The SPI Fund of Scottish Provident Limited

Principles and Practices of Financial Management

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Glossary

This Glossary is intended to be read as offering guidance on the general meaning of words and phrases, rather than as setting rigid legal definitions.

"Abbey"	Abbey National plc. *Abbey* was the ultimate parent company of *SPL* prior to *Resolution's* acquisition of *SPL* on 1 September 2006.
"Actuary"	The actuary who has been appointed to a specific role in *SPL* in accordance with applicable regulatory rules and *SPL*'s governance structure. Actuaries are specialists in financial mathematics.
"annual bonus"	A bonus declared following the principal annual investigation of the financial position of the *SPI Fund* and that applies to all policies in a specified class. It is added to the policies, but becomes payable only when the policy as a whole becomes payable. Different rates of *annual bonus* may apply to different types of policy.
"annuity"	An annual (or monthly) payment to be made to a policyholder, or a policy that provides for such payments. Annuities are usually payable for as long as the policyholder remains alive.
"asset share"	The amount of money that arises from: • the *premiums* paid for a policy, • together with the *net investment returns* that are due, • less any expenses and charges not allowed for in *the net investment return.*
"conventional business"	One of two distinct sub-classes of business within the *SPI Fund* that are relevant for the purposes of this document. The other class is the *unitised business.* The *conventional with-profits business* comprises the classes of with-profits policy where there is no choice of investment and there is usually a *guaranteed benefit* available at a fixed date, with bonuses declared once per year. There are further sub-divisions within the *conventional business* that are described in section 4.2 below.

"deposit administration"	The *deposit administration business* consists of the Active Simplified Pension Investment Funding Plans, which are group pension policies effected by the trustees of occupational pension schemes.
"final bonus"	A bonus that is added when a policy becomes payable. Rates of *final bonus* are set from time to time, but can be changed without notice. Different rates may apply to different types of policy and to policies of the same type issued at different times.
"FSA"	The Financial Services Authority, or any successor body, acting as the regulator of UK insurance businesses.
"guaranteed benefit"	The *sum assured* plus the total of all *annual bonuses* in respect of a particular policy (or *Specimen Policy*, where the context admits).
"Market Value Reduction (MVR)"	A deduction that may be made from the value of the with-profits *units* attached to a policy when the policy is surrendered.
"net investment return"	The investment return earned by the *SPI Fund* in any year after the deduction of tax and all relevant costs, charges and expenses (including where we judge it to be appropriate, the costs of guarantees and the provision of capital) and after taking account of the outcome of all relevant business risks, including insurance experience.
"payout"	The amount of benefit to be paid when a policy becomes a claim.
"PPFM"	This document, the Principles and Practices of Financial Management. We also produce a customer-friendly summary document – a guide that covers the main points of the *PPFM.*
"premium"	Money the policyholder pays to the insurance company to buy his policy. This may be a single lump sum payment or regular (often monthly) payments.
"Resolution"	Resolution plc. *Resolution* is the ultimate parent company of *SPL*.

“Scheme”	This has the meaning given in section 1.9.
“shareholder”	Resolution plc, in its capacity as the owner of *SPL*.
“smoothing”	An averaging process whereby *SPL* may adjust the *payout* that would arise from a mechanistic use of the *net investment return*.
“specimen asset share”	The *asset share* of a *specimen policy*.
“specimen policy”	A theoretical policy that is used in calculations. For example we may not do individual calculations for each of several policies of the same type issued at the same time. We do the calculations for one policy and then treat the other policies proportionately.
“Special Fund”	The *Special Fund* is a sub-fund of the *SPI Fund.* This was established by the *Scheme.*
“SPI”	Scottish Provident Institution
“SPI Fund”	The with-profits fund of *SPL*. This was established by the *Scheme*.
“SPI Fund Supervisory Committee”	The *SPI Fund Supervisory Committee*, a committee established by the *Scheme* to have regard solely to the interests and reasonable expectations of *SPI Fund* and *Special Fund* policyholders.
“SPL”	Scottish Provident Limited
“SPL Board”	The governing body of *SPL* with the final authority in decision making. It consists of executive and non-executive directors.
“sum assured”	The initial sum guaranteed under policy documentation in respect of a particular policy (or *Specimen Policy*, where the context admits). For some policy types this may be expressed as a pension or *annuity* rather than a cash sum.
“surrender value”	The amount payable, at the discretion of *SPL*, if a policyholder terminates his policy at a time when the policy conditions do not provide for a *guaranteed benefit* to be payable.

"unit"	Some policies have their benefits defined in terms of *units*. A *unit* represents a share of the assets in the *SPI Fund*.
"unitised business"	One of two distinct sub-classes of business within the *SPI Fund* that are relevant for the purposes of this document. (The other class is the *conventional business*.) The *unitised with-profits business* includes all the with-profits business under which benefits are expressed in terms of the value of with-profits *units*, usually arising as a result of the exercise of choice within the policy between investing in with-profits or in property-linked or index-linked funds.

Introduction, Structure and Overriding Principles

1. Introduction

Purpose of the PPFM

1.1 This document applies to the business carried on within the *'SPI Fund'* which is one of the With-Profits Sub-Funds of Scottish Provident Limited ('*SPL*'). It aims to define the Principles and Practices of Financial Management *('PPFM'*) according to which this business ('the Business') is currently conducted.

1.2 This *PPFM* applies only to the *SPI Fund*. *SPL* publishes a separate *PPFM* for the *Special Fund*. The *Special Fund* is not invested in the *SPI Fund*. However, the *SPI Fund* is entitled to receive up to 10% of the distributed surplus within the *Special Fund*.

1.3 The *PPFM* may be revised by *SPL* from time to time and in any respect subject only to the constraints imposed by law and regulation. *SPL* will review the *PPFM* every year, although changes to Principles and Practices may be made more frequently.

Availability of the PPFM and reporting

1.4 The *PPFM* is available to policyholders and their advisers (amongst others), thus helping them to understand the way in which *SPL* is currently seeking to manage the Business.

1.5 Accordingly, any policyholder with an *SPL* with-profits policy will be supplied with a copy of the relevant *PPFM* at any time on request and without charge. Other persons will be supplied with a copy of this document on request and on payment of a fee.

1.6 *SPL* will maintain a record of each version of the *PPFM* for at least six years from the date on which that version is superseded.

1.7 Under regulatory rules, *SPL* is obliged to publish an annual report on its compliance with the *PPFM*. This report will not necessarily be sent to every policyholder, but it will be available on our website, or on request.

Governance

1.8 The *PPFM* is approved by the *SPL Board* and a committee (the *SPI Fund Supervisory Committee*) established by the *Scheme*. Compliance with the *PPFM* is subject to assessment by the Committee. The Committee and *Scheme* are explained in more detail in the paragraphs below.

The Scheme and the SPI Fund Supervisory Committee

1.9 The *SPI Fund* was established by the scheme of demutualisation ('the *Scheme*') under which the business of The Scottish Provident Institution ('*SPI*') was transferred to *SPL* on 1 August 2001. The *Scheme* was approved by the Court of Session in Scotland and should there be any conflict between the *Scheme* and the *PPFM*, the *Scheme* shall take precedence. In particular, the *Scheme* includes

'Principles of Financial Management'. As with the other provisions of the *Scheme*, these *Scheme* Principles take precedence over the contents of this document.

1.10 The *Scheme* also established the *SPI Fund Supervisory Committee*, which is independent of the *SPL Board.* The responsibilities of the *SPI Fund Supervisory Committee* include the investment and bonus policy of the *SPI Fund*, and overseeing many aspects of the operation of the *Scheme.* The Committee also fulfils the role of a With-profits Committee as described in the Rules of the Financial Services Authority (*FSA*).

1.11 The *SPI Fund* includes both business issued in the UK and denominated in sterling, and business issued as Irish branch business and denominated in Irish currency.

PPFM relationship

1.12 The *PPFM* is not intended to alter the rights and obligations under any policy documents that *SPL* has issued. Should there be any conflict between what is said in the *PPFM* and what is said in any such policy document, the latter shall prevail. (For these purposes, 'policy documents' means the documentation containing the terms of the contract between *SPL* and the policyholder. This may include information or documents supplied to *SPL* by the policyholder, or on his behalf.)

1.13 The Principles and Practices set out in this document describe the way in which *SPL* currently seeks to manage the Business.

1.14 Management of the Business is not a mechanistic process carried out strictly on the basis of compliance with a detailed set of pre-determined criteria. Rather, it requires *SPL* to make many judgements about the actions it should take in endeavouring to meet the objectives which are described in the Principles and Practices set out in the *PPFM*.

1.15 Those judgements are made by *SPL* in good faith, with a view to achieving what *SPL* believes to be a fair balance between the different interests of individual policyholders and groups of policyholders, and furthering the interests of policyholders as a whole. They are based, amongst other things, upon assumptions about the future, the fulfillment of which clearly cannot be guaranteed by us. Equally, *SPL* cannot guarantee that the judgements it makes will result in the objectives described in the Principles and Practices set out in this document being achieved.

1.16 With-profits contracts of insurance are long-term in nature. While *SPL* wishes its policyholders to have as clear an understanding as practicable of the material bases on which it seeks to manage the Business, it is not in policyholders' interests for it to do so by reference to inflexible criteria. *SPL* therefore seeks to respond to events in managing the Business, and to evolve the Principles and Practices by reference to them. These Principles and Practices have evolved significantly over time, in response to changing experience within the Business, and changing events outside it. This evolutionary process is likely to continue into the future.

1.17 For these reasons, policyholders are asked not to treat the statements made in this document as binding commitments on, or binding representations by, *SPL* as to how it manages the Business or as to how it will do so in the future. Instead, they represent the criteria to which *SPL* currently has regard, and the objectives it is currently seeking to pursue, in making judgements about the management of the

Business. While those judgements will be made in good faith, the statements in this document are not intended to enable those judgements to be challenged with the benefit of hindsight.

New business

1.18 Other than as described in Section 9 (Volumes of new business) below, the *SPI Fund* is not currently open to new business.

2. Structure of the *PPFM*

The Principles

2.1 The Principles describe *SPL*'s aims and objectives in the management of the Business and are designed to be long-term in nature (although this does not mean they will not change, particularly if there is a need for change due to difficult circumstances). The *PPFM* contains two different types of Principle: 'Overriding Principles' and 'Operating Principles'.

2.2 The Overriding Principles are intended as enduring and overarching standards adopted by *SPL*. There are then more detailed Operating Principles and Practices covering specific topics.

2.3 In the event of any conflict between them, the Overriding Principles take precedence over the Operating Principles and Practices, and the Operating Principles take precedence over the Practices. Within the Overriding Principles, the first and second Overriding Principles take precedence over the others.

2.4 Unless the *FSA* grants a waiver, three months' written notice will be given to those policyholders affected by any intention to change the Principles. *SPL* cannot undertake that every person potentially affected by any change will actually receive a notice.

2.5 Principles are shown in **bold text** in this document.

The Practices

2.6 The Practices aim to set out the way in which *SPL* seeks to manage the Business in more detail. Taken with the Principles, they aim to provide sufficient detail to enable a knowledgeable observer to understand the material risks and rewards for a policyholder investing in the *SPI Fund*. *SPL* may change the Practices without advance notice as *SPL*'s circumstances and the business environment change.

3. Overriding Principles

3.1 The Overriding Principles are as follows:

(1) The *SPI Fund* will be managed on a sound and prudent basis with the objective of securing that its assets are sufficient to meet its liabilities and related reserving and capital requirements without the need for capital additional to its existing resources and such other assets as the *shareholder* may from time to time agree may be utilised[1].

(2) *SPL* seeks to operate within the legal framework governing its long-term insurance business. This framework includes:

(i) the *Scheme* and *SPL*'s Articles of Association;

(ii) the contractual commitments made to all *SPL*'s long-term policyholders (including guarantees); and

(iii) the requirements, from time to time, of the *FSA* as the regulator of its long-term business.

