



Scottish Friendly Assurance Society Ltd.

Principles and Practices of Financial
Management for Unitised Ordinary
Branch With-Profits Business

Effective: November 2021

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Scottish Friendly has won “Best Mutual Insurer” at the CFI.co.uk UK awards for the last three years running.

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 the 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 Unitised Ordinary Branch With-Profits Business, other than that managed within a Notional Fund. 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 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 The Board is required by FCA Rules to establish arrangements to ensure that there is appropriate independent oversight and challenge of the way it manages Scottish Friendly’s with-profits business. Scottish Friendly has established a With-Profits Committee to advise the Board. The Board continues to be advised by the With-Profits Actuary.
- 1.5 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 a formal report to the Board from the With-Profits Actuary reviewing PPFM compliance, subject to oversight from by the With-Profits Committee.
- 1.6 Scottish Friendly operates a single fund (referred to as our “Main Fund”) which contains all of the firm’s assets and liabilities. Within the Main Fund, we have constituted and operate a number of separate, notional internal sub-funds (referred to in this document as “Notional Funds”) in respect of certain blocks of business which have transferred to us. Separate Notional Funds have been constituted in respect of the business transferred from each of the following:
- Scottish Legal Life Assurance Society;
 - Marine & General Mutual Assurance Society;
 - Rational Shelley Friendly Society;
 - London, Aberdeen and Northern Mutual Assurance Society; and
 - the Manulife with-profits fund of Canada Life Limited.
- 1.7 Scottish Friendly maintains separate PPFM documents in respect of the operation of the with-profits business in each Notional Fund, as well as two PPFM documents in respect of the operation of the with-profits business managed outside of the Notional Funds - one covers Conventional With-Profits Business and the other covers Unitised With-Profits Business.
- 1.8 This PPFM document covers the operation of the Unitised With-Profits Business that is managed outside of the Notional Funds.
- 1.9 We manage our overall financial position taking into account the Industrial and Ordinary Branch in aggregate. (Industrial Branch is business where home service agents originally collected the policy premiums in cash.)
- 1.10 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.
- 1.11 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. Premiums of Unitised with-profits policies are invested in the with-profits fund; units are allocated to policies as premiums are paid (and in some cases may be cancelled to meet expense charges and the cost of life cover or other benefits). 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 pay-out. Annual bonuses are declared in the form of daily increases in the price of with-profits units. Policies

are split into two types Type G and Type NG. Type G policies have conditions which allow for the unit value to be guaranteed and the policy contract provides such details. Type NG policies do not have any unit value guarantees. If units are paid out at a date or in circumstances when the unit price is not guaranteed then the value of units may be reduced if the underlying market value of the assets in the fund is lower than the unit value. But, where the underlying market value of the fund is higher, a final bonus may be payable expressed as an increase in unit value as at the claim date.

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 pay-outs.
- 4.1.2 For most classes of with-profits business, pay-outs will be determined having regard to asset shares to try 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 investment returns (after tax, where appropriate), mortality, expenses, and other charges. For classes of business where asset shares do not represent an equitable guide to pay-outs, pay-outs will be determined by other appropriate methods.
- 4.1.3 Our method of determining the amount payable to a unitised with-profits policyholder aims to ensure that, on average over the longer term, the amount paid out when units are realised is 100% of asset share. This is subject to maintaining the

solvency position of Scottish Friendly and meeting a minimum payment equal to the guaranteed benefits at maturity date (or, where appropriate, such other dates as are specified in the policy document where the unit price is guaranteed). The average amount payable 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.

- 4.1.4 The amount payable on claim is determined as the value of units at the quoted unit price, which increases over time due to the additional of annual bonuses, plus any final bonuses (or less any Market Value Adjustments if appropriate) that apply on the date of the claim. 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. Our bonus policy is described in Section 5.

- 4.1.5** Any approximations which are used should not materially affect resulting pay-outs 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 pay-outs will be determined having regard to asset shares (see below) to try to ensure 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** 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

Asset shares are calculated for each type of unitised with-profits contract and premium type (regular and single) for each policy based on month of entry. In the context of a unitised with-profits contract, such an asset share is referred to as the contract's "shadow fund".

- 4.2.3** If the retrospective approach outlined above is not appropriate then a prospective method will be considered.
- 4.2.4** 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.
- 4.2.5** The investment returns allocated to shadow funds are the same as the investment returns on Scottish Friendly's linked funds in respect of the relevant asset mix. Expenses and tax are allowed for in the underlying unit price calculation for those investment returns.
- 4.2.6** The investment returns 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.

- 4.2.7** 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 annual charge for guarantees for Type G policies is 0.25% of the asset share.

- 4.2.8** Should the Estate fall outside the boundaries of our target range then, on the advice of our With-Profits Actuary, options will be considered to bring the Estate back within the target range, which may include an enhancement (or reduction) to asset shares as discussed in Section 10.

