PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT

June 2017

TABLE OF CONTENTS

GLOSSARY

This Glossary defines some of the terms and abbreviations used in this PPFM.

Term	Meaning
Annual bonus	Annual bonuses are normally declared each year, but are not paid until a policy becomes a claim. Also referred to in product literature as reversionary bonus.
Audit Committee	The Audit Committee is a sub-committee of the Board with specific Terms of Reference and reporting procedures. Its primary function is to review and challenge the actions and judgements of the management in relation to the annual financial statements before submission to the Board.
Board	The body, elected by the Members of The Society, in whom responsibility for the management of The Society is vested.
Chief Actuary	The person having responsibility for the Actuarial Function specified in the PRA Rule Book: Solvency II Firms: Conditions Governing Business Instrument.
Counterparty	An organisation with which The Society has a commercial arrangement.
Court	A branch of the incorporated Society.
Court Funds	The aggregate of the funds maintained by each Court in pursuit of its fraternal, benevolent and social activities.
Court Investment Account (CIA)	The centrally invested assets of the Courts and the Court Reserve Fund.
Court Investment Fund (CIF)	An internal fund held by The Society for the purposes of investing the assets of The Society's Courts.
Court Reserve Fund (CRF)	A fund of assets available to support the activities of the Courts.
District	A branch of the former unincorporated society (all Districts closed on 31 December 2002).
Final Bonus	An additional bonus which may be declared when a policy becomes a claim. It is also referred to in product literature as terminal bonus.
Financial Conduct Authority (FCA)	The FCA is an independent body responsible for conduct regulation from 1 April 2013 (the FCA and PRA jointly replaced the FSA from this date).
Financial Services Authority (FSA)	The body established under the Financial Services and Markets Act 2000 to whom The Society reported in respect of the management and control of its affairs until 1 April 2013.
Group Business Fund (GBF)	Defined in Section B2.6 as the assets in respect of business written under specified group and individual non-investment life policies.
Group Capital Fund (GCF)	Defined in section B2.10 as assets not specifically allocated to any other fund. This fund was formerly known as the General Reserve Fund.
Industrial Business (IB)	Industrial business is long-term insurance business where collectors originally collected the policy premiums in cash.
Inherited Estate	Defined in section B10.1
Investment Association	A specially registered friendly society registered under section 7(1)(f) of the Friendly Societies Act 1974.
Investment Committee	The Investment Committee is a sub-committee of the Board with specific Terms of Reference and reporting procedures. Its primary function is to recommend to the Board the investment

	strategy including asset allocation decisions in line with the agreed policy and strategy.
Individual Savings Account (ISA)	The Individual Savings Account (ISA) was launched on 6 April 1999 to replace the Personal Equity Plan (PEP) and Tax Exempt Special Savings Account (TESSA) regimes that had been introduced by past governments.
Leek Fund (LF)	Is defined in section B2.5 as the assets in respect of policies of the former Leek Assurance Collecting Society Limited transferred to The Society on 31 December 2005.
Market Value Reduction (MVR)	Refers to the practice whereby surrender values on certain with-profits policies are adjusted downwards to reflect falls in the value of underlying assets.
Member	A Member is either a holder of a policy that confers membership rights on the holder or someone who has joined The Society through the Foresters' membership package.
Non-Profit Fund (NPF)	The assets in respect of POIS branded unit-linked and certain non-profit policies.
Order Insurance Fund (OIF)	Is defined in section B2.4 as the assets in respect of all policies written in or subsequently allocated to the OIF.
Ordinary Business (OB)	Ordinary Long-term Business is long-term insurance business which is not Industrial Business.
POIS Fund	The assets in respect of with-profits policies and certain non-profit non-linked policies written under the POIS brand by Family Assurance Limited transferred to The Society on 27 September 2015.
Policyholder	The holder of an in-force Foresters Friendly Society policy.
Pure Endowment Fund (PEF)	Is defined in section B2.8 as the assets in respect of all pure endowment and with-profits whole-of-life policies issued by the Courts prior to 1 January 2003.
Prudential Regulation Authority (PRA)	The PRA is a subsidiary of the Bank of England which carries out the regulation of financial firms, including banks, investment banks, building societies and insurance companies from 1st April 2013.
Risk & Capital Committee	The Risk & Capital Committee is a sub-committee of the Board with specific Terms of Reference and reporting procedures. Its primary function is to review and challenge the actions and judgements of the management in relation specifically to risk management before submission to the Board.
Sick and Death Fund (SDF)	Is defined in section B2.7 as the assets in respect of policies issued by the Courts prior to 1 January 2003 that do not form the PEF.
Solvency Capital Requirement	Is capital set aside to ensure that the Society can withstand a range of adverse events without breaching solvency rules.
Tunstall Fund (TF)	Is defined in section B2.5 as the assets in respect of policies of the former Tunstall Assurance Friendly Society Limited transferred to The Society on 31 December 2003.
United Kingdom	Comprises England, Wales, Scotland and Northern Ireland.
With-profits Advisory Arrangement (WPAA)	The role of the With-profits Advisory Arrangement (WPAA) is to provide independent judgement to the Board in assessing compliance with the Society's Principles and Practices of Financial Management and in addressing conflicting rights and interests of policyholders within a with-profits fund. All members of the WPAA are Independent Non-Executive Directors.
With-profits Actuary	An actuary who has been appointed, in accordance with FCA rules, to advise the Society's management on key aspects of