(3) *SPL* aims to balance the interests of different groups of policyholders fairly (and fairly in relation to the interests of the *shareholder*).

(4) Bonus rates may be smoothed so that some of the fluctuations in the value of the investments of the *SPI Fund* are not reflected in payments on with-profits policies.

(5) Returns on with-profits policies may be reduced by adverse experience within the *SPI Fund*, and in extreme circumstances, returns on policies may be reduced by adverse experience on other insurance business in the long-term fund.

(6) *SPL* will endeavour to give policyholders participation in the asset classes they have been led to expect by statements made by *SPL*, and with the overall risk profile in the fund that they have been led to expect by statements made by *SPL* (in each case in the context, for example, of policy documents and related literature, changes in industry investment policies and outlook and the financial condition of *SPI Fund*).

3.2 The first Overriding Principle may impose restrictions on the ability to declare bonuses or may require adjustment to the liabilities, perhaps by reduction to the *net investment returns* credited to the *specimen asset shares* in accordance with Section 4.

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1 Notwithstanding this principle, resilience reserves and risk based capital may be held outwith the *SPI Fund*.

Current Operating Principles and Practices

The following point is necessary to the understanding of this part:

As a general guide, sections lettered (A) below refer to *conventional business*, sections lettered (B) refer to *unitised business*, sections lettered (C) refer *to deposit administration business*, and unlettered sections and sections lettered (D) apply to all three classes.

4. The Amount Payable under a With Profits Policy

Introduction

For most policies the lifecycle is that the policyholder pays a *premium*, or regular *premium*s. We use some of the *premium* to pay our expenses and costs and the rest becomes part of the *SPI Fund* and shares in the *net investment returns*. The policy may receive *annual bonuses* and when the time comes for the policyholder to claim the benefit of the policy we may add a *final bonus* or, for a *unitised* policy, charge an *MVR*. *Final bonus* and *MVRs* are commonly based on our *specimen asset shares*.

Exceptions to this general description are policies where the benefit is not a single payment, but a series of payments. Policies of this type include some pensions schemes covering a group of employees.

The *SPI Fund* is primarily an investment fund. There is some averaging, or *smoothing*, of achieved investment results.

Most policies will have a *sum assured*, but *SPL* may add *annual bonuses* from time to time and may also add a *final bonus* at the end of the policy.

This section discusses in turn the four topics of *specimen asset shares*, *annual bonuses*, *final bonuses* and *smoothing*.

Specimen asset shares

4.1 Sections 4.2 to 4.5 cover the methods used by *SPL* to guide its judgment of the amount that it believes it is appropriate to pay individual with-profits policyholders.

4.2 (1) The normal form of a with-profits policy has historically been that it is subject to either a single *premium* paid at the start or to *premiums* payable in regular (and usually equal) instalments paid annually (or more frequently).

4.2 (2) The *deposit administration* contracts differ from the above in that neither the *premiums* nor the benefits are defined in advance. The *premiums* are determined according to the contributions under an occupational pension scheme, and the benefit is expressed as a notional account from which amounts can be applied from time to time to secure benefits for individual members in terms of the rules of the occupational scheme.

4.2 (3) The primary method used by *SPL* to guide its judgment of the amount it believes it is appropriate to pay individual policyholders is to calculate specimen *asset shares*, although some exceptions apply. There are some

differences in the way *specimen asset shares* are calculated for different classes of policy, both between *conventional business*, *unitised business* and *deposit administration* business and between classes in the *conventional business* category.

Naturally, the size of any particular *specimen asset share* changes over time. It may increase or decrease from time to time, according to (amongst other things) investment performance and other experience within the *SPI Fund* (for example, *specimen asset shares* may be adjusted in order to accommodate exceptional developments within the *SPI Fund*).

The following classifications of *conventional business* policies are relevant for later sections of this *PPFM*:

(i) ***All individual policies treated for tax purposes as basic life assurance and general annuity fund contracts.*** **Endowment assurances (including low-cost mortgage endowments and flexible endowments) and whole of life policies are the main classes in this group.**

(ii) ***Policies written on individual terms for the provision of retirement benefits.*** **This group includes the Self-Employed Retirement Annuity and Personal Pension contracts (SEDA contracts) and the Individual and Executive Pension Arrangement policies (E-Type contracts).**

More details are given in the following sections.

<u>*Conventional with-profits business*</u>

4.3 (1) (A) **For those contracts in classes (i) and (ii) in 4.2 the primary guide to *payout* for a maturing policy (or for a pension policy at a normal retirement date) is *specimen asset share*. A second important consideration is whether the target payment should be 100% of *specimen asset share* (or more or less than 100%). The overall aim is to give each maturing policy its fair share of the available funds, basing *payouts* on *specimen asset shares*, subject to a minimum *payout* based on the *guaranteed benefits* of any particular policy. More details of the current *specimen asset share* calculation method are given in section 4.4.**

<u>*Unitised with-profits business*</u>

4.3 (1) (B) **For all *unitised* contracts the aim is to pay a fair share of the available assets (subject to any *guaranteed benefits*), basing the *payouts* to policyholders on *specimen asset shares* as described in 4.3 (1) (A) above and section 8. More details of the current calculation method are given in section 4.4.**

<u>*Deposit administration* business</u>

4.3 (1) (C) **For the *deposit administration* contracts the aim is that the notional account available to secure benefits for members represents a fair share of the available assets, based on *specimen asset shares* as described above, subject to any guarantees applying to each contract.**

<u>General</u>

4.3 (1) (D) **In seeking to achieve the aims set out in paragraphs (A) to (C) above, *SPL* is bound by the terms of the *Scheme*.**

4.3 (2) ***SPL* does not calculate *asset shares* individually for each policy, but uses *specimen asset shares* based on *specimen policies* that represent groups of policies with the same material characteristics. *SPL* aims to calculate the *specimen asset shares* for its *specimen policies* to within an accuracy of a few percentage points. However the application of other principles and practices, particularly the degree of *smoothing* applied (see section 4.12), may result in a wider gap between the *specimen asset share* and the actual *payouts*. Guarantees of minimum amounts may also apply.**

4.3 (3) **Material changes to methods would only be made following a decision of *SPI Fund Supervisory Committee*, based on a recommendation by the *Actuary*. Any change in the methods is subject to the terms of the *Scheme*.**

4.3 (4) ***SPL* seeks to base its decisions on what it believes to be the best and latest reasonably available information. Assumptions and parameters for the current and immediately previous year are subject to revision at any time as more detail becomes available on emerging trends. Such assumptions and parameters will be set by the *Actuary* and reported to the *SPI Fund Supervisory Committee*.**

Changes to assumptions and parameters for earlier years would be unusual and made only after the *Actuary* had submitted a report to the *SPI Fund Supervisory Committee* giving his explanation and justification for the changes.

Examples of previously applied assumptions and parameters that might be changed in this way are *net investment returns*, charges or allocations of miscellaneous surplus that have been derived from the *SPI Fund*'s historical experience and actions.

<u>*Conventional with-profits business*</u>

4.4 (1) (A) (i) This subsection describes the method used to calculate the *specimen asset shares* for endowment policies in class (i) of 4.2 (3).

Background: the Scheme

The starting point for the calculation of *asset shares* are the relevant provisions of the *Scheme*. In summary, the *Scheme* required *asset shares* to be determined by the *Actuary* as at the effective date for the *Scheme* using the *asset share* basis and methodology

employed by *SPI* prior to the effective date of the *Scheme*. The accumulation thereafter must be in a manner consistent with that basis and methodology, except to the extent required to allow for the distribution of any surplus assets in accordance with the *Scheme*.

In determining the underlying rate of investment return applicable to the accumulation of *asset shares* in respect of each class of *SPI Fund* With-Profits Policies, the *Scheme* requires assets to be notionally ring-fenced separately to UK and Irish business and, within each such territory, separately to Active Simplified Pension Investment Plans and other *SPI Fund* With-Profits Policies, having regard to *SPI*'s practice in respect of such notional ring-fencing of assets prior to the effective date of the *Scheme*.

Paragraph 5 of Schedule 2 of the *Scheme* deals with this subject in more detail. In practice, *SPL* calculates *specimen asset shares* using net rates of investment return.

Current Practices

Within the framework set by the *Scheme*, *SPL* currently seeks to adhere to the following practices.

Specimen asset share calculations are done separately for a range of policy terms starting in different years and now due to mature. The method is based on *specimen policies*. This means that:

- We take a sample average sized policy;
- We charge an estimate of the cost of death benefits under the life assurance element of the policies;
- We charge an estimate of the expenses incurred in maintaining the policies and managing the business; and
- We allow for each year's *net investment return*.

We will do this for a range of policies in each main business class.

An adjustment may be made to *specimen asset shares* with a view to distributing any surplus or deficit in the *SPI Fund* either immediately or over a period up to and including the remaining lifetime of the *SPI Fund* with profits policies, as required under the *Scheme*. This adjustment is currently implemented by means of an enhancement or reduction to the *net investment return* credited to *specimen asset share*. The enhancement or reduction is reviewed from time to time, and in any case normally not less frequently than every three years.

4.4 (1) (A) (ii) This subsection describes the method used to calculate the *specimen asset shares* for policies in class (ii) of 4.2 (3). The method is similar to that described for class (i) above (and the comments regarding the *Scheme* Principles apply), but with appropriate allowance for the following differences:

(a) The policies are pensions policies and are subject to different tax treatment.

(b) On the early death of a policyholder, these polices will tend to yield a profit to the fund or have a neutral financial effect, rather than to cause a loss.

Unitised with-profits business

4.4 (1) (B) This subsection describes the method used to calculate the *specimen asset share* for *unitised* policies. The comments in 4.4 (1) (A) (i) regarding the *Scheme* also apply in this context.

A model is maintained which rolls up an accumulation of a specimen allocation of investment premium at the achieved *net investment return*, and allowing for the adjustments described in 4.4 (1) (A) (i). The model allows for the different tax treatment of different classes and for the applicable management charges. The annual management charge allowed for in this calculation is currently fixed at 0.60% per annum for life policies and 0.85% per annum for pensions policies. These are the charges which applied before demutualisation and are considered by the *SPI Fund Supervisory Committee* to be consistent with policyholders' reasonable expectations. The resulting accumulation for the date of the *premium* concerned is taken as the *specimen asset share* for *units* allocated in the year of that start date.

Deposit administration business

4.4 (1) (C) This subsection describes the method used to calculate the *specimen asset share* for *deposit administration* policies.

A model is maintained which rolls up an accumulation of the aggregate amount of *premiums* paid, less explicit charges, at the applicable rate of *net investment return*, and allowing for the adjustments described in 4.4 (1) (A) (i). The resulting accumulated value is adjusted at the end of each calendar year to reflect the fact that a proportion of the notional account will be deemed to have been used to secure benefits. The resulting adjusted accumulation is then comparable with the notional account value. There are several tranches of notional account bearing different guarantees, and this calculation is carried out for each tranche separately. The resulting adjusted accumulation for each tranche is taken as the *specimen asset share* for that tranche over all relevant policies.

General

4.4 (1) (D) The *specimen asset share* is compared to any guaranteed minimum payments promised to the policyholder. Where any guarantee gives an amount greater than the *specimen asset share* the guaranteed amount is paid.

4.4 (2) Some of the assumptions and parameters used relate to factors that apply to all classes of policy. The principal assumptions in this group are:

(a) *Net investment return*, based on the actual return achieved in each calendar year, adjusted as necessary for tax and other charges.

(b) Taxation, based on what *SPL* judges to be a best estimate of actual current tax payable, in particular in relation to taxation of investment returns and tax relief available on some expenses.

(c) Investment expenses, based on what *SPL* judges to be a best estimate of the actual expense incurred or, for periods after demutualisation, the terms of the *Scheme*.

