

# **Scottish Friendly Assurance Society Limited**

## **Principles and Practices of Financial Management for With-Profits Business Transferred from Marine & General Mutual**

February 2016

## **1. Introduction**

### **Overview**

- 1.1. This document is required by the Conduct of Business Sourcebook issued by the Financial Conduct Authority (FCA).
- 1.2. The Principles and Practices of Financial Management (PPFM) document aims to explain how Scottish Friendly Assurance Society Limited (“Scottish Friendly”, “we” or “us”) manages the financial aspects of the With-Profits business which was transferred to us from Marine & General Mutual (M&G) on 1 June 2015 under the terms of a Scheme approved by the High Court on 22 May 2015 (the “Scheme”). The Scheme contains details of the Fundamentals of Financial Management (“FFM”) which apply to this business, and the PPFM needs to comply with the Scheme and the specific obligations of the FFM.
- 1.3. This PPFM document covers the operation of the With-Profits business, originally written in M&G’s long-term business fund and subsequently transferred to Scottish Friendly, which is referred to as ‘the M&G Sub-fund’ in this document. It is referred to as the ‘M&G PPFM’, separate PPFM documents cover Scottish Friendly’s other with-profits business (Conventional With-Profits Business, Unitised With-Profits Business and the former With-Profits Business of Scottish Legal Life, Rational Shelley and LANMAS).
- 1.4. Subject to its wider corporate, legal and regulatory obligations (including its capacity and appetite to bear risk), Scottish Friendly seeks to manage the investments and expenses allocated to the With-Profits business in the M&G Sub-fund in a way that achieves the best returns for M&G Sub-fund With-Profits policies.
- 1.5. The remainder of Section 1 explains the governance arrangements for the PPFM.
- 1.6. Section 2 describes the products covered by the PPFM.
- 1.7. Section 3 sets out the overarching principles used by Scottish Friendly to manage its With Profits business in the M&G Sub-fund.
- 1.8. Sections 4 to 13 provide a description of the detailed Principles and Practices applied to the M&G Sub-Fund, as required by the FCA’s Conduct of Business rules.
- 1.9. This document was first published on 1 June 2015 and is based on the PPFM that was previously maintained by M&G which was first published on 30 April 2004.

### **Principles of Financial Management**

- 1.10. The ‘M&G Principles’ are enduring statements of the standards Scottish Friendly adopts in managing the M&G Sub-fund. All principles set out in the M&G PPFM apply only to the business in the M&G Sub-fund.
- 1.11. They describe the business model used by Scottish Friendly in meeting its duties to With-Profits policyholders in the M&G Sub-fund and in responding to longer term changes in the business and economic environment.

### **Practices of Financial Management**

- 1.12. The “M&G Practices” describe Scottish Friendly’s current approach to managing the M&G Sub-fund and to respond to changes in the business and economic environment in the shorter term. The M&G Practices will normally be reviewed annually, but could be reviewed at any time in exceptional circumstances. A review may not result in any

changes to the Practices. All M&G Practices set out in the M&G PPFM apply only to the business in the M&G Sub-Fund.

- 1.13. These M&G Practices are intended to contain sufficient detail to enable a knowledgeable observer to understand the material risks and rewards from maintaining a With-Profits policy with Scottish Friendly in the M&G Sub-fund.

### **Arrangements for changes**

- 1.14. For any change to the M&G Principles in the M&G PPFM, Scottish Friendly will send its M&G Sub-fund With-Profits policyholders written notice, setting out the proposed changes to the M&G Principles, at least three months in advance of the effective date of the proposed changes (unless such changes are required by changes to the FCA Rules).
- 1.15. The M&G Practices are expected to change as the M&G Sub-Fund's circumstances and the business environment change.
- 1.16. For any change to the M&G Practices, Scottish Friendly will send its M&G Sub-fund policyholders written notice setting out the changes to the M&G Practices. This notice may be in arrears, but will be within a reasonable time period of the effective date of the change.
- 1.17. Scottish Friendly will make every effort to ensure that the costs of notification are kept to a minimum, and in accordance with the FCA Rules, will not give the above notice if the changes are required to correct errors or omissions, improve clarity or are immaterial. In addition, the changes will not be pre-notified to policyholders if the change is due to new FCA Rules and do not materially change the way in which the With-Profits policies are being managed.

### **Corporate structures and governance**

- 1.18. 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.
- 1.19. Oversight of Scottish Friendly's With-Profits business ultimately rests with the Board. 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. The Board has opted to nominate an individual (the "Independent Adviser") to provide this challenge, to ensure that With-Profits policyholders are treated fairly and that their interests are fully considered. The Independent Adviser may be a non-executive member of Scottish Friendly's Board but will be required to act independently from it for this purpose.
- 1.20. In addition, under the terms of the Scheme, Scottish Friendly has established a Monitoring Committee, whose function is to support implementation of the Scheme in accordance with the FFM and this PPFM, through review of the management and the operation of the M&G Sub-Fund, the SF Framework Agreement (described later) and the M&G PPFM. It shall also support the other governance arrangements within Scottish Friendly by providing a source of knowledge and experience as to the nature and previous management of the business within the M&G Sub-Fund.
- 1.21. Each year a report will be prepared by Scottish Friendly stating whether it believes it has complied with the M&G PPFM, together with reasons for that belief. Scottish Friendly has appointed a With-Profits Actuary, as required by the FCA, whose main duty is to provide advice to Scottish Friendly on the exercise of discretion. The With-Profits

Actuary also provides a report to accompany Scottish Friendly's report, commenting on Scottish Friendly's compliance with the M&G PPFM. The With-Profits Actuary is not, and will not be, a member of Scottish Friendly's Board.