	the discretion to be exercised affecting with-profits business and report to the Board on the key aspects of discretion exercised.
With-profits Bond (WPB)	A lump sum investment into an insurance company's with-profits fund.
With-profits Policies	With-profits policies are long-term policies which can share in the profits and losses of a with-profits fund. If profits arise within the fund, such as those arising from investments, these may be shared through the addition of annual and final bonuses (which may or may not be guaranteed).

A. INTRODUCTION

A1 The Society

A1.1 The Ancient Order of Foresters Friendly Society Limited ("The Society") is an incorporated friendly society registered under the United Kingdom Friendly Societies Act 1992 which includes all Foresters Courts in the United Kingdom and those in the Channel Islands. It does not extend to other Foresters Courts overseas, however known, which are not part of the incorporated friendly society.

A1.2 This document does not extend to cover the financial arrangements concerning Courts in the Channel Islands, except to the extent that they may impact on UK with-profits business.

A1.3 The Society's governing body is known as the 'Board'. It is ultimately responsible for the direction and supervision of The Society.

A1.4 Prior to incorporation, The Society was subject to extensive and detailed rules set out in its Rules (known as General Laws). On incorporation on 1 January 2003, a new Memorandum and Rules were adopted which are more flexible than those which previously applied. In particular the Rules give discretion to the Board as to the financial structure of The Society.

A1.5 Consequent on incorporation was a centralisation of The Society's UK insurance business. In turn this necessitated a considerable restructuring of The Society's finances in order to effect efficiency in the administration of the business.

A2 Principles and Practices of Financial Management

A2.1 This document (known as the PPFM) sets out the Principles and Practices by which The Society's financial affairs shall be run and thereby supplements The Society's Rules described in A1.4. It has been authorised by The Society's Board in accordance with the powers granted to them by The Society's Memorandum and Rules, and has been adopted by the Board.

A2.2. The document was originally written to meet the standards required by the Financial Services Authority according to the relevant rules and guidance as set out in their Conduct of Business Sourcebook. These standards have been adopted by the new regulatory regime of the Financial Conduct Authority (FCA). A second purpose is to enable a better understanding of the way The Society conducts its with-profits business and, in particular, the principles and practices adopted by the Board in the application of its discretion in relation to such business. This improved understanding is intended to protect the interests of and promote confidence among with-profits policyholders.

A2.3. The PPFM is divided into two parts: Principles of Financial Management and Practices of Financial Management. Principles are intended to be enduring statements of the overarching standards adopted by The Society and are expected to change infrequently. Practices, on the other hand, describe The Society's current approach and will be subject to more frequent change whilst remaining within the principles currently applying. The format of this report considers each key area where discretion is applied.

A3 Governance and change

A3.1. In the event that The Society determines that changes are required to any of the principles contained herein, robust procedures are in place to control such changes that include providing with-profits policyholders with at least three months prior notice. Changes to practices must be similarly communicated but do not require prior notice. The procedures are described in Section D.

A3.2. The Society is required to have and has in place governance arrangements to ensure that the conduct of its with-profits business complies with this PPFM. These procedures are also described in Section D.

B. PRINCIPLES

B1. OBJECTIVES

The financial objectives of The Society are:

(a) To meet the contractual liabilities to its members and policyholders.

(b) Subject to (a), to meet
- the reasonable expectations of its policyholders, and
- the Society's ethos of supplying financial services products to ordinary people whilst retaining caring values.

(c) Subject to (a) and (b), to maximise the financial returns to members without incurring an undue level of risk.