(d) Other profits and losses reasonably allowable or chargeable against the relevant classes (*eg* for the costs of certain guarantees, as described in 6.4, and capital reserves).

Conventional with-profits business

4.4 (2) (A) There are some assumptions and parameters used only for *conventional* with profits policies. The principal such assumptions are:

(a) *Premium* size. This is based broadly on a typical policy size for the starting year concerned.

(b) Any allowance for death benefits is based on one of the standard industry mortality tables.

(c) Expense charges other than investment expenses. These are based on:

a. Our own detailed analysis of actual incurred running costs.

b. An initial cost based on an estimate of typical costs for the year of entry.

c. For periods after demutualisation, the terms of the *Scheme*.

4.4 (3) (A) Within each of the classes listed in 4.2, *SPL* currently uses common assumptions and common values for many parameters and uses *specimen policies* to represent a group of policies whose material characteristics are similar. There is, therefore, a degree of approximation, but such approximation is a reflection only of the sharing of experience that is part of the essential character of with-profits business. This approximation, or shared experience, is across generations of policyholders and between types of policy within each of the broad classes in 4.2.

Unitised with-profits business

4.4 (3) (B) For the *unitised* classes, the experience within the *SPI Fund* borne by the policies is limited to the investment and financial experience and other profits and losses reasonably allowable or chargeable against the relevant classes. Other elements, such as expenses, are dealt with outside the *SPI Fund*. Guarantee and other costs may be charged against the investment return where *SPL* judges it to be appropriate. The sharing and approximation is limited to the assumption that within any completed calendar year, the achieved *net investment return* accrued evenly over the year.

<u>*Deposit administration* business</u>

4.4 (3) (C) For the *deposit administration* contracts the experience within the *SPI Fund* borne by the policies through *specimen asset shares* is limited to the investment experience of the part of the *SPI Fund* ring-fenced to these contracts and other profits and losses reasonably allowable or chargeable against these contracts. Guarantee and other costs may be charged against the *net investment return* where *SPL* judges it to be appropriate. The sharing and approximation is limited to the assumption that within any completed calendar year, the achieved *net investment return* accrued evenly over the year. *SPL* believes this degree of sharing of experience is consistent with the nature of these contracts.

4.4 (4) The overall methods for determining *specimen asset shares* are as documented in the *PPFM* (as updated from time-to-time). What *SPL* believes to be sufficient further details of the underlying models to enable them to be taken over by new staff are included in the procedure notes for the models used and successive changes to the parameters and assumptions are documented in reports submitted to the *SPI Fund Supervisory Committee*.

The interpretation of the results and the development of proposed bonus scales are documented in the reports submitted by the *Actuary* to the meetings of the *SPI Fund Supervisory Committee* at which decisions on new scales of bonus are to be taken.

4.4 (5) The methods and parameters discussed in this section 4.4 are subject to controls exercised by the *Actuary*, the *SPL Board* and the *SPI Fund Supervisory Committee*.

Values for parameters for the current or previous year that are assessed under agreed methods will be subject to sign-off only by the *Actuary* and reported to the *SPI Fund Supervisory Committee*. Changes to parameters for earlier periods will be made by the *Actuary*, but only after the submission to the *SPI Fund Supervisory Committee* of a written report explaining and justifying the changes.

Changes to methods will be subject to sign-off by the *SPI Fund Supervisory Committee* on the recommendation of the *Actuary*.

4.4 (6) *SPL* may set aside reserves within the *SPI Fund* to cover matters relevant to policyholders' interests and security. In considering whether this is necessary (and if so how much to set aside), factors that are likely to be relevant include:

(i) the level, and volatility, of asset values and the return on such assets;
(ii) the levels, and volatility, of interest rates;
(iii) past and projected mortality;
(iv) the credit and liquidity risks run in the *SPI Fund*;
(v) the operational risks that are run in the *SPI Fund*;
(vi) exercise of policyholder options;
(vii) the extent to which the various risks that the *SPI Fund* runs are likely to occur at the same time;

(viii) actual, or possible future, changes in the investment, tax, legal or regulatory environment of the *SPI Fund*;
(ix) the level and availability of capital support to the *SPI Fund*, (such as the financial support discussed in section 10.4);
(x) the extent to which it is appropriate to anticipate the introduction of management actions (as discussed in 10.4); and
(xi) any other factors relevant to the individual capital assessment or the enhanced capital requirement of the *SPI Fund*.

4.5 The sections above contain general descriptions of how *SPL* brings investment returns, other profits and losses, expenses, charges and tax into account in determining the guideline amounts for payments to policyholders. Further details of the determination of actual amounts to be paid are included under *final bonuses* (sections 4.9 to 4.11 below). Some further specific details are noted in the subsections below.

4.5 (1) In recognising the *net investment return* to use in its calculation of *specimen asset shares SPL* currently makes only those distinctions between different parts of *SPI Fund*, or between different classes of policy, that are documented in 4.4 above. The actual calculations use net of tax returns and the different tax applicable to different classes of business is allowed for.

This practice has evolved to the current position over a period of many years. It is possible, for reasons of fairness, that the practice will continue to evolve.

For example, if it is fair to do so, *SPL* may in recognising the *net investment return* to use in its calculation of *specimen asset shares*, make further distinctions between different parts of the *SPI Fund*, or between different classes and vintages of policy. In particular, the return from any assets bought specifically to cover guarantees may be reserved to meet the costs of these guarantees.

4.5 (2) In setting the expense parameters to use, *SPL* expects to set these at levels that would, if applied across all policies, give an overall level of expenses close to the actual expenses apportioned to the *SPI Fund*. The general basis for setting the charging and expense parameters is that laid down in the *Scheme*.

In summary, the *Scheme* provides that there shall be charged to the *SPI Fund* only such part of the total costs, liabilities and expenses incurred by *SPL* as the *Actuary* and the *SPI Fund Supervisory Committee* consider fair and equitable, having regard to policyholders' reasonable expectations.

The *Scheme* then goes on to set out, in detail, (by way of elaboration of this provision) the charges to be borne by the *SPI Fund* in the 10 years following demutualisation.

4.5 (3) The *Scheme* contains complex and detailed provisions regarding the taxation of the *SPI Fund*. In summary, *SPL* is to charge (or credit, as the case may be) the *SPI Fund* for taxation (as defined therein) as if the *SPI Fund* constituted the whole of a long-term fund of a mutual life assurance company carrying on business in the UK and Ireland with no other business other than the business carried out in the *SPI Fund*.

In setting the parameters for netting down gross items to net of tax amounts for use in the model the aim is to set parameters at levels that would, if applied across the whole fund, result in a tax charge broadly similar to that actually paid by the *SPI Fund*.

4.5 (4) When bonus is allocated to *conventional* and *deposit administration business* the *shareholder* is entitled to a transfer of one ninth of the value of the allocated bonuses. These transfers can give rise to a tax charge on the company. Neither the relevant cost of transfers to *shareholders* on surplus distribution, nor any additional tax attributable to the transfer is charged to the *specimen asset shares* of policies.

4.5 (5) Guarantees, other risks and cost of provision of capital may be charged for within the calculation of *specimen asset shares*. To the extent that any such costs fall on the *SPI Fund* and are not charged to *specimen asset shares* they will affect the overall level of surplus or deficit within the fund. This may then have an effect on the actual payment scale adopted, either through the mechanism of influencing the percentage factor described in the first paragraph of 4.3 (1) (A) and sections 8, or that of influencing the adjustment described in 4.4 (1) (A), or both. The effect of guaranteed *annuity* options under certain pensions plans is discussed under the *final bonuses* section below.

4.5 (6) When a policy surrenders early there may not be a corresponding reduction for factors relevant to the risks contributing to the individual capital assessment or the enhanced capital requirement. A charge is made against the asset share based on a fair contribution to potentially higher costs which would otherwise fall on the continuing with-profits policies.

Annual Bonuses

4.6 Although most of *SPL*'s *annual bonus* rates are currently zero, Sections 4.7 and 4.8 cover *SPL*'s approach to setting *annual bonus* rates for policies in the *SPI Fund*. *Annual bonuses* normally become guaranteed additions to the policy benefits, so long as the benefits are not surrendered early.

If positive returns are made on the *SPI Fund*'s investments, at present, *SPL*'s priority will be to direct *net investment returns* towards increasing *surrender values* and *final bonus* levels (including, where applicable, reducing *market value reductions*), before declaring *annual bonuses*. These practices will be kept under review and are subject to change in light of circumstances.

The framework for the *SPI Fund*'s bonus policy is set by the *Scheme*, and the following Principles and Practices should be read with that context in mind.

For the *conventional* with profits policies, *annual bonuses* take the form of percentage additions to the benefit payable on the policy. For *unitised* policies they take the form of an annualised growth rate in the bid value of the *units*, as an addition to a guaranteed minimum growth rate (the latter may be zero). For *deposit administration* business they take the form of an

annual rate of increment on the value of the notional account, as an addition to a guaranteed minimum increment (the latter may be zero).

4.7(1) **The *Scheme* provides that *annual bonuses* will be maintained at levels consistent with policyholders' reasonable expectations, having regard to the past practice of *SPI*. Consistent with such past practice, any changes to *annual bonus* rates will be gradual under normal circumstances.**

***SPL*'s general aim in setting rates of *annual bonus* is to give policyholders the security of having guaranteed addition to benefits, but only to the extent that the company believes such guarantees will be supportable under reasonably foreseeable economic conditions and that the giving of them would not adversely affect other policyholders.**

Conventional with-profits business

4.7 (1) (A) ***SPL* believes that the following factors are relevant in determining classes of *conventional business* for which different rates of *annual bonus* would be appropriate:**

(i) The tax treatment of the policy.

(ii) The assumptions in the *premium* basis and in particular any guarantees.

(iii) Any *sum assured* explicitly included in the policy document.

(iv) Material in marketing, policy or other relevant literature that gives rise to expectations of future actions.

(v) The form in which benefits can be taken.

The first Overriding Principle leads to a general constraint on *SPL* in that it will declare *annual bonuses* only if it believes it can do so without undue risk to its solvency. If the *SPI Fund* has no, or very little, surplus of its own, there is likely to be no *annual bonus*.

Unitised with-profits business

4.7 (2) (B) ***SPL* has several different series of with-profits *units*. Bonus rates may vary between series, and within any one series the rate for *units* allocated to life assurances may be different to the rate for *units* allocated to pension plans. Certain series also offered 'initial' *units* which were to be subject to higher charges, and correspondingly lower bonus.** The factors that have caused different series to be thought necessary or desirable have been:

(i) The relevant business was to be subject to a different tax treatment.

(ii) The underlying guarantees were to be different.

(iii) The policies to which the *units* applied were issued in the UK or Ireland (as Irish branch business).

***Units* denominated in UK and Irish currencies respectively will have *net investment returns* based on the ring-fencing of assets described above.**

4.7 (2) (D) **The *SPI Fund* is not currently open to new policyholders, but the factors referred to in 4.7 (2) (B) would be relevant (amongst other things) to any decision on a new bonus class were the *SPI Fund* to be reopened. In any event, the ability of the *SPI Fund* to reopen is constrained by the *Scheme*.**

Conventional with-profits business

4.8 (1) (A) *Annual Bonus* on *conventional* contracts in the *SPI Fund* is guaranteed once added, although the guarantee applies only at maturity and (usually) death. On early surrender there is no entitlement to the full nominal value of the bonus.

The contracts in the classes being discussed are usually long term. Life plans are contracts for at least 10 years, although some pension plans can be for shorter terms. *SPL* can, therefore, take a longer term view, often averaging experience over several years. The *annual bonuses* carry a guarantee once declared and so a conservative view (*ie*, an underestimate of likely surpluses) is appropriate. It follows that the *annual bonuses* are normally based on a deliberately low estimate of average results although during a period of high investment returns some of the excess may be used to declare a higher bonus. Any shortfall between the declared *annual bonuses* and the actual results can be covered by *final bonuses* (subject to *smoothing*).