## **2. Fund & Product Structures**

- 2.1. M&G closed to new business on 1 December 2013 prior to the transfer of its business to the M&G Sub-fund. The M&G Sub-fund will continue to accept new business arising from options granted in its existing policies, or to meet its commitments to the Staff Pension Plan under the "SF Framework Agreement". M&G previously wrote both With-Profits and non-profits business. None of the unit linked business sold by M&G (where the policyholders' benefits are linked to the value of unit in internal funds) transferred to the M&G Sub-Fund. The non-profits business within the M&G Sub-fund is non unit linked business such as income protection and annuities.
- 2.2. Under the Scheme of Transfer the unit-linked business and the term assurance business written by M&G have been transferred into the main SF fund. The with-profits business and the annuity business have been transferred into the M&G sub fund.
- 2.3. The assets of the M&G Sub-fund are notionally allocated between different classes of business into internally segregated funds. These notional funds reflect the appropriateness of different asset mixes for different classes of business. A description of the different types of With-Profits business is set out below.

### **Conventional With-Profits (CWP) – Life**

- 2.4. An initial guaranteed sum assured is granted; this is the minimum amount that will be paid on maturity or earlier death.
- 2.5. Annual bonuses are added to the policy each year following the Board's bonus declaration. Annual bonuses are only paid on maturity or death. They are guaranteed once declared. A non-guaranteed interim bonus is also added, reflecting the time elapsed since the effective date of the last declaration.
- 2.6. A simple annual bonus system is currently used, i.e. each year's bonus is expressed as a percentage of the sum assured.
- 2.7. At maturity or on death, a final bonus may be paid in addition. The final bonus varies with date of commencement and is expressed as a percentage of the sum assured plus a percentage of annual bonuses already declared.
- 2.8. On surrender there are, for most policy types, no guarantees which apply to the amount paid or the methods used to determine the surrender value.
- 2.9. The exception is for "Selecta" and "SelectaPlan" policies, where a table of reduced guaranteed sum assured amounts applies depending on number of years in force. The amount payable on surrender for these policies is that which would apply to equivalent policies reaching their maturity date with this reduced guaranteed sum assured maturing on the same date.

### **Conventional With-Profits (CWP) – Pensions**

- 2.10. An initial guaranteed annual annuity is granted; this is the minimum amount that will be paid on maturity. There are guaranteed cash option rates at which annuities may be converted into cash at any age after age 60.
- 2.11. Annual bonuses are added to the initial guaranteed annuity each year following the Board's bonus declaration. Annual bonuses are only paid on maturity. They are guaranteed once declared. A non-guaranteed interim bonus is also added reflecting the time elapsed since the effective date of the last declaration. A compound annual bonus system is used, ie each year's bonus is expressed as a percentage of the annuity plus attaching annual bonuses.

- 2.12. At maturity a final bonus may be paid in addition. The final bonus varies with date of commencement and is expressed as a percentage of the annuity plus annual bonuses already declared.
- 2.13. On transfer or early retirement for some policies, in some circumstances, guarantees apply as follows:
- For scheme AVC contracts a guarantee has been given that provided premiums continue to be payable to the date of transfer or early retirement, the amount payable will be the same as would have applied had this date been chosen at outset as the maturity date.
  - For some Self Employed Retirement Plans, guaranteed early retirement factors apply for transfer or retirement after age 60.

### **Unitised With-Profits (UWP) - Life and Pensions**

#### **(a) Policies originally issued directly by M&G**

- 2.14. For policies originally issued directly by M&G contracts may be either single or regular premium. Each premium buys units in the Bonus Growth Life or Pension Fund as appropriate.
- 2.15. The price of units in the Bonus Growth Fund increases daily in line with the declared annual bonus rate. Units are cancelled to cover some or all of the following charges: initial and/or administration charge, policy fee, cost of risk benefits.
- 2.16. Final bonuses may be added or Market Value Reductions (MVRs) deducted from partial or complete policy surrenders, except at the maturity date of regular premium contracts, and regular withdrawals from single premium contracts of not more than 7.5% pa of the premium, where there is a guarantee that no MVR will be applied.
- 2.17. The amount payable on death is as follows:
- For regular premium contracts, the higher of the guaranteed sum assured (if any) and the value of units including any final bonus.
  - For most single premium life assurances, 101% of the value of units including any final bonus.
  - For single premium pensions contracts, 100% of the value of units including any final bonus.

#### **(b) Policies originally issued by a subsidiary of M&G**

- 2.18. For policies originally issued by M&G's subsidiary MGM International Assurance (hereinafter referred to as "former M&GI policies") all contracts are single premium contracts.
- 2.19. The price of units increases daily in line with the declared annual bonus rate (referred to as regular bonuses in policy documentation). Units are cancelled to cover the administration charges.
- 2.20. Final bonuses (referred to as terminal bonuses in policy documentation) may be added or Market Value Reductions (MVRs – referred to as Market Value Adjustments in policy documentation) deducted from partial or complete policy surrenders. For regular withdrawals from single premium contracts there is a guarantee that no MVA will be applied.
- 2.21. The amount payable on death is 101% of the value of units including any terminal bonus.