(d) To be managed so as to bring the benefits of The Society to current and future generations of members.

B2. GENERAL DESCRIPTION OF FINANCIAL STRUCTURE

B2.1 Funds

The Society is divided into a number of separate funds as follows.

- Court Funds
- Court Reserve Fund
- Order Insurance Fund (Note: this fund contains with-profits policies)
- Individual transfer funds such as the Tunstall Fund and Leek Fund established to accommodate transfers of engagements (Note: these funds contain with-profits policies)
- POIS Fund created as a result of a transfer of engagements from Family Assurance (Note: this fund contains with-profits policies). This fund has its own PPFM.
- Group Business Fund
- Pure Endowment Fund (Note: this fund contains with-profits policies)
- Sick & Death Fund
- Non-profit Fund created as a result of a transfer of engagements from Family Assurance
- Discretionary Benefit Funds
- Group Capital Fund

The business and activity of each fund is detailed in Appendix A.

Further funds may be created by the Board at any time to meet the requirements of The Society, for example on receipt of a transfer of engagements from another friendly society or other body.

B2.2 Court Funds

Courts operate subject to the overriding authority of the Board although they have delegated powers outlined in Society Rule 8 and within Court Rules.

Each Court maintains its own fund of assets. Income and capital from its fund are available to a Court in pursuit of its fraternal, benevolent and social activities.

Court Funds in the United Kingdom are not available to support the long-term insurance business activities of The Society. Courts in the Channel Islands support their own insurance activities and their funds are not available to support the UK long-term insurance business

The Court Funds are invested in accordance with instructions issued by the Board and are further detailed in section C1.

A Court's income is derived from the assets in its Court Fund, fraternal contributions, donations and the subsidiary benefit proportion of contributions in force at the time of incorporation. The Board requires that, when averaged over a period of time, a Court's expenditure is within the income available to that Court. In other words, it is a requirement of Courts that they allocate their income between expenditure and reinvestment so as to maintain a balanced, or surplus, budget over time.

Any allocation of capital reserves may only be made on the express permission of the Board.

If a Court is dissolved, the members and the funds of that Court are transferred to one or more Courts as determined by the Board.

B2.3 Court Reserve Fund (CRF)

The CRF is under the direct control of the Board; authority is not delegated to the Courts.

The CRF is credited with income arising from the Court Investment Account. It is debited by interest distributed to Courts invested in the Court Investment Fund and an annual per capita amount paid to those Courts. The Board has discretion to transfer into the Fund from the Group Capital Fund (see B2.10) as it sees fit.

The objective of the CRF is to support Courts:

- by smoothing the income payable to Courts, so that the Courts may plan their activities with a reasonable degree of freedom from financial uncertainties;
- by providing financial assistance to ailing Courts to overcome temporary financial problems or to ensure an orderly transfer; and
- in any other way as is considered appropriate by the Board in the circumstances at the time.

The accumulated balance of the CRF may be used by the Board to meet the above objectives as outlined in section C2.

The with-profits policyholders have no rights to participate in the CRF, nor to support from that fund.

The accumulated balance of the CRF is invested in the Court Investment Fund.

B2.4 Order Insurance Fund (OIF)

The OIF comprises the accumulated assets backing policies specifically allocated to the OIF. This includes business previously in other funds which are no longer extant, including the High Court Annuity Fund and the Scottish Exemptor policies previously issued through the Scottish and Northern District.

The OIF has both with-profits and non-profit policies. Those sharing in profits are expressly stated to do so. The OIF is currently open to new business.

The assets of the OIF are primarily for the benefit of OIF policies but may, in exceptional circumstances and only when the resources of the Group Capital Fund and other non-profit insurance funds have been exhausted as described in B7.6, be used to support other long-term insurance funds.

B2.5 Transfer Funds (TF, LF and POIS fund)

The Tunstall Fund (TF) came into effect at 31 December 2003 as a direct consequence of the transfer of the engagements of the Tunstall Assurance Friendly Society Limited to The Society and in pursuance of the obligations placed on The Society by the Instrument of Transfer registered by the Financial Services Authority on 29 December 2003.

For convenience the salient points from the Instrument of Transfer of Engagements between the two societies are set out in Appendix B.

The Leek Fund (LF) came into effect at 31 December 2005 as a direct consequence of the transfer of the engagements of the Leek Assurance Collecting Society to The Society and in pursuance of the obligations placed on The Society by the Instrument of Transfer registered by the Financial Services Authority on 31 December 2005.