SPL aims not to have rapidly varying *annual bonuses*, although this policy may be affected by experience - such as an unexpected period of poor investment performance. Accordingly, there must be an expectation that a roughly similar (but not necessarily identical) bonus rate to that in place at the time of the adoption of this document could be declared in the immediately following few years.

It is possible to calculate the bonus rate that would result from an estimate of future experience. *SPL*'s starting point for *annual bonuses* is the bonus supported by a low estimate of likely average investment returns and adjusted for tax and any non-investment factors that are thought likely to be significant. One such factor that can be important is the effect of any guaranteed options inherent in the contracts. Two examples of guarantees which might be allowed for are the guaranteed *annuity* options attached to some pension plans, and also the underlying guaranteed *sum assured*. The cost of this latter item has historically been much higher for business in class (ii) of section 4.2 (3) than for class (i).

The groupings of policies indicated in 4.2 should normally expect to share an *annual bonus* scale within each of the groupings.

Recent economic experience will be relevant to the extent that for those contracts where a *final bonus* can be paid under the policy terms, *SPL* aims to keep an element of the potential benefit to pay in the form of *final bonus*. After a period of less favourable conditions, any margin for *final bonus* will have been reduced and one way of helping to rebuild the margin

is to have a lower rate of *annual bonus* for a period. In particularly adverse conditions (as have applied in 2002 and 2003) the general constraint referred to in 4.7 (1) may apply. Conversely after a period of favourable experience and growing *final bonuses*, some of the potential for *final bonus* may be converted to *guaranteed benefit* by means of a higher *annual bonus*.

Unitised with-profits business

4.8 (1) (B) For the *unitised business*, *annual bonus* is the rate at which the *unit* price grows. It is declared in advance as an annual rate, although the *unit* prices are recalculated daily to reflect the declared rate. The starting point for *annual bonuses* will be the current expectation of the average long term *net investment return* on the fund. From this will be deducted, for example:

(i) Any tax due. That is, *SPL* expects to reflect the tax differences between Life and Pensions, and between UK and Irish business.

(ii) An annual management charge as described in 4.4 (1) (B).

(iii) An annual allowance for a build-up of *final bonus*. The allowance will vary with the investment strategy. Typical current annual allowances might be 1% if all investments were in government fixed interest bonds, or 2.5% if 50% of the fund were in ordinary shares traded on the stock market.

(iv) A further deduction may apply where there are higher guarantees (and so restrictions on *SPL*'s ability to apply *MVRs*).

Historically, the actual bonus has often been in excess of the rate that this formula would give and there have been successive reductions to move towards the target. The formula automatically brings in one aspect of current economic conditions, the expected long term return. Recent economic experience would also be a factor in that after a period of favourable experience (as applied during much of the 1990s), *SPL* would be more tolerant of rates in excess of the target and conversely after a period of adverse experience would aim for a lower rate. In seriously adverse conditions the general constraint referred to in 4.7 (1) above might apply.

Some *units* have guaranteed minimum rates of 4% on the pension *units* and 3% on the life *units*. These minimum rates should continue, even if other rates are zero. Some older pensions plans had 'initial' or 'capital' *units* allocated in respect of their first few monthly *premiums*. These carry an extra annual management charge which reduces the rate at which the price of these *units* grows, and in some cases may cause the price of 'initial' or 'capital' *units* to reduce.

Deposit administration business

4.8 (1) (C) *Annual Bonus* on *deposit administration* contracts in the *SPI Fund* is 'guaranteed' once added, although the guarantee applies in full only on application of the notional account to secure benefits for an individual member. The starting point for setting the *annual bonus* is the bonus that could be supported by a low estimate of likely investment returns.

However, the term of the contract is inherently uncertain as it depends on the incidence of retirements and other events that give rise to benefit payments. A bulk transfer value payment may occur as a result of the occupational scheme being wound up or seeking alternative investments. Contributions to an occupational pension scheme will also vary from year to year, giving rise to unpredictable variations in the *premiums* paid. *SPL* therefore aims to set bonuses such that the level of notional account will, subject to the effect of any guarantees, be close to the *specimen asset share*, with a view to meeting the aim of 4.3 (1) (C). It follows that if *specimen asset shares* are relatively low, *annual bonuses* are likely to be lower than those implied by a low estimate of *net investment return*. Conversely when *specimen asset shares* are relatively high bonuses are likely to be higher than those implied by a low estimate of *net investment returns*.

Conventional with-profits business

4.8 (2) (A) For *conventional business*, *annual bonuses* are declared once a year. This annual declaration is a declaration for the policy year ending in the calendar year just completed.

Unitised with-profits business

4.8 (2) (B) For *unitised business*, the rates are set for the future. The time for which they will apply is not fixed and they are reviewed from time to time. There will be a review at the time of the annual declaration for *conventional business*. There will also be a review in the middle of the year, although this mid-year review is less likely to lead to a change in rate. In principle the rate can be reviewed at any time, but reviews more often than twice a year would be exceptional.

Deposit administration business

4.8 (2) (C) For *deposit administration* business, the *annual bonus* rates are declared once a year and apply to the policy year ending in the calendar year just completed.

Conventional with-profits business

4.8 (3) (A) Subject always to the general constraint referred to in 4.7 (1), *SPL* would not expect to change an *annual bonus* rate on any of the *conventional* classes by more than the larger of a change in the percentage rate of 1, or 25% of its previous value.

Unitised with-profits business

4.8 (3) (B) Subject always to the general constraint referred to in 4.7 (1), *SPL* would not expect an *annual bonus* rate on any of the *unitised* classes to change at any one resetting by more than the larger of a change in the percentage rate by 1, or 25% of its previous value. Where there has been more than one change in any calendar year the normal limit for aggregate change for the year would be the larger of a change in the percentage rate of 2, or 40% of the value at the end of the previous year.

Deposit administration business

4.8 (3) (C) The *annual bonus* rates on the *deposit administration* business are normally declared as a percentage addition to the relevant rate of guaranteed increments which are themselves defined as a percentage of the notional fund. Subject always to the general constraint referred to in 4.7 (1), *SPL* would not expect to change an *annual bonus* rate on *deposit administration* business by more than the larger of:

(i) 30% of the relevant rate of guaranteed increment, or

(ii) 2% of the notional fund.

Conventional with-profits business

4.8 (4) (A) On the *conventional* classes included under (i) and (ii) of 4.2 (3), the *annual bonus* declared applies for years in the past. *SPL* may declare an interim bonus to apply for claims arising during the current year to allow for the period for which no bonus has yet been declared. This is most commonly set at the same rate as the most recent declared rate, but it may be set at a different rate if there is an expectation that the next declared rate will be at a different level.

Unitised with-profits business

4.8 (4) (B) The concept of interim bonus does not apply to the *unitised business.*

Deposit administration business

4.8 (4) (C) On the *deposit administration* business, the *annual bonus* declared applies for years in the past. *SPL* may declare an interim bonus to apply for claims arising during the year on account of the current period for which no bonus has yet been declared. This is most commonly set at the same rate as the most recent declared rate, but it may be set at a different rate if there is an expectation that the next declared rate will be at a different level.

Final Bonuses

4.9 Sections 4.10 and 4.11 cover *SPL*'s approach to setting *final bonus* rates. *Final bonuses* are adjustments made to the claim value of a with-profits policy which is terminating in whole or in part.

Final bonuses may be declared on all *unitised* policies and on those *conventional* policies in classes (i) and (ii) of 4.2 (3).

For *deposit administration* contracts, *SPL* would not normally expect to declare *final bonuses* as the approach to *annual bonuses* is designed to produce *payouts* close to the *specimen asset shares* for these contracts.

The framework for the *SPI Fund*'s bonus policy is set by the *Scheme*, and the following Principles and Practices should be read with that context in mind.

4.10 **The *Scheme* provides that *final bonuses* will be set having regard to the intention that *payouts* on maturity, vesting and surrender should be determined by reference to *asset shares* (as determined in accordance with the *Scheme*), subject to the application of *smoothing* (in accordance with the *Scheme*).**

Conventional with-profits business

4.10 (A) The subsections (i) and (ii) below of this section describe the Principles that apply to the setting of *final bonus* for the contracts in the correspondingly numbered subsections of section 4.2 (3).

4.10 (A) (i) **Where, at the maturity date of an endowment, the *guaranteed benefits* and the *annual bonuses* added over the years are materially less than the *specimen asset share* already described, then *SPL* will seek to reduce (but not necessarily eliminate) the gap by declaring, subject to *smoothing* (see *Smoothing* section below), a scale of *final bonuses*.**

Whole life contracts and endowment contracts that become death claims will be given the same *final bonus* rate as applies to maturing endowments that have been in force for the same period.

4.10 (A) (ii) **These contracts are pensions business. For the SEDA contracts the benefit available at the normal retirement date is an *annuity* payment. For the E-type contracts the benefit available at the normal retirement date is a choice between a cash fund and an *annuity* payment, with conversion rates between cash and *annuity* which are fixed in the policy conditions and which may not reflect the economic conditions at the time of retirement. The general principles for setting *final bonus* are as for endowment policies in (i) above except that the *specimen asset share* is compared with a *specimen* cash sum which represents the value of the benefits to be taken into account for determining *final bonus*. For the SEDA contracts the relevant cash sum is the cost of purchasing the *annuity* benefit on *SPL*'s current immediate *annuity premium* rates. For the E-type contracts the relevant cash sum is the cash fund.**

Unitised with-profits business

4.10 (B) **For *unitised business* the term '*final bonus*' can be interpreted in two ways. Each policy will have certain occasions when a negative amount cannot be applied, but for surrender at other times the '*final bonus*' can be negative or positive (or zero). A positive adjustment is normally called a *final bonus* and a negative adjustment a *Market Value Reduction* (*MVR*). The same methods and principles apply in both circumstances except that the target percentage of the *specimen asset share* may differ on surrender.**

The overall aim is to pay out over time something close to the full amount of the *specimen asset share* to policyholders as a class, but this may be modified as indicated in 4.3 (1) (B) and 4.4 (1) (B).

Deposit administration business

4.10 (2) (C) **Under a *deposit administration* contract, benefits are taken principally by securing benefits for members of an occupational scheme as they retire at various times during the lifetime of the contract. Bonuses payable on the eventual termination of the policy would be inappropriate as most of the members' benefits would have already been secured.**

Conventional with-profits business

4.11 (1) (A) (i) For life policies (class (i) of 4.2 (3)) the *final bonus* is currently declared as a percentage addition to the *sum assured* and accrued *annual bonuses*. *SPL* will calculate for a *specimen policy* for each term of maturing endowment the theoretical *final bonus* rate required to match the *payout* to the *specimen asset share*. *SPL* may then adjust the theoretical figures to give a reasonably smooth progressive scale. The aim of the adjustments will not be to alter materially the overall amount to be paid, but only to produce a reasonably regular scale.

Recent economic experience is already reflected in the calculation of the *specimen asset share* and may be further reflected in the degree of *smoothing* applied (see sections 4.12 to 4.14 below).

Policies becoming claims by death are currently awarded the same rate of *final bonus* as maturing endowments of the same completed duration (if there are such policies). For terms below 10 years and for very long terms there may be no maturing policies and in these cases *SPL* projects any apparent trend from the terms at which matures are occurring. Lower rates of *final bonus* may apply to endowment policies surrendered before the maturity date or to whole life policies that are surrendered, as opposed to becoming a claim by death.

4.11 (1)(A)(ii) For pension policies (class (ii) of 4.2 (3)) the *final bonus* is declared as a percentage addition to the *sum assured* and accrued *annual bonuses*. The method used to set the scale is similar to that described in 4.11 (1) (A) (i) with the following differences:

(a) In calculating the theoretical *final bonus* rate *SPL* will use the specimen cash sum described in 4.10 (A) (ii).