- 4.2.9** When units are to be realised there will be an adjustment to the value of units to allow for the difference between the value of the units and the value of the shadow fund. This will take the form of a rate of final bonus or, where the shadow fund is lower than the unit value, a Market Value Adjustment. However, a Market Value Adjustment will not be applied to any Type G policies on any date when the unit price is guaranteed (ie death, maturity or often a policy anniversary specified in the policy document).

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);
 - 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 claim is determined as the value of units at the quoted unit price, which increases over time due to the addition of annual bonuses, plus the final bonus (or less the Market Value Adjustment) that applies on the date of the claim.
- 5.1.3** Part of the surplus is allocated to a with-profits policy each year by adding an annual bonus. Provided the policy is maintained until maturity (or any other date specified in the policy document when unit price is guaranteed) 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 such other dates as are specified in the policy document).

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 (or, where appropriate any Market Value Adjustment) will be set so that the value of any units that are realised will be close to the asset share of the policy, but not reflecting day to day fluctuations in asset share due to market volatility.

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, annual bonus 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 pay-out 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 accumulated units including 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 Paragraph 5.2.3 does not apply to Type NG policies. Such policies have no guarantees and are invested more heavily in equity-type assets than Type G policies. The range of final bonuses, or Market Value Adjustments which might be applied, is therefore much wider.

5.2.5 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.

- 5.2.6** 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.
- 5.2.7** 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. Final Bonuses may fall to zero in some circumstances such as significant falls in the values of the fund's assets. In such circumstances, provided the unit price is not guaranteed on the claim date, a Market Value Adjustment may be applied. We aim to target pay-outs at 100% of asset shares, subject to the Smoothing Policy described in Section 6. The target is for at least 90% of both surrender and

maturity payments to fall within the range 80% to 120% of the unsmoothed asset share.

- 5.2.8** Our current approach for Type G policies is to review final bonuses (and Market Value Adjustments) four times a year although more frequent reviews will be undertaken in volatile market conditions. pay-outs for type NG policies are updated monthly and reflects the asset share at that date.
- 5.2.9** In certain circumstances it may be necessary to make approximations in setting bonus rates. In the majority of cases, the most significant approximation for unitised with-profits policies is the grouping of policies by duration in setting the scale for, and in applying, any Market Value Adjustment and/or terminal bonus. 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.

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.

6.2 Practices

- 6.2.1** We aim to target maturity pay-outs at 100% of asset shares, subject to, in normal market conditions, a maximum change in the pay-outs on policies of the same original term maturing from one review to the next of 10% (upwards or downwards).
- 6.2.2** As discussed in paragraph 10.2.3, Scottish Friendly, having considered the expected cost of Smoothing, may limit the extent of Smoothing if necessary to protect the Estate.
- 6.2.3** Market Value Adjustments may be applied to claims at any date where the policy does not provide for the unit price to be guaranteed. Unit prices are normally guaranteed at policy maturity or on death. Certain

Type G policies may also specify a date in the policy document when the unit price is guaranteed and units may be realised free of any Market Value Adjustment. There are no such guaranteed dates or circumstances for Type NG policies. Market Value Adjustments are applied to maintain fairness between policyholders exiting the fund, and those remaining in it. Market Value Adjustments will only be applied due to the effects of movements in the value of assets held by the fund and the level of the reduction will be set so that pay-outs will be close to the asset share of the policy based on the underlying shadow fund for the relevant monthly cohort.

- 6.2.4** Our current practice on smoothing of claim values other than by death or maturity is to apply Market Value Adjustments where necessary to limit the smoothing cost to 5% of the asset share. Market Value Adjustments apply to partial claims on a proportionate basis. Our current practice is to apply the same approach to smoothing for all policy types on claims of all sizes and terms, irrespective of the date at which they joined the fund.

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 policyholders 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 Until February 2009 the same investment strategy was used for the Estate as for other parts of the Main Fund. This Principle is considered to be too restrictive for the ongoing management of the fund and with effect from March 2009 this Principle no longer applied
- 7.1.6 Parameters for counterparty exposure are monitored and set by the Board on the advice of the Finance Director considering any relevant regulatory requirements. Where derivatives are used, appropriate constraints on counterparty exposures are established.

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 Type G policy asset shares of most with-profits policies in the Main Fund to normally be in the range of 20% to 70%. We target a lower maximum equity backing ratio for a small number of products with high levels of guarantees.
- 7.2.6 Type NG policies can give policyholders greater exposure to equity-type assets and the investment profile is therefore normally more heavily weighted towards this type of asset and may have an equity backing ratio of up to 100%.
- 7.2.7 No move away from these provisions can be made without the sanction of the Board, taking into account advice from the Investment Committee and the With-Profits Actuary.
- 7.2.8 Due regard is also given to security and diversification within each asset class, taking into account Scottish Friendly's risk appetite.
- 7.2.9 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 changes between Committee meetings. The above counterparty guidelines apply to all counterparties, approved or otherwise.
- 7.2.10 The Main Fund may invest in derivatives either as part of efficient portfolio management or to help manage risk by matching specific liabilities or to protect solvency. Any decision to invest in derivatives is subject to Board approval.