For convenience the salient points from the Instrument of Transfer of Engagements between the two societies are set out in Appendix C.

Both the TF and LF are closed to new business except to the very limited extent shown in the transfer documents and comprise both with-profits and non-profit policies; those sharing in profits are expressly stated to do so.

The number of policies in the TF, LF and POIS Fund will decline over time and the transfer instruments provide for the merger of the respective funds with another fund once specified criteria are met. In such an eventuality the basis of any merger will be such as to be fair to the policyholders of both funds.

The assets of the TF, LF and POIS Fund are primarily for the benefit of TF, LF and POIS Fund policies respectively but may be used, in exceptional circumstances and only when the resources of the Group Capital Fund and other non-profit insurance funds have been exhausted as described in B7.6, to support other long-term insurance funds.

The POIS fund came into effect at 26 September 2014 as a result of a transfer of the engagements from Family Assurance Limited. The POIS fund is closed to new business and comprises both with-profits and non-profit policies. The POIS fund has a separate PPFM.

B2.6 Group Business Fund (GBF)

The GBF is a long-term business fund and comprises the assets in respect of business specifically written as GBF business. Group business consists of non-profit insurances without any investment element either written under group policies or under individual policies. The fund is currently open to new business.

All policies written in the GBF are non-profit although some Group business may be eligible for profit-share payments in the event of favourable experience.

The Board reserves the right to distribute surpluses arising in the GBF to the GCF after taking advice from the Chief Actuary.

B2.7 Sick & Death Fund (SDF)

The SDF comprises the former Sick & Death business of the Courts previously reinsured by the Districts and centralised as at 1 January 2003, plus the former business known as the High Court Sick & Death Fund.

No new business has been credited to the Fund since 31 December 2002.

All policies written in the fund are non-profit, although certain policies previously insured by the former London United District have in the past been awarded additional benefits. The surplus in the fund as at 1 January 2003 was reserved for the benefit of Courts and was transferred to the CRF following the annual valuation at 31 December 2010.

The Board reserves the right to use surpluses arising after 31 December 2002 for the benefit of SDF policies or in such other way it may elect after taking advice from the Chief Actuary.

B2.8 Pure Endowment Fund (PEF)

The PEF is a long-term business fund and comprises the assets in respect of all with-profits pure endowment and with-profits whole-of-life business issued by the Courts and previously reinsured by the Districts prior to being centralised in 1 January 2003.

The PEF comprises a range of business written through different parts of The Society before it was centralised. Historically business had been written and administered by different Courts. The administration of the business was transferred into Districts in the 1980s. A number of Districts were closed and amalgamated with others until by 31 December 2002 only nine Districts remained. The Pure Endowment business administered by these Districts formed the PEF.

Following each amalgamation, the bonus rates applicable to the business amalgamated was put on a uniform basis, with differential bonus rates applying only in regard to differences in the guaranteed rate of interest implicit in the premium basis.

As at the time of centralisation and incorporation, special bonuses were declared to reflect the differing financial positions and the differing past practices of the remaining Districts so as to ensure equitable treatment for the former members of each District.

Regardless of the basis on which the business was written, all business is now regarded as being with-profits business with the exception of certain policies with a high level of guaranteed return.

The assets of the PEF are primarily for the benefit of PEF policies but may, in exceptional circumstances and only when the resources of the Group Capital Fund and other non-profit insurance funds have been exhausted as described in B7.6, be used to support other long-term insurance funds.

No new business has been credited to the Fund since 31 December 2002. Over time the number of policies in the PEF will decline and the assets diminish. The Board after taking advice from the With-profits Actuary and With-profits Advisory Arrangement reserves the right to merge the PEF into the OIF, or such other fund as it deems appropriate, when it deems it is appropriate to do so.

B2.9 Discretionary Benefit Funds (DBF)

There are several DBFs under the control of the Board and their purposes are detailed in Appendix A. These funds do not form part of the long-term insurance business of The Society.

The balances of the DBFs are not available for any purpose other than those specified.

The DBFs comprise such amounts as are credited to the each fund by subscription, gift or donation.

B2.10 Group Capital Fund (GCF)

The GCF (previously known as the General Reserve Fund) comprises such assets as are not allocated to any other fund and its resources are available to support all other funds in respect of regulatory and other commitments as the Board shall decide after taking advice from the Chief Actuary.

The GCF supports solvency or capital requirements and is also used to meet business risks as determined by the Board.