**(c) Flexible Income Annuity (FIA)**

- 2.22. Contracts are single premium pensions business. Premiums are invested in units in internal segregated funds as selected by the policyholder. A regular annuity (pension) is paid to the policyholder funded by cancelling units.
- 2.23. The annuity amount payable is initially determined as the lifetime annuity supportable by the assets allocated to the policy. It is then reviewed periodically. The level of the supportable lifetime annuity takes into account the benefits selected by the policyholder and is based on assumptions regarding future life expectancy and investment returns. The investment return assumption is chosen by the policyholder, within a range set by Scottish Friendly.
- 2.24. The annuity amount is subject to a guaranteed minimum level and a charge will be taken to meet the cost of this guarantee. The level of the assets allocated to the policy will change over time, reflecting investment returns earned on those assets, and reduced by annuity amounts paid. A monthly policy fee will be deducted and other charges may be made against the FIA funds. Annual bonuses are added to the policy each year following the Board's bonus declaration. Annual bonuses are applied as a percentage increase to increase the unit holdings allocated to the policy. Once added to a policy the bonus unit additions are guaranteed.
- 2.25. No final bonus is payable for a FIA policy.
- 2.26. The value of the assets allocated to the policy, including annual bonuses declared, will be available for transfer, subject to a deduction to reflect the health of the policyholder, and an exit charge if required in order to protect the interests of remaining M&G Sub-fund policyholders.
- 2.27. The policy is automatically converted to a fixed income annuity at age 90, or earlier if the policyholder so chooses. On conversion, the annuity amount is reassessed and the revised amount then applies for the lifetime of the policyholder. The assets allocated to the policy are released into the M&G sub-fund. Annual bonuses may be added to the annuity amount each year following the Board's bonus declaration, and are guaranteed once declared.

### **3. Overarching principles**

- 3.1. Scottish Friendly applies a number of overarching principles to the management of the With-Profits business in the M&G Sub-fund. They are set out below in the order in which they would normally apply.
- 3.2. Scottish Friendly aims to:
  - comply with the terms of the Scheme and the FFM;
  - meet all contractual obligations to policyholders, in particular relating to the timely payment of guaranteed benefits;
  - maintain a level of solvency and capital adequacy (the Notional Capital Requirement as set out in the FFM) to be based on the requirements as specified by the UK regulator which would apply if the M&G Sub-fund were a separate company;
  - treat all policyholders fairly, taking into account the conflicting interests between them; and
  - distribute the Estate over time to With-Profits policyholders in an equitable manner, subject to the need to maintain an appropriate level of capital over the Notional Capital Requirement to secure the benefits of continuing non-profit policyholders in the M&G Sub-fund.
- 3.3. In the event of conflict arising as a result of the application of any one or more of the Principles set out in Section 4, these overarching principles will take precedence. Areas where a particular need to make reference to these overarching principles may be likely are highlighted in Section 4.

#### **4. The Amount payable under a With-Profits policy**

##### **Principles**

- 4.1. The aim of the methods used to determine the amount payable to With-Profits policyholders is to provide a fair return that broadly reflects the experience of the M&G Sub-fund as it applies to each type of contract, subject in adverse circumstances to the application of the overarching principles.
- 4.2. The return on the M&G Sub-fund can be viewed as having four components
  - Investment returns on the M&G Sub-fund assets
  - Mortality profits/losses
  - Other profits/losses arising from the experience of With-Profits business
  - Profits/losses from non-profits business and other business risks remaining within the M&G Sub-fund
- 4.3. Investment returns earned on assets deemed to be backing CWP and UWP policies will be allocated to those policies. For FIA policies investment returns will reflect the returns on the segregated funds supporting each policy.
- 4.4. Mortality profit/losses on FIA policies will be pooled and shared out across those policies alone.
- 4.5. Other mortality profits and all other profits and losses will be shared out between all With-Profits business or retained within the Estate (see section 11) in ways that take account the source of those profits, the contribution of the With-Profits business to the financial strength of the M&G Sub-fund and any other factors that the Board of Directors consider relevant to the fair treatment of all policies.
- 4.6. The methods used involve a degree of approximation, for example in determining historical assumptions for which there are no detailed records. Further approximations which may be made include averaging groups of policies by policy type, size of premium and year of issue.
- 4.7. Because of these approximations, historical assumptions or parameters may be changed in the light of further information, if the Board considers it fair and reasonable to do so. Any changes will be approved by the Board, having received advice from the With-Profits Actuary and the Independent Adviser as appropriate.
- 4.8. The type of change that would be made is to more accurately determine the amount payable, or more efficiently determine the amount without significant loss of accuracy.

##### **General Practices**

- 4.9. Scottish Friendly currently uses asset shares as the starting point for determining the amount payable under a With-Profits policy. The historical assumptions used in the calculation of asset shares include experience in previous years in respect of investment returns and on industry experience in respect of mortality.
- 4.10. Asset shares are calculated as premiums paid accumulated by investment returns less charges for expenses, risk benefits and tax.
- 4.11. The other profits and losses arising from other insurance business in the M&G Sub-fund will be reviewed at least annually and will either be:
  - Added to asset shares for all With-Profits business,
  - Added to claim values for policies falling due in the following year, or
  - retained in the Estate, or a combination of these.
- 4.12. In determining the application of these profits or losses, the Board will have regard to the source and sustainability of these profits, and the adequacy of the current level of

the Estate to meet the Notional Capital Requirement under the FFM. Note that former M&GI policies will not usually share in such normal profits and losses.