(b) Calculations are carried out separately for regular *premium* and single *premium* policies and for the SEDA and E-Type contracts. Separate *final bonus* scales are set, in each case aiming for average rates that are reasonably representative of each of SEDA and E-type policies and for each of regular and single *premium* policies.

(c) The scale set for single *premium* policies may be irregular to reflect the impact on *specimen asset shares* of the variability of investment returns between calendar years.

Recent economic conditions can affect the scale in three ways. It affects the calculation of the *specimen asset share*, it may affect the calculation of the specimen cash sum and it may be a factor affecting the application of *smoothing*.

Lower rates of *final bonus* may be paid to policies where a benefit is being taken at dates other than those on which *guaranteed benefits* apply under the policy.

Unitised with-profits business

4.11 (1) (B) For *unitised business* a model is maintained which calculates a roll-up of *premiums* for *specimen policies*. Two sets of calculations are carried through. One is a roll-up at the rates of *annual bonus* that have applied over the years and the other is a roll-up at the achieved *net investment returns*. The *net investment return* is adjusted for charges, the cost of guarantees (as described in 6.4) and, where relevant, net of tax. The *net investment return* may also include a deduction for the costs of charges and expenses where *SPL* judges such a charge to be appropriate. The *net investment return* in any one calendar year (other than the current year) is deemed to have accrued evenly over the year. This implies a degree of investment *smoothing* on the way in. Calculations are performed separately for *units* allocated in various periods. These *unit* allocation periods generally correspond to calendar years but may be shorter, for example where investment returns have varied particularly widely or rapidly.

The primary output from the model is the ratio that the roll-up at the *net investment return* bears to the roll-up at the bonus rates. Where this ratio is greater than 1.000 there is potential for a *final bonus* and where the ratio is less than 1.000 there is theoretical justification for an *MVR*. The overall aim is to pay out over time something close to the full amount of the *net investment return* (after the deductions referred to above) to policyholders as a class, subject to *smoothing*. The neutral value of 1.000 for the ratio may be departed from when the 100% factor discussed in 4.3 (1) (A) and sections 8 and 10.4 is departed from.

Different scales also apply to contracts subject to different tax treatment and to contracts denominated in different currencies.

Irish life business does not have a separate scale. The scale produced for Irish pensions policies is applied to Irish life policies.

Within each scale of *final bonus* or *MVRs* a different rate may apply to each of the *unit* allocation periods referred to above.

Where policy conditions allow, *MVRs* may also be applied when there has been, or is expected to be, a high volume of surrenders in relation to the liquidity of the *SPI Fund*.

When a new scale of *final bonus* or of *MVRs* is set the aims are:

(a) To set the scale at levels such that no individual policyholder is more than a few percentage points away from the theoretical result.

(b) To limit the size of change for a given policy at any one review. Changes in excess of 10% in the *payout* level should be exceptional. There is, however, no limit on the frequency of reviews.

There will often be some conflict between these aims, particularly following periods when large stock market movements have been recorded. Aim (a) would normally be taken as having priority.

4.11 (2) *Unitised business* scales of *final bonus* are set by the *SPI Fund Supervisory Committee*. The setting of *MVRs* is delegated to the *Actuary* by the *SPI Fund Supervisory Committee.* Whenever a new *final bonus* scale is set, a new *MVR* scale accompanies it with there being no *units* subject to both *final bonus* and *MVR*. However, if conditions deteriorate and the *Actuary* decides to introduce a new *MVR* scale, without there being a new *final bonus* scale, it is possible that there will be *units* to which both an *MVR* and a *final bonus* would apply. The calculation systems will apply both rates and produce a net result.

4.11 (3) The amount payable on a *conventional* policy that is being surrendered or transferred up to a few years before the date on which the *guaranteed benefits* apply will be aimed at achieving a *specimen asset share* based on a *specimen asset share* calculated similarly to 4.3 (1) (A), but may use a percentage figure of *specimen asset share* that might differ to that used for maturing policies.

<u>*Conventional with-profits business*</u>

4.11 (4) (A) *SPL* currently reviews the scales of *final bonus* twice a year for *conventional* policies, although it reserves the right to review them more frequently should there be a material alteration in the economic conditions or the current assessment of the financial position of the *SPI Fund*. For this purpose a material change would normally be one that might affect the *specimen asset shares* by 10% or more.

<u>*Unitised with-profits business*</u>

4.11 (4) (B) *SPL* currently reviews the scales of *final bonus* twice a year for *unitised business*, although it reserves the right to review them more frequently should there be a material alteration in the economic conditions or the current assessment of the financial position of the *SPI Fund*. The *unitised business* is treated as incorporating less *smoothing* than *conventional business* and for this purpose a material change would normally be one that might affect the *specimen asset shares* by 5% or more. The *MVR* scales are checked more frequently, although many reviews do not lead to a change in the scale.

Smoothing

4.12 Sections 4.13 and 4.14 cover *SPL*'s approach to *smoothing*. *Smoothing* means that the amount paid or allocated as bonus may not be exactly equal

to the *specimen asset shares*. Section 4.15 notes the target ranges that indicate the limits of *smoothing*. There are two types of *smoothing*:

(a) *smoothing* changes over time when making *payouts*; and

(b) *smoothing* differences in *payouts* across different vintages of policies within policy classes.

4.13 **The framework for *smoothing* is provided by the *Scheme*. According to the *Scheme*, *payouts* at maturity, on vesting and on surrender of *SPI Fund* With Profits Policies will, subject to any minimum guaranteed amounts, be determined by reference to *asset shares* (as determined in accordance with the *Scheme*) and will be smoothed having regard to the *smoothing* policy employed by *SPI* before the effective date of the *Scheme* so as to avoid, other than in exceptional circumstances, excessive differences in *payouts* on similar policies over short periods of time.**

The following Principles and Practices should be read in the context of this framework.

4.13 (1) ***SPL* may differentiate in its *smoothing* policy between claims of different types, in particular:**

(i) Early surrenders may be treated differently than maturity or death claims.

(ii) *Unitised* contracts will be subject to less *smoothing* than will apply to *conventional business*.

4.13 (2) ***SPL* is required by the *Scheme* to manage bonus policy with the overriding aim to distribute all the surplus of assets over liabilities in the *SPI Fund* over the remaining lifetime of the with-profit policies in the *SPI Fund*. To this extent, *smoothing* must therefore be neutral over the lifetime of the fund. *SPL* has not adopted any specific shorter time period over which it will aim for *smoothing* to be neutral.**

4.13 (3) ***SPL* believes the total cost or scale of *smoothing* over the shorter term should be kept small in relation to the size of the fund.**

Conventional with-profits business

4.13 (4) (A) **Other than in exceptional circumstances, *SPL* expects to base any decision to change the surrender bases for conventional with-profits policies primarily on whether *specimen asset shares* are sufficient to support the *payouts* resulting from the current scale.**

A percentage adjustment such as is referred to in 4.3 (1) (A) may apply, although the percentage is likely to be lower than would be applicable to a date on which *guaranteed benefits* would apply. Secondary influences may include the rate of surrenders in the fund and the overall level of surplus in the fund (and considerations similar to those noted in 4.3 (1) (A) apply).

Unitised with-profits business

4.13 (4) (B) **Other than in exceptional circumstances, *SPL* expects to base any *MVRs* for *unitised business* primarily on a comparison of the *specimen asset shares* with the *annual bonus* additions. The percentage adjustment referred to in 4.3 (1) (B) may apply and may differ from that which would be applicable to a date on which *guaranteed benefits* would apply. Secondary influences will be the rate of surrenders in the fund and the overall level of surplus in the fund (considerations similar to those noted in 4.3 (1) (A) apply).**

4.14 (1) The speed at which *SPL* might adjust the value of with-profits policies will not be affected by any rule that *smoothing* requires to be neutral over any specific time period other than over the life of the fund. On a short to medium-term basis *SPL* is more likely to be influenced by the degree of over or under-payment in current *payouts* and the aggregate result of previous *smoothing*. As the overall resources of the fund are limited, any over-payment to one group of policyholders has the result that there is less available for other groups of policyholders. If *SPL* believes the current *payouts* are potentially a material drag on the likely future *payouts* to policyholders remaining in the fund it is likely to adjust the value of current *payouts* quite rapidly.

4.14 (2) For the purpose of 4.13 (3) 'small' is currently taken to be 5% of the fund.

Conventional with-profits business

4.14 (3) (A) *SPL* seeks to apply different strategies for certain different classes of policy.

For policies in classes (i) and (ii) of 4.2 (3), the aim will be to return the actual *payout* levels to the *specimen asset shares* by making changes to the bonus scale that will reduce any gap between current *payout* and *specimen asset shares*.

Unitised with-profits business

4.14 (3) (B) For *unitised business* the strategy for *smoothing* is similar to that described in 4.14 (3) (A), but subject to the proviso that because there is a more frequent checking of the position for *unitised* contracts, it is probable that in a period of particularly adverse conditions the *unitised* scales might be changed sooner, and possibly also more frequently, than might apply to the *conventional business*.

Deposit administration business

4.14 (3) (C) For *deposit administration business*, the aim of *smoothing* will be to return the value of the notional account to the *specimen asset shares* by setting *annual bonus* rates which would achieve this aim over a period of 3 to 5 years on a low estimate of future investment returns on the assets notionally ring-fenced to this business

4.14 (4) *SPL* will normally limit changes in *payout* between similar policies maturing in successive periods so that over the two reviews that will be the normal practice in any year the overall change will not exceed 15%. Exceptionally, if investment returns are extreme, the overall change in a year might be up to 25%.

Conventional with-profits business

4.14 (5) (A) Our general approach to surrender and transfer bases for *conventional business* is to adopt formulae which approximately reproduce the *specimen asset shares* described in 4.11 (3). *Smoothing* may be used to bring surrender and transfer bases into line with *specimen asset shares*.

Unitised with-profits business

4.14 (5) (B) *SPL*'s approach to surrender and transfer values for *unitised* contracts is based on setting *final bonus* and *MVR* scales that approximate to within 5% of the *specimen asset shares* at the time the scale is set. *SPL* would normally expect to review the scale when it became aware of a shift in the theoretical scale of 5% or more, although at times of very rapid fluctuations in asset values this 5% limit might be exceeded.

Deposit administration business

4.14 (5) (C) The calculation of the transfer value of a *deposit administration* contract which has been in force more than 5 years is on a prescribed basis specified in the policy document. All such policies currently in force have been in force for at least 5 years.

4.14 (6) Where a partial payment is made under a policy in circumstances where no penalty can apply (most commonly where there is 'income' from a with profit bond) and there is, in consequence, an overpayment relative to the appropriate *specimen asset share* any cost is charged against the fund and not against the individual policy concerned. Policies taking advantage of such guarantees do not therefore have their own costs taken into account when the policy finally becomes a claim for the full remaining benefit, other than in respect of the way in which such costs have a general impact on the fund.

Target Ranges

4.15 (1) *SPL* has adopted a set of target ranges and aims to manage the business so that at least 90% of the *payouts* will fall within the target ranges. The ranges are expressed as a proportion of the *specimen asset share*. The sections of 4.15 (2) are numbered to match the numbering of subsections in 4.2 and 4.3 that described various classes of policies for which different rules might apply.

Conventional with-profits business

4.15 (2)(A) (i) The target range for maturity payments on unaltered life fund endowments is 80% to 120% of *specimen asset share*. The target range for surrenders of such policies is 80% to 120% of *specimen asset share*.

4.15 (2)(A)(ii) The target range for the cost to *SPI Fund* of paying out the cash option of retirement benefits is 80% to 120% of *specimen asset share*. The target range for transfer values of such policies is 80% to 120% of *specimen asset share*.

Unitised with-profits business

4.15 (2)(B) For all forms of withdrawal of *unitised* policies the target range is 80% to 120%.