B2.11 Non-profit Fund (NPF)

The Non-profit fund came into effect at 26 September 2014 as a direct consequence of the transfer of engagements from Family Assurance Limited. The fund contains non-profit and unit-linked business and is open to New Business.

B3 Amounts payable under with-profits policies (applies to OIF, PEF, TF and LF)

B3.1 Aims of method

The bonus methodology aims to meet the objectives set out in B1.

B3.2 Approximations permitted

The methodology allows for extensive approximations for the following reasons:

- The portfolio is not sufficiently large to justify detailed and extensive investigative work. The costs of such an exercise would potentially be such that it would adversely affect policyholders to a greater extent than the use of broad approximations.
- Historical information has not been rigorously collected over the lifetime of the existing business. In particular the recording and allocation of costs to the long-term business has not been carried out.

As The Society moves forward the use of approximations is becoming less material as the collection and retention of the necessary information since 2006 enables greater accuracy.

B3.3 Control of changes to the methodology

The methodology and any changes to the methodology, used by the With-profits Actuary in making bonus recommendations is reported to the With-profits Advisory Arrangements and the Board and discussed with each before any bonus decisions are made by the Board.

The With-profits Advisory Arrangements annually review the performance of The Society against the PPFM and reports to the Board. The With-profits Advisory Arrangements are empowered to obtain such assistance as it needs e.g. the services of an independent actuary in formulating its opinion.

B3.4 Circumstances under which changes to historical assumptions may be made

Historical assumptions may be changed when further evidence comes to light that indicates that assumptions previously used materially disadvantage parts of the membership.

B4 Approach to setting annual bonus rates (applies to OIF, PEF, TF and LF)

B4.1 General aims

<u>B4.1.1 OIF and PEF</u>

The general aim in setting annual bonus rates is to set the rates no higher than those which could be maintained in the future were current investment conditions to remain broadly unchanged.

B4.1.2 TF and LF

For the TF, the rates of annual bonus are generally lower than described in B4.1.1 as it is intended to limit the guaranteed liabilities of the TF to permit greater investment freedom. The annual bonuses payable will be no higher than those achieved by investing in a portfolio of UK Government gilt-edged fixed interest stocks of appropriate durations. For the TF the policy on final bonus described in B5 ensures that policyholders are treated equitably.

For the LF, the rates of annual bonus are lower than described in B4.1.1 as it is intended that as the business of the LF runs off, the assets of the LF will progressively be exhausted. The bonus policy seeks to meet the reasonable expectations of policyholders and to maintain equity between different classes and generations of Leek policies. Furthermore, the bonus policy will be such that where possible an appropriate level of free assets within the fund shall be maintained to allow flexibility of response to changing conditions.

B4.2 Constraints imposed by changing external circumstances (applies to OIF, PEF, TF and LF)

Changing external circumstances may impose constraints on the bonuses which can be declared. Such changes may impact on The Society's finances and necessitate a more conservative bonus distribution policy. Examples of such circumstances (which do not limit the generality of the statement) may include the following:

- Changes in the financial markets which limit the expected investment return to below that which has been guaranteed on some contracts, thereby restricting the amount which may be allocated to with-profits policies.

- Regulatory changes necessitating the demonstration of additional margins of solvency, in turn requiring that surplus be withheld to increase The Society's margins.

- Increases in the unit costs of administering the existing portfolio of business beyond the levels previously anticipated.

If the change in circumstances is extreme, then The Society may decide to pay no bonus at all, or to restructure the way in which it pays bonuses. Extreme circumstances may include:

- A fall in investment returns below the levels implicit in guarantees contained in many policies;

- A major default in the financial system or a substantial decline in investment values leading to a fall in The Society's asset values with a diminution of solvency to below or near to the statutory minimum levels.

B4.3 Determination of the range over which a single bonus rate is appropriate and when a new bonus series is appropriate (applies to OIF, PEF, TF and LF)

Where business has previously been pooled for the purpose of determining a bonus rate, The Society will generally continue to operate the same pool for annual reversionary bonuses. Rates and amounts of any final bonus payable may be adjusted to fine-tune the total payouts.

Should it become apparent that certain contracts within the pool would thereby be disadvantaged by other contracts, the Board may, after receiving advice from the With-profits Advisory Arrangement and the With-profits Actuary, agree to revise the basis of pooling.