- 4.13. In addition to these profits and losses as a result of the closure of M&G to new business and transfer to Scottish Friendly, it may in future be possible to make additional distributions of the working capital provided by the Estate. These distributions may be made using a different mechanism.
- 4.14. Asset share values are then smoothed as described in Section 7 before the amount payable is determined, which is not lower than any guaranteed benefit
- 4.15. The investment returns allocated to asset shares are equal to the returns on the assets backing different types of policy. Separate asset allocations apply to CWP and UWP business (and within UWP business to former M&GI policies separately from other UWP policies) on a notional basis, as described in Section 8.
- 4.16. Tax deducted from asset shares reflects best estimates at the time of calculation of that part of Scottish Friendly's tax liability attributable to With-Profits business in the M&G Sub-fund. This includes allowance for the expected deferment of the tax due on unrealised capital gains and of tax recoveries on realised and unrealised capital losses.
- 4.17. For this purpose asset portfolios backing With-Profits asset shares are considered on a stand-alone basis – that is, unrealised losses are carried forward and credit given only when offset against future gains in the same portfolio rather than immediately offset against gains already existing elsewhere in Scottish Friendly's assets.
- 4.18. Policy charges in respect of expenses taken from the asset shares or unit-funds after the Effective Date of the Transfer will initially be taken at the levels in place as at the Effective Date and will be reviewed annually as set out in the FFM.
- 4.19. The historical assumptions used in asset share calculations and the basis on which the assumptions have been applied have been documented.
- 4.20. The methodology described above sets out Scottish Friendly's current approach. Calculations may have been done differently or more approximately in the past. Changes in the methods to be used are approved by the Board, having received advice from the With-Profits Actuary and the Independent Adviser as appropriate.

#### **Conventional With-Profits Practices**

- 4.21. For CWP maturities the rates of final bonus are determined by:
  - asset share values determined as described above,
  - the target payout percentage of asset share, and
  - explicit smoothing adjustments, as described in Section 7.
- 4.22. Classes of CWP contract which benefit from the additional guarantees described in Section 2 have different premium rates to classes without such guarantees. These differences (other than to the extent that they reflect different commission scales applying at point of sale) are deemed to represent charges for the guarantees and directly impact the level of the asset share.
- 4.23. Maturity payouts will reflect the level of guaranteed benefits and the final bonus declared at the date of maturity.
- 4.24. These asset shares are normally calculated as at a date midway through the period for which the final bonus rates are expected to apply, assuming future investment returns at Scottish Friendly's middle growth rate for future benefit projections for the final period.

- 4.25. Policies that have been made paid-up (where premiums have ceased prematurely and benefits reduced correspondingly) and other categories of altered policies are represented by premium-paying specimen policies, with due adjustment for level of benefit. This reflects established practice as regards annual and final bonus rates in the M&G Sub-fund. Payouts on older policies (commencing before 1975) are not based on asset shares as this methodology is not appropriate to these policies.
- 4.26. For maturities the target payout percentage will be in the range between 80% and 120% of asset share, and Scottish Friendly would expect at least 90% of actual payouts on maturities to be in this range. Final bonus rates for groups of similar policies will be set to achieve this aim.
- 4.27. For CWP life death claims and for CWP early terminations with guarantees, as described in Section 2, the same final bonus rates apply as for maturities.
- 4.28. For other CWP early terminations a formulaic basis applies, which is regularly reviewed to ensure that payouts fall within a target range of percentages of asset share. For this purpose asset shares are calculated on the same basis as for maturity values.
- 4.29. For surrenders the target payout percentage will be in the range between 80% and 120% of asset share, and Scottish Friendly would expect the average across groups of similar policies of actual payouts on early termination to be in this range.

**Unitised With-Profits Practices**

- 4.30. For UWP surrenders and maturities, and for deaths where the guaranteed death sum assured does not apply, the rates of final bonus or MVR and hence total payout are determined by:
- asset share values determined as described above,
  - the target payout percentage of asset share, and
  - explicit smoothing adjustments, as described in Section 7.
- 4.31. For surrenders and maturities the target payout percentage will be in the range between 90% and 110% of asset share, and Scottish Friendly would expect at least 90% of actual payouts to be in this range.
- 4.32. For this purpose, asset shares are calculated for all policies and the results grouped by month of commencement.

## **5. Setting annual bonus rates**

### **Principles**

- 5.1. In setting annual bonus rates for CWP and UWP business, Scottish Friendly is mindful of the objective to maximise the overall return on a policy subject to an acceptable level of risk, which is best achieved by expressing a relatively modest proportion of the total policy proceeds in guaranteed form through annual bonuses. This allows greater investment freedom and the potential to provide higher returns to policyholders. The setting of annual bonus rates is always subject to the overarching principles in Section 3.
- 5.2. For FIA policies, the allocation of investment returns is carried out directly rather than by means of a bonus allocation. All other sources of surplus are allocated by way of annual bonuses (there being no final bonus), and the level of annual bonus rates is set accordingly.
- 5.3. Scottish Friendly operates different bonus series for each of the Conventional With-Profits (CWP) and Unitised With-Profits (UWP) life and pensions business in the M&G Sub-fund, and for Flexible Income Annuities (FIA). Policies based on the same underlying premium rates and which were effected at the same time will normally have the same bonus rate declared, unless this would lead to unfairness in the treatment of different groups of policyholders, in which case different bonus rates may be declared.

### **General Practices**

- 5.4. Annual bonuses are declared by the Board, having regard to the overarching principles in Section 3.
- 5.5. Annual bonuses are reviewed at least once a year as part of the year end investigations. Other relevant investigations may also be carried out during the year.
- 5.6. In setting annual bonus rates in normal circumstances for CWP and UWP policies the aim is to reflect the after tax investment yield on the underlying assets. However, significant consideration is given to the scope left for adding final bonus on future claims by declaring a given rate. If this scope is deemed insufficient or excessive (having regard to foreseeable adverse investment scenarios), then this would affect the basis on which the annual bonus rate was declared.
- 5.7. Consideration is also given to the ability to sustain the annual bonus rate in the future under different investment scenarios.
- 5.8. There is no maximum amount by which annual bonus rates may change between successive declarations.