Deposit administration business

4.15 (2)(C) Target ranges are not set for these policies for the reasons set out in 4.10 (2)(C) and 4.14 (5)(C)

4.15 (3) *Specimen asset shares* are not calculated for altered policies. The general approach is that the terms of the alteration were agreed with the policyholder at the time of the alteration and were our estimate of what was fair at the time of the alteration. Altered contracts are then related to what we think is a reasonably comparable unaltered policy, or set of unaltered policies. Examples of how this might work are:

- A policy that stops paying *premiums*, but continues for reduced benefit is given a *final bonus* at the same rate (but applied to the reduced benefit) as an unaltered contract issued at the same time.
- A policy which is altered so that it retains the same *sum assured*, but pays a higher *premium* and matures earlier is given the same *final bonus* as a policy that was issued, and which matures, at the same times as the altered policy.
- A policy which is altered so that is pays a higher *premium* in return for a higher *sum assured* will receive a composite *final bonus* based in part on the original term of the policy and in part on the period since the date of alteration.

5. Investment strategy

5.1 The framework for the *SPI Fund*'s investment strategy is set by the *Scheme*.

The *Scheme* states that:

(i) the investment policies for the *SPI Fund* shall be determined by the *SPI Fund Supervisory Committee* having regard to the recommendations of the *Actuary* and the nature of the liabilities of the *SPI Fund*; and

(ii) the policies shall seek to maximise the investment return earned on the assets in the *SPI Fund* while recognising the need to safeguard the *SPI Fund*'s financial security.

The following Principles and Practices should be read in the context of this framework.

5.2 (1) The *SPI Fund* currently aims to invest in a broad range of asset types which may include bonds, equities, property, cash and alternative investments.

'Bonds' includes fixed-interest investments issued by the UK and overseas governments and non-governmental bonds (for example, those issued by companies).

'Equities' includes ordinary shares issued by U.K. and overseas companies.

'Cash' is taken to include bank deposits and short-dated commercial paper.

'Alternative investments' include hedge funds, but use of these may be constrained by the *SPI Fund Supervisory Committee*. Credit quality is controlled by investment guidelines.

The aim of the strategy is prescribed by the *Scheme* - see paragraph 5.1(ii) above. *SPL* believes that the consequence of this is that it should aim:

(i) to achieve security for the *guaranteed benefits* through choice of asset mix, widely diversified risk and matching of expected cash flow from the investments with the projected cash flow required to meet required payments to policyholders; and

(ii) (as a secondary aim) to maximise the return, consistent with acceptable risk.

The degree of matching between assets and liabilities will depend upon the level of surplus assets within the fund. Where a large surplus exists a higher level of exposure to 'real' assets (equities and property), which have a less predictable, but potentially higher, future cash flow than bonds or cash, will normally be maintained. If there is no, or only a small, surplus matching will be closer with a lower exposure to 'real' assets.

The part of the *SPI Fund*'s assets notionally ring-fenced to UK business includes a high proportion of investments denominated in sterling currency, while that part notionally ring-fenced to Irish business includes a high proportion denominated in Irish (Euro) currency.

5.2 (2) **The *SPI Fund* is able to rely upon assets outside the fund to maintain statutory solvency.** (See further section 10 below.)

5.2 (3) **Where a mis-match between assets and liabilities represents a risk to *SPL*'s overall solvency, assets to hedge those risks may be purchased and held either inside or outside the *SPI Fund*. This applies both to equity risk and to interest rate risk (for example with respect to the interest rate risk arising from guaranteed *annuity* options).**

In addition, where a negative view is taken by *SPL* of the immediate progress of equity values, additional hedging of short-term equity exposure may take place within *SPI Fund*. This could involve purchasing put options (say for maturity a number of months in the future) or by purchasing collars at nil cost. (A 'collar' is a bought put option in conjunction with a sold call option.)

Derivatives may also be used to implement policy decisions where this would be efficient portfolio management.

At the time of writing, the *SPI Fund* has entered into hedging arrangements which are intended substantially to reduce the *SPI Fund*'s market-risk exposure to certain guarantee costs. These arrangements may be altered, replaced or terminated in the future.

5.2 (4) The acceptable risk profile of *SPI Fund* has been assessed at the level of the ring-fencing of assets described in 5.2(1) and section 4, but other than this *SPL* have not imposed any further constraints on the investment strategy to apply to particular parts of the fund.

5.2 (5) ***SPL* aims always to keep assets within the counterparty limits set by financial regulators and may impose on the fund stricter limits, where it is judged to be prudent. More details of current practice can be found in 5.3 (4).**

5.3 (1) Any transfer of assets to *SPI Fund* would be made only after the *SPI Fund Supervisory Committee* had received a report from the *Actuary* that he was satisfied that the financial support being provided to the *SPI Fund* was in the interests of the *SPI Fund* policyholders. From an accounting viewpoint, such asset transfers would be valued taking into account the chance of recovery and the likely amounts and timing of recovery. This would not, however, prevent actual recovery being greater or less if prospects changed.

5.3 (2) The *SPI Fund* investment strategy is currently reviewed by management monthly.

5.3 (3) If the level of statutory surplus is high and a positive view was held of the future values of real assets, exposure to real assets could also be higher. At weaker levels of solvency cover *SPL* would move progressively towards closer matching of liabilities by assets whose return is more certain.

5.3 (4) Counterparty limits are set based upon counterparty credit ratings, or *SPL*'s assessment where no published ratings apply. The relevant exposures are calculated based upon the value of all investments excluding assets and liabilities of dependants, but including all debts. Derivatives, the value of units

in collective investment schemes and its trade investments are specifically excluded from this calculation.

Investment guidelines are kept under regular review and may vary in the light of changing financial conditions, industry developments and the Overriding Principles. The guidelines on asset allocation as at the date of this *PPFM* were as follows.

	Percentage
Equities	40 - 55
Real estate	0 - 15
Bonds	25 - 45
Alternative assets	0 - 5
Cash	5 - 15

This, for example, requires that a minimum of 5% of the fund is held in cash at all times and allows at any particular time, zero investments in real estate. Investments in real estate may be direct or indirect.

As at the date of this *PPFM*, the *SPI Fund Supervisory Committee* has limited use of hedge funds to a maximum of 5% of the fund.

As explained in 5.2(3), the *SPI Fund* has entered into hedging arrangements which are intended substantially to reduce the *SPI Fund*'s market-risk exposure to certain guarantee costs. Since the return from those arrangements is expected to be used to help meet guarantee costs (rather than to be applied to *specimen asset shares*), the table does not take into account assets which are invested in those hedging arrangements.

Credit quality is controlled by investment guidelines.

5.3 (5) The use of new investment instruments would require prior approval in principle from the *SPI Fund Supervisory Committee*.

5.4 There are no material holdings of assets in the *SPI Fund* that would not normally be traded because of their importance to *SPL*, nor is it currently expected that there will be in the future.

6. Business risk

6.1 Although it is primarily an investment fund, the *SPI Fund* also assumes significant insurance risks and also bears some of the risks borne by any trading company. This section of the *PPFM* covers the exposure of with-profits policies to business risks.

6.2 With-profits funds are typically exposed to risks arising from:

(i) other with-profits policies;

(ii) non-profit policies; and

(iii) more general business risks arising from investment in connected companies.

As noted in the following sections, the *SPI Fund* is somewhat different to the typical pattern.

6.3 The *SPI Fund* will not normally undertake any business risks other than those resulting from maintaining and acquiring with-profits policies. The *SPI Fund* is not currently accepting new policyholders, so such business risks will in future be restricted largely to those arising from maintaining (and having acquired) existing with-profits policies, and from associated activities - such as risks associated with investments made in the ordinary course of business. Also, the *SPI Fund* is exposed to business risks taken on prior to demutualisation (for example, potential mis-selling).

Other investments, such as investment in connected companies (eg investment management companies, service companies or overseas subsidiary insurance companies), would normally be made either directly by the *shareholder* or from outside the *SPI Fund*. Any proposal for any such material investment by the *SPI Fund* would be considered by the *SPI Fund Supervisory Committee* and by the *Actuary*. In the unusual event of *SPI Fund* agreeing to any such investment, or where such investments already exist within the fund, then all profits and losses from such investment would be earmarked for the *SPI Fund*.

The management of, and the risks and rewards from, non-profit policies are outside *SPI Fund* and could affect the *SPI Fund* only in the extreme event of the insolvency of the whole of *SPL*.

6.4 The *SPI Fund* has operated since demutualisation, and the Scottish Provident Institution operated for many years before demutualisation, a system of notional ring-fencing with the ring-fenced portfolios of business being the UK and Irish business, and within each of these the *deposit administration business* and the other *SPI Fund* business. This ring-fencing is long-standing practice, but not legally watertight in the event of insolvency of the fund or of *SPL*.

The *Scheme* constituted the *SPI Fund*, the *Special Fund* and the Non Profit Fund as separate sub-funds of the Long Term Fund of *SPL* and states that the *SPI Fund* shall provide no financial support for any other sub-fund except the *Special Fund*. However, the establishment or maintenance of the sub-funds is 'for the purpose of establishing policyholder entitlements from time to time

and shall not be taken to limit the availability of all the property from time to time of *SPL* to meet the liabilities which it is obliged by law to meet'.

Hence the ring-fencing of the sub-funds is not watertight in the event of the insolvency of one of the sub-funds or of *SPL*.

Treatment of guarantee costs

As explained in section 5, at the time of writing, the *SPI Fund* has entered into hedging arrangements which are intended substantially to reduce the *SPI Fund*'s market-risk exposure to certain guarantee costs. These arrangements may be altered, replaced or terminated in the future.

The hedging arrangements may not cover all guarantee costs.

To the extent not covered, guarantee costs will be met through an adjustment to the *net investment return* available to be applied to *specimen asset shares* within the *SPI Fund*.

Currently no explicit, fixed charge for guarantees is levied and before introducing any such explicit charges for guarantees we would communicate this fact to policyholders, the proposal having previously been commented on by the *FSA*, and approved by the *SPI Fund Supervisory Committee* and by the *SPL Board.*

6.5 ***SPL*** **has not established a formal monetary limit to the taking on of business risk by the** ***SPI Fund*****, but the general statements in 6.3 apply and any such risk is expected to be small in relation to the overall size of the fund. Any costs arising from business risks will be borne by the fund (or part of the fund) which took them on and expects to profit from them if the experience is favourable. Risks taken on prior to demutualisation (for example mis-selling which took place prior demutualisation) will normally be deemed to have transferred to the** ***SPI Fund*** **and may be charged to the** ***SPI Fund*****. Risks taken on after demutualisation (other than normal insurance risks directly associated with the conventional with-profit policies) are normally outside** ***SPI Fund*****, in particular mis-selling which occurred after demutualisation would not be charged to the** ***SPI Fund*****.**

6.5A Regarding the allocation of risks taken on after demutualisation, the *Scheme* provides that such risks will be met by the *SPI Fund* where they are "properly attributable" to the *SPI Fund* in accordance with the principles underlying the *Scheme* or such an attribution is "fair and equitable", having regard to policyholders' reasonable expectations.

6.6 (1) *SPL* has no formal monetary limits for the taking on of business risk in the *SPI Fund*, but the general statement above that this would be done only in rare circumstances applies.

6.6 (2) Where any profits or losses did arise these would belong to the *SPI Fund* and would either (exceptionally) be allowed for as a specific adjustment to the *net investment return* for the year, or (normally) would affect the residual size of the inherited estate and hence the *specimen asset shares*. (See also the following paragraph. This is discussed at more length in section 8)

6.6 (3) Profits and losses from business risks within the *SPI Fund* will normally be taken as affecting the size of the inherited estate. This implies a large degree of *smoothing* with any benefit to individual policies emerging over many years. Profits and losses arising on business outside the *SPI Fund*, for example profits from non-profit policies, fall to the *shareholder* and will not affect with-profits policies.

