arising from business risks arising in the Main Fund are currently borne by the estate of the Main Fund; the With Profits Actuary will consider each year the extent to which these should be credited to the investment return applied to asset shares to ensure that these are distributed fairly. 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. Equally profits arising from these risks may be used to enhance asset shares.

9. Charges and Expenses

9.1 Principles

9.1.1 The aim of Scottish Friendly's approach to applying charges and apportioning expenses to with-profits policies is to achieve an overall broad fairness in such application of charges and apportionment of the total charges incurred by Scottish Friendly between policies and classes of policies, in the context of the pooled experience of a with-profits fund, based on an assessment of the underlying causes of such charges and expenses.

9.1.2 The expenses allocated to with-profits policies are a fair proportion of the total expenses of Scottish Friendly. Investment expenses will be allocated with due regard to the categories of asset in which the fund is invested; new business expenses, including commission, will be allocated according to new business transacted, and renewal expenses will be allocated according to the relative administration requirements of the in-force portfolio.

9.1.3 These allocations exclude the costs attributable to the non-profit business although the benefits on with-profits policies may ultimately be affected by these costs if the estate is insufficient to absorb any excess of costs over the expense loadings of the non-profit business.

9.1.4 The basis for allocation of expenses to with-profits business would only change if it could be demonstrated that the new basis would improve the fairness of the allocation.

9.2 Practices

9.2.1 Expenses include those relating to the acquisition of business (commission to IFAs, marketing, setting up the policy, etc), expenses relating to investment in assets and expenses relating to ongoing administration. These expenses are charged to the fund at cost.

9.2.2 The level of expenses depends on many factors. Acquisition expenses depend on volumes of business acquired and so a growth in new business will increase expenses. However, administration expenses include fixed overheads as well as activity-based costs. Expenses also vary according to the type of policy being written, and so the 'business mix' is an important factor. These expenses must be met by the fund in the calculation of the surplus emerging. The allocation of expenses, including the application of any element of judgement, to the with-profits policies in the Main Fund is based on an analysis of the above cost-drivers which underlie the business.

9.2.3 A number of Scottish Friendly's services are provided under outsourcing arrangements – such as fulfilment of direct marketing activity and some IT software development – and these arrangements are reviewed regularly; these arrangements are generally able to be terminated without penalty.

9.2.4 The asset share for policyholders transferred from the Royal Standard Friendly Society will have a deduction made in respect of expenses in accordance with the transfer agreement.

10. Management of the Estate

10.1 Principles

10.1.1 Each class of transferred business that has been attributed its own notional fund will have its own notional estate. For the Main Fund we operate our estate on a combined basis, so that it includes both the Ordinary Branch business and the Industrial Branch business funds.

10.1.2 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 asset shares;
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 acquisition and maintenance of those policies;
e) Providing capital support to cover the costs of meeting guarantees. Charges deducted from asset shares to provide guarantees remain within the Main Fund as part of the estate, which meets the costs of those 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.

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

10.1.4 The level of the Estate is managed in line with the approved risk appetite framework, which sets targets for the financial position of Scottish Friendly and applies to each of its notional internal funds.

10.1.5 If the estate falls below the minimum level, then we will restrict the investment policy of the fund, the smoothing of benefits to existing policyholders and/or the level of new business being written in the funds. The aim is to manage policy values closer to the stated aim of paying claim values around 100% of asset share on average. If the estate exceeds the maximum level, then we will pursue a less restrictive investment policy and/or (if possible) greater volumes of new business with the overall aim of improving policy values for a greater number of policyholders. There is no division of the estate between any classes of business within the fund and there is no obligation on the Directors to distribute the estate to the current generation of policyholders.

10.1.6 In the event of the closure of Scottish Friendly to significant amounts of new business, then Scottish Friendly would continue to operate the estate as described above but with a view to distributing amounts excess to requirements by means of enhancements to asset shares and so policy values.

10.2 Practices

10.2.1 Where required, the estate can be used to meet the excess of any expenses over the charges to with-profits policies and the excess of the cost of any guarantees over the charges to with-profits policies for those guarantees.

10.2.2 The Risk Appetite framework currently sets out the minimum level of capital that should be held in the Society, the trigger level which the capital position would not be expected to fall below and an upper limit. These are currently 150%, 200% and 450%, respectively, of the Board's assessment of the Solvency Capital Requirement (SCR) and are reviewed regularly. Here the SCR represents the loss of capital that would be suffered by the Society following the occurrence of an adverse scenario of a severity that is expected to occur only once in 200 years.

10.2.3 If the estate falls below the minimum level, then we will restrict the investment policy of the fund, the smoothing of benefits to existing policyholders and/or the level of new business being written in the funds. The trigger level acts as an indication that the level of Estate is close to the level at which such actions will be required.

10.2.4 The estate provides the capital support required to maintain the solvency of the Main Fund. It is therefore important that in adverse market conditions the value of the estate is sufficiently robust to continue to maintain the solvency of the fund. The investment strategy of the estate will therefore tend to be more restricted than the rest of the fund and a significantly lower proportion of its assets will be invested in equity type investments.

11. Volume of new business

11.1 Principles

11.1.1 The fund is closed to new Industrial Branch business but continues to issue Ordinary Branch business.

11.1.2 The volume of new business (both with-profits and non-profit) accepted into the fund will be such that it is likely to have no adverse effect on the interests of the existing policyholders in the opinion of the Board (having taken advice from the With-Profits Actuary).

11.1.3 Should the Main Fund be subject to closure to significant amounts of new business, any estate would be used for the benefit of Scottish Friendly's members, not necessarily restricted to with-profits policyholders. The pace of any such distribution would depend on the ongoing need for such an estate (see Section 7 above) and the rate of decline in the fund and would be decided by the Board, advised by the Independent Person appointed to review PPFM compliance and the With-Profits Actuary.

11.2 Practices

11.2.1 There are currently no constraints on the volume of new business that may be accepted into the fund. However, Scottish Friendly reviews its new business plans each year to ensure that the costs of acquiring such business, including the impact of any financial strain, can be supported by the existing margins in the Main Fund or from the estate without damaging the interests of existing policyholders.

11.2.2 Scottish Friendly considers that the Main Fund should remain open to new business provided that it is likely to have no adverse effect on the interests of existing with-profits policyholders.

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.

12.3.2 Changes made in these circumstances will not necessarily be notified to policyholders as described in Sections 12.1 and 12.2 above.

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 other risk benefits plus the investment return on the underlying assets.
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.
Equity Backing Ratio	The proportion of equity and property assets of the total asset portfolio backing specific liabilities.
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 Main Fund covering Transferred Business.
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.