### **Conventional With-Profits Practices**

- 5.9. It is not Scottish Friendly's intention to change the rates of annual bonus frequently in order to reflect short-term movements in investment conditions.
- 5.10. Interim bonuses, which apply proportionately to claims falling due between one declaration date and the next, are normally added at the same rate as the latest declared annual bonuses (although lower rates may be declared). They may change during the year, particularly if investment conditions change significantly.
- 5.11. Annual bonuses are declared for the previous calendar early in the following calendar year.
- 5.12. One annual bonus rate is declared for all life contracts and a separate rate is declared for all pension contracts.

***Unitised With-Profits Practices***

- 5.13. Annual bonuses are reviewed at least once a year. They are also considered as part of more regular reviews of final bonus rates.
- 5.14. One annual bonus rate is declared for all life contracts, one rate for all pension contracts and a further rate for all former M&GI policies.
- 5.15. Annual bonuses are declared in advance, so there are no interim bonuses.

***Flexible Income Annuity Practices***

- 5.16. Annual bonuses are declared for the previous calendar year, currently on 1 April. No interim bonuses are paid.

## **6. Setting final bonus rates**

### **Principles**

- 6.1. Final bonus rates are determined for CWP and UWP business, with the aim of ensuring that payouts represent a fair return which broadly reflects the experience of the M&G Sub-fund over the duration of a contract. Payouts are subject to smoothing as described in Section 7.
- 6.2. Policies based on the same underlying premium rates and which were effected at the same time will have the same final bonus rate declared. The final bonus rates depend on the duration in force as a With-Profits policy at the time of a claim. Where different underlying premium rates or product structures are used, Scottish Friendly may choose to declare a different final bonus.
- 6.3. No guarantees are made about the rate of final bonus or that there will be a final bonus. Although the final bonus will not be negative, for UWP business Scottish Friendly is able to impose an MVR, other than in the circumstances described in Section 2, in times of adverse market movements in assets, in order to maintain fairness between policyholders voluntarily exiting the M&G Sub-fund and those remaining in it. Scottish Friendly reserves the right to change final bonuses at any time without advance notice.
- 6.4. Final bonuses are reviewed at least annually. However, particularly in times of significant market movements or if the Notional Capital Requirement under the FFM of the M&G Sub-fund is at risk, the level of current final bonuses and MVRs will be considered and revised bonus rate declarations may be made.
- 6.5. No final bonus applies for FIA policies.

### **General Practices**

- 6.6. Final bonuses in any year are set to bring the total amounts paid out on maturity or (for UWP) early termination, when averaged over all policy types and in force terms, to within the target percentage of asset share as described in Section 4. Over a period of years this target is intended to average 100%, but will vary between individual policies and over successive years due to the degree of smoothing as described in Section 7. This target excludes any distributions of the Estate.

### **Conventional With-Profits Practices**

- 6.7. Final bonus rates are normally reviewed annually as part of the year end investigations. However, in times of significant market movements, when there is the likelihood that payouts will fall outside the target range referred to in Section 4, they will be reviewed more frequently.
- 6.8. Declarations of new final bonus are declared at least once a year are reviewed regularly in between such declarations.
- 6.9. Final bonus is expressed as a percentage of the sum assured (or guaranteed annuity in the case of pensions business) plus annual bonuses already declared. The percentages vary by type of policy and by the commencement date of the policy (except in the case of Self Employed Retirement Plan, where year of commencement of benefit is used).
- 6.10. Three tables apply; one to life, one to Self Employed Retirement Plan and one to other types of CWP pensions. Rates currently vary by year of commencement or benefit (or conversion to With-Profits if later).
- 6.11. For death claims, the same final bonus rates apply as for maturities. For early terminations, a final bonus rate is applied at the same rate as for deaths or maturities of the same period in force.

**Unitised With-Profits Practices**

- 6.12. Rates of Final Bonus are reviewed at least quarterly. However, in times of significant market movements, when there is the likelihood that payouts will fall outside the target range referred to in Section 4, they will be reviewed more frequently.
- 6.13. Final bonus is paid on policies which surrender or transfer out on the same basis as policies which remain in force to maturity.
- 6.14. Policies may either have a final bonus or MVR applied at any time. Final bonuses and MVRs vary by commencement date of the policy (or date of purchase of UWP units if later) and are expressed as a percentage of the value of units under the policy.
- 6.15. Up until 2016 a single table of final bonus rates was applied to both life and pensions contracts in the UK. From 2016 separate tables will apply to UK life and pensions contracts. A separate scale applies to former M&GI policies.

## 7. Smoothing

### **Principles**

- 7.1. The smoothing policy will aim to operate to ensure that, for CWP and UWP business, payouts on similar policies do not vary beyond certain limits if those policies terminate within a certain time span of each other, whilst in the long run ensuring that the long-term cost of smoothing is neutral.
- 7.2. There is no significantly different approach adopted depending on the type of claim arising for CWP and UWP business.
- 7.3. For FIA business, the smoothing policy aims to distribute appropriate profits/losses in full each year although extreme amounts in either direction could be spread over more than one year. In the long run the aim is to ensure that the long-term cost of smoothing is neutral.
- 7.4. There is no specific limit to the total smoothing cost over the shorter term that Scottish Friendly believes should not be exceeded, provided the interests of continuing policyholders are not prejudiced. However, the extent to which smoothing applies will be subject to the overarching principles in Section 3 and in particular would be constrained if the Notional Capital Requirement under the FFM would otherwise be at risk.
- 7.5. Scottish Friendly may apply MVRs to UWP policies and change the surrender bases for CWP policies, to reflect changes in underlying asset values.