7.2.11 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.

7.2.12 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-profits policies that are held in this fund. The Estate of the Main Fund will normally bear the costs of meeting these guarantees. If the level of the Estate falls outside of the target range referenced in Section 10, Scottish Friendly may take various actions to bring the Estate back to within its target range. These actions are described in Section 10. In extreme circumstances these actions could include deducting from asset shares the cost of meeting guarantees in excess of charges already deducted.

- 8.1.4** The limits on accepting new with-profits business containing guarantees are included in Section 11.
- 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** The current limits in relation to business risk from acquiring and maintaining with-profits policies are set out in Section 11.

- 8.2.2** The Main Fund contains non-profit policies, including unit-linked and protection business and remains open to new non-profit 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 Child Trust Fund and Individual Savings Account 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. To ensure that these are distributed fairly, the With-Profits Actuary considers each year the extent to which the investment return applied to asset shares should be increased or reduced to reflect these profits or losses. While this may change, investment returns have been increased in recent years to reflect a distribution of profits arising from business risks.

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 the with-profits fund 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** The charges that are currently applied to unitised with-profits policies are as set out in the relevant policy literature. These are deducted from the unit prices used in the calculation of the valuation of both the unit fund and the shadow fund (which underlies the asset share). Any difference between these charges and the actual expenses of the fund will also be charged to the shadow fund.
- 9.2.2** 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.
- 9.2.3** 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 fund is based on an analysis of the above cost-drivers which underlie the business.
- 9.2.4** 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.

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) Supporting the ongoing corporate purposes of Scottish Friendly, having regard to the needs of current and future generations of members;
- b) Supporting the smoothing of benefits paid to with-profits policyholders;
- c) Supporting the Main Fund's investment strategy for the benefit of policyholders;
- d) Providing statutory capital to meet reserving requirements in excess of the asset shares;
- e) 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;
- f) Providing capital support to cover the costs of meeting guarantees. Charges deducted from asset shares to provide guarantees remain within the with-profits fund as part of the Estate, which meets the costs of those guarantees; and
- g) 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 with-profits 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 funds.

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 sets out the minimum level of capital that should be held in the Society and, separately, the minimum level of capital that should be held in the Main Fund. The framework also sets out the trigger levels for the Society and for the Main Fund, below which their capital positions would not be expected to fall. It also sets out upper limits. These limits and triggers are expressed as percentages of the regulatory capital requirement.

10.2.3 If the Estate falls, or is reasonably expected to fall, below the minimum level, then Scottish Friendly will consider taking a range of actions depending on the current level of the Estate and whether it is expected to increase or decrease over the foreseeable future. Scottish Friendly may initially consider taking actions such as reviewing bonus rates or suspending the application of the Smoothing Policy, and reduction of the equity backing ratio within normal ranges as set out in section 7.2.5. In the event that more extensive

actions are required to restore the Estate, Scottish Friendly may consider reducing equity backing ratios outside of the normal range, restricting new business sales, using Derivatives to hedge risk, and removing part or all of any previous enhancements to Asset Shares reflecting the distribution of profits from the management of the sub-funds and of non-profit business in the Main Fund. In extreme circumstances, Scottish Friendly may consider making further deductions from Asset Shares.

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 volume of new business (both with-profits and non-profit) accepted into the fund will be such that it does not materially worsen the benefit expectations of the existing policyholders in the opinion of the Board (having taken advice from the With-Profits Actuary).

11.1.2 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) and the rate of decline in the fund and would be decided by the Board, advised by the With-Profits Committee 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 with-profits 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 does not materially worsen the benefit expectations of existing with-profits policyholders.

12. Amendment of the Principles and Practices

12.1 Amendments to Principles

12.1.1 The Board may amend the Principles in this document but only upon the advice of the With-Profits Actuary. The With-Profits Committee 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 Amendments to 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.

12.4 Compliance and Record Keeping

12.4.1 The With-Profits Committee 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 with a value that is reliant upon or derived from, an underlying asset or group of assets.

Equity Backing Ratio

The proportion of equity and property assets of the total asset portfolio backing specific liabilities.

Estate

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

Final Bonus

Bonus added when there is a claim

Industrial Branch Business

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

Ordinary Branch Business

Business which is not Industrial Branch Business.

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).

Market Value Adjustment

A reduction in the unit value on any claim other than on maturities and deaths.

Notional Fund

A notional sub-fund of the with-profits 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.

Type G and NG Policies

Policies are split into two types Type G and Type NG. Type G policies have conditions which allow for the unit value to be guaranteed and the policy contract provides such details. Type NG policies do not have any unit value guarantees. As at September 2019, the only Type NG policy is the MiBond product.

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.