6.6 (4) Accordingly, all profits and losses from business risks within the *SPI Fund* have at least some effect on the size of the inherited estate. Only very large profits and losses would be treated other than as an addition to or deduction from the estate.

6.6 (5) There is a degree of segregation of liabilities as described in 6.4. Within any notionally segregated portfolio there is pooling across all categories of policy, except that within the *conventional* pensions classes any sub-categories which are treated as different bonus series are separate, although to the extent that costs cannot reasonably be borne within the class they may be charged initially to the estate and hence, indirectly, to other classes.

The *unitised business* participates only in the investment and financial experience, but this may include the cost of guarantees as described in 6.4. The *conventional business* shares also in other elements of the insurance experience, including expenses and mortality. Charges and expenses are discussed more fully in the next section.

Within classes there are no particular risks borne by particular generations of policyholder.

7. Charges and expenses

7.1 This section of the *PPFM* covers the way in which *SPL* applies charges and apportions expenses in respect of the *SPI Fund.* Most of the costs are initially incurred within related service companies and then recharged to the *SPI Fund.*

7.2 The *Scheme* provides that there shall be charged to the *SPI Fund* only such part of the total costs, liabilities and expenses incurred by *SPL* as the *Actuary* and the *SPI Fund Supervisory Committee* consider fair and equitable, having regard to policyholders' reasonable expectations.

The *Scheme* then goes on to set out in detail the charges to be borne by the *SPI Fund* in the 10 years following demutualisation in order to fulfil this requirement.

Conventional with-profits business

7.2 (1) (A) The overall aim of *SPL*'s approach to applying charges in respect of the *conventional business* is to charge only that part of the actual expenses of *SPL* (including any incurred indirectly and recharged to *SPL*) as can be fairly and equitably attributed to the management of the *conventional business*, having regard to policyholders' reasonable expectations and the relevant provisions of the *Scheme*.

Unitised with-profits and deposit administration business

7.2 (1) (B/C) The approach is different for the *unitised* and *deposit administration business.* For these class of business there were stated levels of charges disclosed in the product and marketing literature (although there are provisions that would allow *SPL* in certain circumstances to alter these levels). For the *unitised* classes the overall aim of *SPL* is to levy charges at these levels.

Unitised with-profits business

7.2 (2) (B) There is also an explicit annual management charge payable by *SPI Fund* to the *SPL* Non Profit Fund in respect of the *Unitised* With Profit Business.

The circumstances which might lead *SPL* to increase the levels of annual management charge would be an overall increase in the costs of managing the business which was making it uneconomic, or unprofitable, to continue the policies on their existing basis. *SPL* would also expect to consider the basis on which other similar companies were charging. Any such change would be subject to the provisions of the *Scheme*.

The implicit annual management charge which is currently taken into account in determining *specimen asset shares* is however lower than the explicit actual charge to *SPI Fund*, having been fixed at the level which applied before demutualisation. The excess of the actual amount over that taken into account in determining the *specimen asset shares* falls to be met from the *SPI Fund* estate.

<u>*Conventional with-profits business*</u>

7.2 (3) (A) **_SPL_ does not currently foresee circumstances in which it would expect to depart from the principle that the _conventional with-profits business_ should be charged according to a fair and equitable attribution system based on actual incurred costs, subject to the provisions of the _Scheme_, the latter including the specified charges which apply in the 10 years following demutualisation.**

<u>*Unitised with-profits business*</u>

7.2 (3) (B) **The charges for the _unitised_ contracts arise from:**

- **A Bid/Offer spread - that is _units_ may be sold to policyholders at a higher price than is used to buy them back.**
- **Policy fees charged by cancelling _units_.**
- **Charges for insured mortality and morbidity risks charged by cancelling _units_**

The effect of these charges on policyholder benefits is in principle the same as if the policyholder had elected to invest in investment-linked units within the _SPL_ Non Profit Fund, rather than with-profit _units_. There may be profit margins in the charges which accrue to the Non Profit Fund of _SPL_.

SPL does not currently foresee circumstances in which it would seek to increase the bid/offer spread.

Many of the policy fees charged have a standard provision that they are reviewable annually (in some cases specifically in line with increases in Retail Prices or National Average Earnings). _SPL_ expects to implement such changes, with the aim of keeping charges broadly in line with increases in costs.

In most cases, charges for insured mortality and morbidity risks may be reviewed. _SPL_ would expect to review these from time to time to reflect emerging trends in mortality and morbidity.

<u>General</u>

7.2 (3) (D) **_SPL_ would expect for all policies to take action on charges and expenses to reflect adverse changes in the external fiscal or regulatory environment, subject to the provisions of the _Scheme_.**

<u>*Conventional with-profits business*</u>

7.3 (1) (A) The principles stated in 7.2, 7.2 (1) (A) and 7.2 (3) (A) apply to all *conventional with-profits business.*

<u>*Unitised with-profits business*</u>

7.3 (1) (B) The charges currently applied to *unitised business* are at the rates or on the bases indicated in the original disclosure, save where they have been uprated in accordance with the original disclosure. The explicit annual management charge that is charged to the *SPI Fund* is 1% of the value of the *units*. The implicit annual management charge taken into account in determining the *specimen asset shares* is 0.60% in respect of Life *units* and 0.85% in respect of Pensions *units*. To the extent that the explicit charge exceeds the implicit charge, the balance is in effect charged to the estate and hence ultimately to all with-profit policyholders. This continues the pre-demutualisation practice.

Conventional with-profits business

7.3 (2) (A) In determining the *specimen asset shares* the aim is to use expenses per policy that, if applied across the whole of the fund, would give an aggregate expense close to the actual charges and expenses borne by the fund. In the 10 years following demutualisation, the per policy expenses used are the same as those used to determine the actual charges.

Unitised with-profits business

7.3 (2) (B) On the *unitised business*, the charges reflected in the *specimen asset shares* are the same as the actual charges with the exception of the annual management charge which has been fixed at the level current immediately prior to demutualisation.

Conventional with-profits business

7.3 (3) (A) *SPL* does not currently foresee circumstances under which the charges attributed to *SPI Fund* in respect of the *conventional business* would be based on anything other than the actual costs charged to the *SPI Fund*

Unitised with-profits business

7.3 (3) (B) On the *unitised business*, the charges levied are based on disclosed rates of charging. The charges are transferred out of *SPI Fund* and the corresponding actual expenses are then also borne outside *SPI Fund*. The charges include margins which allow *SPL* to operate these classes of business at a profit, with this profit accruing to the *shareholder*. *SPL* expects to continue with the current basis of charging which is not based on actual costs, the difference between charges levied and actual costs being a profit or a loss for the *shareholder*.

7.3 (4) The administration and investment management in connection with the policies in *SPI Fund* are outsourced, which may be to connected companies in the *Resolution* Group or to third parties. *SPL* believes that these agreements are currently on fair terms and reviews these terms from time to time, but not to any fixed timetable. Contracts are subject to normal third party terms and can be cancelled on giving appropriate notice.

7.4 (1) The initial and renewal expenses attributed to the *SPI* Fund are those prescribed by the *Scheme* for the 10 years commencing 1 August 2001. After expiry of this period *SPL* expects to charge to the *SPI Fund* the

expenses fairly attributable to or fairly apportioned to the *SPI Fund*, and that these will be assessed using the methods outlined in 7.4 (2) below.

7.4 (2) The method used to judge how to attribute expenses within the *SPI Fund* is a two-stage process. The first stage is to split the total actual expenses into broad categories such as new business costs, ongoing maintenance costs, policy termination costs and general costs. There is a more detailed breakdown within each of these. The second stage is to apportion each of the categories between different classes of business. The appropriate measure for apportionment will vary; for example administration costs might be split by numbers of policies but investment expenses are more likely to be related to the value of the policies. The underlying criteria in making any decisions about apportionment is to select the most appropriate basis which *SPL* believes is the fairest for policyholders as a whole.

8. Management of the inherited estate

8.1 The fair market value of the assets in a with-profits fund may be more or less than the realistic value of the liabilities in the fund. Such an excess or deficiency is called realistic surplus or realistic deficit. A realistic surplus is also sometimes called an inherited estate, and this section 8 describes *SPL*'s Principles and Practices on the management of any such inherited estate.

8.2 (1) *SPL* will manage any inherited estate as part of the *SPI Fund* and for the benefit of policyholders in that fund. *SPL* will manage the impact of any negative estate with the aim of eliminating it, whether immediately or over a longer timescale.

8.2 (2) *SPL* will distribute any inherited estate in the *SPI Fund* as an adjustment to the *payout* amounts available to policyholders in accordance with the *Scheme*, aiming to eliminate any inherited estate equitably (subject to any minimum level which may be required directly or indirectly by the *FSA*, or considered necessary by *SPL* for the prudent management of the Fund). The aim is to produce the result that after all sums falling to be paid in respect of policies invested in the fund have been so paid no inherited estate shall remain and *SPI Fund* shall cease to exist.

8.2 (3) The Principle in 8.2 (2), when combined with the fund not being open to new policyholders, means that over the long term the target level of inherited estate is effectively zero, and at any given time the target level is determined by the regulatory and prudential requirements.

8.2 (4) The implications of *SPL*'s preferred scale of inherited estate is that *SPL* is likely to reflect any realistic surplus or deficit by making an addition to, or deduction from, *specimen asset shares*.

8.2 (5) Any inherited estate within the *SPI Fund* is reserved (by virtue of the *Scheme*) for the sole benefit of the *SPI Fund* as indicated by 8.2 (2). *SPL* expects to manage other with-profits funds so that any inherited estate within those funds is also used primarily for policies invested in those other funds.

8.2 (6) *SPL* is constrained in its use of any inherited estate in *SPI Fund* by the *Scheme*. The effect of the constraints is summarised in 8.2 (2) above.

8.3 (1) If the *SPI Fund* is in surplus, subject to the terms of the support mechanism set out in 10.4 below and any other support arrangements from time to time, the following management actions would, for example, be considered (which could be combined or operated separately):

(i) make future enhancements to *specimen asset shares* on the basis of a defined profile of future augmentations;

(ii) enhance *payouts* to policyholders invested in the *SPI Fund* by using a percentage other than 100% as the target – this has the same effect on *payouts* as using 100% of an adjusted *specimen asset share*;

(iii) make immediate enhancements to *specimen asset shares*;

(iv) use to meet the cost of honouring *guaranteed benefits* for policyholders in the *SPI Fund* where the *guaranteed benefits* are higher than the *specimen asset shares*;

(v) allow the surplus to roll forward in the *SPI Fund* as an estate - it would then act as the first resort for any future deficit and in the meantime, while it constitutes surplus, it would be available to meet risk based capital requirements (see further section 10 below);

(vi) use for bearing valuation strains incurred in writing new business in the *SPI Fund* (valuation strains arise where the required reserves and provisions for a new policy exceed the funds immediately available from the *premiums* after expenses have been paid - such strains can normally be recovered as the policy ages); and/or

(vii) use to cover miscellaneous losses attributable to the *SPI Fund*.

And conversely, any underpayment below the *specimen asset share*, any recovery of valuation strain and any miscellaneous profits would be put to the credit of the estate.

8.3 (2) Any inherited estate is managed along with the rest of *SPI Fund* and does not follow any different investment strategy, but this may not always be the case.

8.3 (3) Under *FSA* rules there is a regulatory minimum value for the liabilities. Should the assets have a lower value than the minimum regulatory value of the liabilities plus 0.5% of the total *asset shares* in respect of the *SPI Fund* the actions described in Section 10 apply. There are further rules and guidance, including individual capital guidance, that may impose on the company an enhanced capital requirement or a higher individual capital assessment in addition to the regulatory minimum liability value. If, following an annual review, actual asset values exceed these higher levels then one of the first three subsections of 8.3 (1) will apply. If the asset values cover the minimum regulatory value of the liabilities plus 0.5% of the total *asset shares* in respect of the *SPI Fund*, but not the additional capital requirements (so that the company has to cover these from resources outside the *SPI Fund*) then a distribution under one of these early subsections of 8.3 (1) will be made only if the company expects cover for the additional requirements to emerge from the fund over the next twelve months.