### **General Practices**

- 7.6. Smoothing for CWP and UWP policies applies in two ways:
  - (a) implicitly:
    - by grouping policies for the purpose of determining final bonuses by year or month of commencement;
    - by holding final bonus rates and MVRs unchanged between declaration dates; and
    - by limiting the number of different bonus scales, so that minor product classes share the experience of the major classes; and
  - (b) explicitly:
    - by paying more or less than the target percentage of asset share in order to reduce the volatility of payouts.
- 7.7. The cost of implicit smoothing can be expected to be close to zero. The cost of explicit smoothing is intended to be zero over the long-term. However, there is no period over which Scottish Friendly has decided that smoothing should be neutral, neither is there any overall limit to the accumulated cost or benefit from smoothing that Scottish Friendly has decided it is prepared to tolerate. However, the extent to which smoothing applies in periods of sustained asset falls may be constrained if the M&G Sub-fund is at risk of being unable to meet its Notional Capital Requirement.
- 7.8. In determining the level of explicit smoothing to be applied to policy payments Scottish Friendly takes into account:
  - The relationship between the asset share for each year of commencement with the corresponding figure at the previous declaration,
  - The level of smoothing applied for each year of commencement at the previous declaration,
  - The aggregate cost or benefit of the proposed smoothing,
  - The resources available to support this smoothing cost.
- 7.9. Except where guarantees are directly affecting payouts, the change in payouts for policies with similar characteristics expressed as a percentage of asset share would not

on average be more than 5% from one year to the next, subject to the overarching principles in Section 3.

- 7.10. The Board would, in some cases, invoke the overarching policyholder fairness principle and breach this limit. Circumstances where this is likely are when the value of the underlying investments change significantly in a short period of time, e.g. more than 7.5% in a month. The 5% limit would, in these cases, be used as a longer term constraint.
- 7.11. Smoothing accounts are maintained, separately for CWP and UWP (and within UWP business separately for former M&GI policies and other UWP business), to keep track of the costs and benefits of smoothing, both explicit and implicit. These accounts may, from time to time, be negative, implying that temporary support is being given by the Estate to the smoothing process.

**Conventional With-Profits Practices**

- 7.12. For CWP policies, smoothing operates by assuming that policies entering into With-Profits in each calendar year enter and leave the M&G Sub-fund halfway through the relevant bonus years when determining final bonuses, as described in Section 4

**Unitised With-Profits Practices**

- 7.13. For UWP policies, smoothing operates by treating policies' investments in each calendar month as entering and leaving the M&G Sub-fund halfway through the relevant calendar month when determining asset shares, final bonuses and MVRs.
- 7.14. The cost of guarantees, for example partial surrender payments under UWP policies to which no MVR applies, is not charged to the smoothing account.

**Flexible Income Annuity Practices**

- 7.15. For FIA business, the smoothing policy aims to distribute appropriate profits/losses in full each year although extreme levels of profits/losses may be spread over more than one year. In the long run, the aim is to ensure that the long term cost of smoothing is neutral.

## 8. Investment Strategy

### Principles

- 8.1. The investment strategy of the M&G Sub-fund is determined by the Board.
- 8.2. The aim of Scottish Friendly’s investment strategy, for CWP and UWP policies, is to maximise the returns to those With-Profits policyholders whilst preserving the ability of the M&G Sub-fund to meet the guarantees it has given. In determining the mix of assets between asset classes, the investment strategy will take into account the financial strength of the M&G Sub-fund, its ability to meet regulatory capital requirements, and the long-term expected returns anticipated for each asset category, together with their volatility. Different classes and generations of policy within the M&G Sub-fund may have different investment strategies depending on their liability profile and levels of guarantees. The Estate may also have a different investment strategy. In considering the range of assets in which to invest, the M&G Sub-fund may use derivatives and other instruments within limits determined by the Board. Limits may be set as to the maximum exposure to specific assets, asset types, and counter party exposure.
- 8.3. The M&G Sub-fund may invest in assets which would not normally be traded, provided the Board can demonstrate that such investments are likely to have no adverse effect on the interests of the With-Profits policyholders. The basis of valuation, yield, and the proportion of the M&G Sub-fund invested in such assets is reviewed regularly to ensure they remain appropriate investments of the M&G Sub-fund.
- 8.4. For FIA business the policyholder chooses their own investment strategy via their selection of segregated funds.

### General Practices

- 8.5. The investment strategy for the M&G Sub-fund is formally reviewed at least once a year.
- 8.6. Non linked, non-profit liabilities are backed by a portfolio including fixed interest assets of suitable outstanding term and cash on deposit.
- 8.7. Different asset allocation strategies apply to CWP business, UWP business and the Estate. In particular, UWP business has a higher proportion of equities and property than CWP business, reflecting the lower level of guarantees and the desire to maximise returns, subject to an acceptable level of risk. Within UWP business separate assets are held for former M&GI policies which have benefits payable in Euros.
- 8.8. If the M&G Sub-fund’s ability to meet its Notional Capital Requirement was at risk, equity assets would be switched to fixed interest to restore capital levels to acceptable levels.
- 8.9. Investment guidelines allow an investment mix within the following ranges:

	Equities (including property)		Fixed interest, variable interest, deposits and cash	
	Lower Limit	Upper Limit	Lower Limit	Upper Limit
CWP	0%	60%	40%	100%
UWP	30%	80%	20%	70%
UWP (ex- M&GI policies)	30%	80%	20%	70%

- 8.10. The actual investment mix is shown on the members’ pages on Scottish Friendly’s website and is updated each quarter.

- 8.11. In respect of fixed interest investments in With-Profits Funds, up to 5% may be invested in sub-investment grade bonds.
- 8.12. Investment in new or novel investment instruments is subject to approval by Scottish Friendly's Board. The risks and rewards of such instruments would be analysed in the context of the M&G Sub-fund's investment strategy, the existing assets held and the liability profile of the With-Profits policies. The Board would approve new or novel instruments if they believe the benefits associated with such investments outweighed any increase in risk or cost.
- 8.13. The M&G Sub-fund currently holds no investments which it would expect not to be traded.

***Conventional With-Profits matching Practices***

- 8.14. Scottish Friendly will look to match a proportion of its guaranteed liabilities in the CWP fund with fixed interest and cash. Such matching will have due consideration to both the investment policy outlined above, and the overall impact on both regulatory capital and internal capital assessments.
- 8.15. The duration of the assets is chosen to match, on an approximate basis, the pattern of expected cash outflows of the proportion of claims less premiums being matched, making best estimate assumptions for the early termination of policies and mortality.

***Unitised With-Profits matching Practices***

- 8.16. Scottish Friendly does not operate a policy of seeking to match precisely the anticipated profile of UWP liabilities with fixed interest assets, although due regard will be paid to guarantees which have been given when determining the level of fixed interest investment.

***Investment of Estate Practices***

- 8.17. The investment strategy applying to the Estate differs from that applying to assets backing insurance business. The strategy for the Estate is intended to complement the investment of the With-Profits assets backing the insurance business and could be materially affected by any potential liabilities that the Directors expect to attribute to the Estate (see note below). At present the strategy for the Estate, recognising the intention to distribute the Estate to With-Profits policies over time, is aimed at reducing risk to the M&G Sub-fund rather than maximising investment return.
- 8.18. The Estate may also make investments in derivative assets and other instruments, subject to approval by Scottish Friendly's Board. The Board would approve such investments if they believe the benefits for the With-Profits funds as a whole outweighed any increase in risk or cost. Such investments might also be used, at certain times, in order to protect the solvency in terms of the Notional Capital Requirement under the FFM and the security of policyholders' benefits.
- 8.19. Note: Where explicit reserves need to be established in respect of liabilities that are to be attributed to the Estate these would then form part of the main policyholder reserves. Amounts are transferred out of the Estate to cover the establishment of such reserves. The investment strategy for such reserves is then consistent with that adopted for other policy reserves (normally non-profit liability reserves).

## **9. Business risk**

### **Principles**

- 9.1. The M&G Sub-fund bears all the risks and reaps the rewards of business risks arising from the business within the M&G Sub-fund. In the normal course it will not bear any business risks that arise from other parts of Scottish Friendly's business.
- 9.2. The M&G Sub-fund is exposed to risk arising from the past acquisition and maintenance of both Non Profit and With-Profits business sold by M&G and from other investments of the M&G Sub-fund. It is not expected to accept new business risks and would only do so if the risks are consistent with the M&G Sub-Fund's risk capacity and appetite.

### **General Practices**

- 9.3. With-Profits policyholders in the M&G Sub-fund share in the results of all the business risks within the M&G Sub-fund.
- 9.4. Examples of business risks are:
  - Exposure to maintaining With-Profits policies.
  - Exposure to maintaining Non-profits policies.
  - Exposure to risks from the Staff Pension Plan.
  - Exposure to any costs of remediation for M&G policies arising from activities of M&G prior to transfer.
- 9.5. Before taking on any new significant business risk, it must be approved by Scottish Friendly's Board, who would consider the costs and benefits, including the impact on the risk capacity and appetite.
- 9.6. The profits or losses arising from these business risks will be treated as described in Section 4.
- 9.7. For those profits or losses arising from business risks that are allocated to With-Profits policyholders in line with the process set out in section 4, With-Profits policyholders share in business risk in proportion to their asset shares. Former M&GI policies will not normally share in such distributions of profits and losses but potentially share in any exceptional profits or losses, for example the profits and losses arising should Scottish Friendly ever decide to close or demutualise.

## **10. Charges and expenses**

### **Principles**

- 10.1. The expenses of the M&G Sub-fund will be restricted to the charges set out in the Scheme.
- 10.2. In the event that the FIA assets reinsured at the time of the Transfer are recaptured by Scottish Friendly, any charge on the M&G Sub-fund in respect of the FIA assets will be set to cover any external costs incurred by Scottish Friendly in maintaining these assets where such costs are not already covered by the charges within the FIA funds and policies.
- 10.3. UWP and FIA policies have defined expense charges as set out in policy literature. These are the same charges as are applied to asset shares. The expense charges made to UWP and FIA policies may be increased (subject to any maximum in the policy terms) or decreased reflecting the actual expenses incurred.
- 10.4. The expenses to be charged to asset shares for CWP policies were fixed at the time of Transfer. These may be increased or decreased in line with changes to charges for UWP and FIA policies.
- 10.5. Any difference between the charges applied to the with-profits policies and the expenses incurred by the M&G Sub-fund will be charged or credited to the Estate.
- 10.6. The basis for apportioning charges and expenses may be changed prospectively if the Board determines that it has become inequitable. This could apply if investigations into expense apportionment or the cost of smoothing and guarantees and the use of capital demonstrated the need to change the basis.
- 10.7. For FIA policies a guarantee charge is also made. Differences between these charges and actual guarantee costs will be charged or credited to the Estate. Guarantee charges reflect expected costs of guarantees over time and can be adjusted if those expectations change.

### **General Practices**

- 10.8. The expenses of the M&G Sub-fund will be apportioned between the different classes of With-Profits policies and are allowed for in the calculation of asset share or fund (FIA).
- 10.9. As a result of the Scheme the majority of the costs arising from each class of policy is clearly defined. The M&G sub-fund is also subject to exceptional costs, including one-off costs defined in the Scheme and here judgement is used in order to apportion the costs between different classes of With-Profits policies and over an appropriate time-frame. Any changes to the charges applied at a policy level will reflect this apportionment.
- 10.10. No charges to policies are currently being made for the cost of smoothing or guarantees other than the charges for FIA described above.