9. Volumes of new business

The *SPI Fund* is currently not open to new policyholders although some policyholders have rights to effect increments and *SPL* has no current plan to re-open *SPI Fund*, although it reserves the right to do so. Some existing group policies for pension schemes also contain rights to effect increments for existing members and rights to add new members. Such new members are admitted and increments are issued if requested, either as additions to existing policies or as new policies, but no other new business is being written.

10. Equity between the *SPI Fund*, the *Special Fund* and the *shareholder*

10.1 Although most of the money in *SPI Fund* is earmarked for policyholders' benefits, the *shareholder* of *SPL* also has certain rights. This section of the *PPFM* aims to cover the approach to maintaining the balance between these conflicting interests. This section also describes the nature and extent of any explicit *shareholder* commitment of support to the *SPI Fund*. At the time of writing there is, effectively, only one *shareholder* as *SPL* is a wholly-owned subsidiary of *Resolution*.

Conventional with-profits and *deposit administration business*

10.2 (1) (A/C) On the *conventional* and *deposit administration business* the *shareholder* is entitled to transfer out of the fund an amount equal to one-ninth of the value of bonuses allocated to policyholders.

Unitised with-profits business

10.2 (1) (B) On the *unitised business*, the *shareholder* has no rights to participate in the profits of the with-profits business. The *shareholder*'s rights are limited to taking the charges and expenses discussed in Section 7 above.

General

10.2 (1) (D) The principles in (A) and (B) above are laid out in the *Scheme*. The *shareholder* could agree to take less than the share indicated in (A).

10.2 (2) Any proposal to amend these profit-sharing arrangements to the detriment of policyholders could be undertaken only after prior publicity to policyholders, discussion with applicable regulators and approval by the courts.

10.2 (3) Where the *SPI Fund* seeks to, or in reasonably foreseeable circumstances might seek to, rely on support from the *shareholder* (and then if the *shareholder* has decided to provide support, which it is not obliged to do) then some constraints on *SPI Fund* activity (for example on the investment activity) are likely to be required to give due weight to the interests of those (usually the *shareholder*) with alternative claims in normal circumstances on the funds providing support to the *SPI Fund*. Any such constraints would be imposed only after a report from the *Actuary* and the approval of the *SPI Fund Supervisory Committee*.

10.2 (4) The *SPI Fund* is entitled to receive out of the *Special Fund* an amount equal to one-ninth of the value of bonuses allocated to policyholders in the *Special Fund*.

10.3 (1) The current basis on which *SPL* divides profit in the *SPI Fund* between policyholders and the *shareholder* is that the *shareholder* does transfer out its one-ninth of the value of bonuses added to *conventional* and *deposit administration* policies.

Likewise the *SPI Fund* does receive its one-ninth of the value of bonuses added to policies in the *Special Fund*. This does not have a direct effect on

the *shareholder*, but may have a small indirect effect in that it may increase the surplus in the *SPI Fund*.

The basis of calculation of the value of *annual bonuses* added is that the value is calculated by the same methods and using the same discount rates and other factors as are used for the annual regulatory valuation that reveals the surplus out of which the *annual bonus* is declared.

Interim and *final bonuses* added to claims (whether by death, maturity or surrender) on *conventional* policies are included in the amount on which the one-ninth is calculated based on the amount added to the claim value. The transfer is then made as a cash amount.

It is first necessary to determine the profit available to be divided in the *SPI Fund* and in the *Special Fund*. This is determined by the *SPI Fund Supervisory Committee* after taking actuarial advice. The *Actuary* in framing that advice will have valued the assets and the liabilities, determined a surplus and then considered whether part of any surplus ought to be carried forward as a reserve to provide for future uncertainties, rather than being immediately divided.

10.3 (2) If the valuation basis is altered (and there is an *annual bonus*), or if the *surrender value* basis is altered, then this would be reflected directly in the value attributed to the bonus and hence in the amount transferred to the *shareholder* from the *SPI Fund*, or from the *Special Fund* to the *SPI Fund*.

10.3 (3) Other factors that might affect the balance between the *shareholder* share and policyholders' share include, but may not be limited to:

(a) Tax. This would have an indirect effect only in that the levels of tax levied on the fund are one of the factors helping to determine the rates of interest used in the statutory valuation.

(b) Distributions in anticipation of a surplus. Generally this covers amounts added as interim or *final bonus* at the time of a claim, rather than as *annual bonus*. Amounts added to *conventional* policies as *annual bonus* result in a transfer to *shareholders* during the life of a policy, but bonus added at time of claim results in a transfer only at the end of a policy's life.

(c) Mix of business. The proportion of distributed surplus allocated to the *shareholder* will vary if there is a change in the mix of business or a difference in the relative amounts of surplus distributed to different classes. The underlying proportions of one-ninth of the *conventional* and *deposit administration* bonus and nil of the *unitised* bonus will not alter, but if the share of surplus allocated changes between the classes then the *shareholder*s' one-ninth will be calculated on a different proportion of the total.

10.3 (4) *SPL* is not currently writing new policies, other than increments to certain existing policies where there is an obligation under the policy conditions to continue to accept such additional *premiums*. There are certain minor classes where the benefits offered are priced on what now appear to be over-generous terms, causing a strain on the fund. These policies are not

currently being awarded any bonus, but if they were then the *shareholder* transfer would add to the strain. Although these strains might be described as systematic, the volume of business written is not such as to make the strain significant.

10.4 (1) *SPL* holds capital in its Shareholders Fund and its Non Profit Sub-Fund ("the NPSF") to ensure that it can meet regulatory capital requirements and satisfy the internal capital policy set by the *SPL Board (with the agreement of the SPI Fund Supervisory Committee)*. Such capital may be used to provide financial support to the *SPI Fund* from time to time, by way of loan to the *SPI Fund* or otherwise.

This section 10.4 of the *PPFM* briefly summarises in what circumstances such financial support will be provided.

10.4 (2) *FSA* rules do not require that all of the capital required to cover the capital requirements of a with-profits fund has to be held within the with-profits fund itself. To the extent that capital requirements in respect of the *SPI Fund* can be met using assets held outside of the *SPI Fund*, the capital held in the Shareholders Fund and the NPSF can, to the extent not required to cover the capital requirements of the NPSF, be utilised on an unlimited basis to cover the capital requirements of the *SPI Fund*.

Additionally, an internal capital support arrangement ("the ICSA") exists for monies to be transferred from the NPSF to the *SPI Fund* with the aim that the amount of assets in the *SPI Fund* exceeds regulatory minima by the 0.5% amount referred to in section 8.3 (3). The amount of monies available to be transferred in this way is currently capped at £125 million.

FSA rules require with-profits funds to satisfy two separate solvency tests referred to as the 'realistic' and 'regulatory' tests. Section 10.4 (3) discusses what might happen if there is a 'realistic' deficit and section 10.4 (4) discusses a 'regulatory' deficit. Sections 10.4 (5) and (6) note some further general conditions if support is provided.

10.4 (3) The realistic balance sheet for the *SPI Fund* will be recalculated at each future period end as required by legislation, or more frequently if considered appropriate for the prudent management of the *SPI Fund*.

In the event of a realistic deficit emerging in the *SPI Fund* over a six month reporting period (or in principle at any time), the *SPL Board* (with the agreement of the *SPI Fund Supervisory Committee* and after consultation with the *Actuary*) would determine the actions required to remove the deficit taking into account all the circumstances including, without limitation, the size and causes of the deficit, whether that deficit were considered temporary or permanent and the outlook for the *SPI Fund* going forward.

For example and by way of illustration only a deficit may be addressed by a reduction in the proportion of the *SPI Fund* invested in equities below the then current level, by absorbing the deficit using the existing surplus assets of the *SPI Fund* and/or by a combination of future yearly reductions in policyholder benefits.

In the event of a deficit emerging for which it is decided that reductions in policyholder benefits and/or the transfer of assets to the *SPI Fund* under the ICSA are appropriate the order in which actions will be taken is:

(i) Removal of planned future enhancements to *asset shares* arising from past surpluses;

(ii) If step (i) is insufficient to remove the deficit and restore the targeted *SPI Fund* surplus assets of 0.5% of total *asset shares*, by removal of past enhancements from *asset shares*;

(iii) If steps (i) and (ii) are insufficient to remove the deficit and restore the targeted *SPI Fund* surplus assets of 0.5% of total *asset shares*, by reducing *asset shares* or commencing applying charges of a maximum of 1% of asset share in any one year, subject to an overall cap on charges of 5%.

(iv) If steps i1) to (iii) have proved to be insufficient to remove the deficit and restore the targeted surplus assets of 0.5% of aggregate *asset shares*, by sharing any further deficit between policyholders and the shareholder by further reducing asset shares to recover 25% of any such remaining deficit and by drawing in monies from the NPSF under the terms of the ICSA to cover the remainder of the deficit.

(v) If it seems likely that the maximum amount available will be transferred to the *SPI Fund* under the terms of the internal capital support arrangement and a deficit will still exist, there would be discussions between *SPL* (having taken advice from *SPI Fund Supervisory Committee*) and the *FSA* to determine the most appropriate course of action at the time taking into account the severe stress that would have occurred to reach such a position.

Realistic surpluses arising in a subsequent period will be applied in the reverse order to these general principles except that there is no cap to future asset share enhancements in the event of favourable conditions.

10.4 (4) As well as calculating the solvency of the *SPI Fund* on a 'realistic' basis, we calculate solvency on a 'regulatory' basis.

There will be a regulatory deficit in the *SPI Fund* if the 'regulatory value' (determined in accordance with applicable regulations) of the assets allocated to the *SPI Fund* is lower than the 'mathematical reserves' in respect of all the business in the *SPI Fund*.

If a regulatory deficit arises in circumstances in which there is not a realistic deficit, the deficit will be removed following a similar process to that described in 10.4 (3) except that the actions involving reductions in *asset shares* will not be available. If a regulatory deficit arises in circumstances in which there is also a realistic deficit, then action will be taken to remove the realistic deficit in accordance with section 10.4 (3) and

any remaining regulatory deficit after this has been completed will be similarly removed, but without use of the actions involving reductions in *asset shares*.

If a regulatory surplus emerges in a subsequent period and a realistic surplus has not emerged in the same period, the regulatory surplus will be used as described in 10.4 (3), but without any requirement to enhance *asset shares*. If a regulatory surplus emerges in a subsequent period in which a realistic surplus has also emerged then the realistic surplus will first be applied as described in section 10.4 (3) and any remaining regulatory surplus after this has been completed will be used similarly, but without any requirement to enhance *asset shares*.

10.4 (5) The *SPI Fund* is to be managed without having regard to the availability of the support arrangements described above and the exercise of discretion in respect of with-profits policies will be managed with the aim that any amounts transferred to the *SPI Fund* under the terms of the ICSA will be repaid to the extent that this is possible whilst still satisfying the Overriding Principles. In determining benefits under with-profits policies, *SPL* will disregard any liability to transfer amounts back to the NPSF under the terms of the ICSA to the extent that this is necessary to treat customers fairly (i.e. in accordance with these *PPFM*).

10.4 (6) No charge is currently made to the *SPI Fund* for the capital that it is necessary to retain in the NPSF in order that *SPL* continues to have adequate capital to support the *SPI Fund*. However during any period when money has been transferred to the *SPI Fund* under the terms of the ICSA any investment return on the funds so transferred shall belong to the *SPI Fund*, but the *SPI Fund* shall normally be liable to pay interest to the NPSF at LIBOR on such amounts.

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