### **Unitised With-Profits and FIA policies Practices**

- 10.11. The charges to be applied to UWP and FIA policies will be those set out in the policy literature. Any difference between those charges and the actual expenses incurred in administering the business will accrue to the Estate. The expense charges made to UWP and FIA policies may be increased (subject to any maximum in the policy terms) or decreased reflecting the actual expenses incurred.
- 10.12. Many of these charges are fixed or linked to inflation. However, the annual management charge, which is charged as a deduction from the investment return credited to asset shares, is at Scottish Friendly's discretion. For most UWP business one

rate is set for life business and a different rate for pensions. For former M&GI policies a separate scale of charges is applied but any changes to these scales will be linked to equivalent changes to charges for the rest of the M&G Sub-fund UWP business. For FIA the charge will vary by fund choice, premium size, commission income, age and health to reflect the different costs of these aspects. These levels of charge are implicitly disclosed to policyholders at point of sale through the reduction in yield quoted at that time.

***Conventional With-Profits Practices***

10.13. The expenses charged to asset shares were fixed at the time of Transfer and will change at the discretion of Scottish Friendly in line with the changes to charges for UWP and FIA business.

## **11. Management of the Estate**

### **Principles**

- 11.1. The M&G Sub-fund's Estate is the excess of the assets of the M&G Sub-fund over the amount required to meet the liabilities and expected benefit payments (including future bonuses), for current policyholders.
- 11.2. Its primary uses include:
- Providing capital to meet the Notional Capital Requirement and reserving requirements in excess of policyholder asset shares and provisions for guarantees that have already been given or which may arise as a result of the investment policy of the M&G Sub-fund.
  - Allowing the M&G Sub-fund to accept a greater degree of investment freedom and diversification, and acceptance of greater investment risk than would otherwise be possible.
  - Providing working capital to cover any mismatch in timing between the receipt of charges on policies in the M&G Sub-fund and the actual expenses incurred in the maintenance of those policies.
  - Supporting the smoothing of benefits paid to With-Profits policyholders.
  - Meeting any exceptional costs in managing both with and non-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.
  - Providing additional security to policyholders in the event of adverse changes in experience.
- 11.3. There is no division of the Estate between classes of business in the M&G Sub-fund, and existing with-profits policyholders have no right to an immediate distribution, although it is intended that the Estate will be distributed over time, in accordance with paragraph 3.2.
- 11.4. The preferred size of the Estate is the level required to meet the above objectives. To the extent that the Estate falls to an unacceptably low proportion of total asset shares, the investment policy and the ability to smooth the payment of benefits to existing policyholders may be restricted. In such circumstances the intention would be to rebuild the Estate by reducing payouts on With-Profits policies.

### **Practices**

- 11.5. The M&G Sub-fund's Estate is used to assist in running all business in the M&G Sub-fund. The primary uses of the Estate are described above.
- 11.6. Scottish Friendly aims to maintain the Estate at a size which allows the criteria above to be met.
- 11.7. To assess the appropriate level of additional security referred to above, Scottish Friendly has regard to its "risk appetite" as determined by the Board from time to time.
- 11.8. Scottish Friendly aims to maintain an Estate that:
- a. meets the Notional Capital Requirement for the M&G Sub-fund; and
  - b. provides sufficient additional capital resources to ensure that the M&G Sub-fund can meet its chosen risk appetite and does not require capital support from the Scottish Friendly Main Fund.
- 11.9. Should the Estate materially exceed this level, it would be Scottish Friendly's intention to return this excess to its With-Profits policyholders.
- 11.10. The Estate is currently meeting the following specific costs, and will continue to do so for the foreseeable future:

- The cost of meeting payments in excess of asset shares on maturing CWP pensions policies resulting from the granting of guaranteed annuity options.
- The cost of meeting MVR free guarantees on UWP policies.

11.11. Reserves have been established in respect of these specific costs. As noted in Section 8 these reserves are initially covered by transferring assets out of the Estate. Any subsequent release of these reserves that is not matched by benefit payments would revert back to the Estate.

## **12. Volumes of new business and closure of the M&G Sub-fund**

- 12.1. The M&G Sub-fund closed to new business on 1 December 2013 and consequently no longer accepts new business, except under certain options available under policies in force prior to closure, or to meet its obligations under the Staff Pension Plan.

**13. Equity between the With-Profits fund and any shareholders**

- 13.1. The M&G Sub-fund is a mutual fund and has no shareholders. Therefore, this section is not applicable.

## Glossary

Asset Share	The accumulation of premiums less charges reflecting the cost of providing the policy plus the investment return on the underlying assets.
Conventional with-profits ("CWP") policy	Policy that has a guaranteed minimum cash sum or annuity (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.
Estate	The difference between the market value of assets and the asset share and provision for guarantees.
FIA policies	flexible income annuity contracts issued by M&G
Final Bonus	Bonus added when there is a claim
Fundamentals of Financial Management ("FFM")	The high level principles to be applied in running the sub-fund as set out in the Transfer Agreement.
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 Capital Requirement	The capital requirement in respect of the sub-fund calculated in accordance with the FFM.
Notional Fund	A notional sub-fund of the with-profits fund covering Transferred Business.
Regular bonus	Bonus that is usually added annually.
Smoothing	A means by which long term returns on with-profits policies are adjusted to even out the impact of short term high or 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 M&G to Scottish Friendly.
Unitised with-profits policy ("UWP")	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.