Where circumstances change to such an extent that it would be unfair to existing policyholders for new business to receive the same rates of bonus, the Board, after receiving advice from the With-profits Advisory Arrangement and the With-profits Actuary, will close any bonus series then still open to new business. It may then offer an alternative bonus series or amend the basis of the contract or withdraw the type of policy altogether.

Examples of such circumstances would be where:

- the costs incurred in acquiring new business substantially increased thereby necessitating a diminution of returns for new policyholders, and

- a fall in investment returns below the level required to meet policy guarantees necessitating a change in policy terms.

B5 Approach to setting final bonus rates

B5.1 OIF, PEF, TF and LF

In determining the total payouts on a policy becoming a claim by death or maturity, The Society has regard to the actual investment return earned on the assets backing the relevant fund and taking into account the actual demographic and expense experience over the lifetime of the policy.

The purpose of the final bonus is to ensure that the guaranteed sum assured plus annual bonuses declared to date and any other amounts of annual bonus is increased to achieve the desired level of total payout. The Board reserves the right to change levels of final bonus at any time after receiving advice from the With-profits Advisory Arrangement and the With-profits Actuary.

The levels of final payouts are reviewed at regular intervals, not less frequently than annually, but more frequently when significant changes in investment markets dictate. Particular regard is paid to the level of the capital values of the investments held to back the fund. A change of investment values of 15% would normally be regarded as significant in this context.

A review of rates does not necessarily lead to a decision to change the rates.

B5.2 Additional aspect for the PEF, TF and LF

For the PEF, TF and LF, the level of final bonus is monitored to ensure that the resources of the Funds are equitably depleted as the portfolio of business runs off the books.

B6 Approach to smoothing

B6.1 OIF, PEF, TF and LF

The Society seeks to smooth the payouts on policies of a similar type, size and term becoming claims in different periods of time, that is to say that the change in the payout may be less than the corresponding change in asset value.

Traditionally The Society has attempted to limit the size of the change in payouts on policies of a similar type to no more than 10% from year to year. However, where market movements are significantly greater than this, the Board may impose bigger changes on payouts after receiving advice from the With-profits Advisory Arrangement and the With-profits Actuary.

B6.2 Additional aspect for the OIF and PEF

For Funds other than the Transfer Funds, the amount of smoothing is intended to be cost neutral over time. However, the application of such a policy is subject to the availability of adequate resources to support the basis.

B6.3 Additional aspect for the TF and LF

For the TF and LF, the amount of smoothing may be more limited to ensure that exiting policyholders receive a fair share of the available assets of the Funds.

B6.4 Market Value Reduction (OIF and TF)

For accumulating with-profits policies issued in the OIF and the TF, a market value reduction may be applied to non-contractual surrenders where there could otherwise be a payment in excess of the value of the assets underlying the policy.

B7 Investment strategy (all Funds)

B7.1 Investment principles

The Society aims to maintain a broad spread of investments so as to meet the financial objectives of The Society described in section B1. The broad spread applies both by asset class and individual holdings, in accordance with the Prudent Person Principle approach to investment decisions and asset allocation introduced by the Solvency II Directive.

The Society makes use of external investment managers for its fixed interest, property and equity assets. Where management is outsourced, the individual investment managers are set specific objectives and portfolio constraints.

Where The Society manages investments directly, it takes professional advice as appropriate.

B7.2 Liability Matching

Attention is given to the nature and extent of The Society's long-term insurance business liabilities in each Fund. Rather than a policy of strict matching of guaranteed benefits with fixed interest assets of the appropriate term and security, the investment strategy varies from this to the extent that free assets allow greater flexibility within each of The Society's Funds. In determining the extent of deviation away from the theoretical position, no distinction is drawn between with-profits and non-profit liabilities.

Regard is also paid to the expectations of policyholders in relation to the nature of asset-backing. This is particularly notable in the past practice of traditionally backing former District business with property rather than equity investments. However, as the number of policies in a fund declines and the remaining policies approach maturity the investment strategy will change to reflect both the liquidity requirements and the level of guarantees within the fund.

B7.3 Asset quality and volatility

The Society requires its investment managers to select new fixed interest investments which are of at least the minimum investment grade quality as rated by a recognised bond rating service. A similar criterion also applies to the selection of deposit-taking institutions.

The Society has some protection against the impact of asset volatility on its solvency position through the capital held to meet the Solvency Capital Requirement.

B7.4 Non-tradeable assets

The Society maintains the following investments which may be regarded as not normally tradeable:

- office premises which are occupied by The Society for its own purposes;
- investments in any one of the two Investment Associations with connections to The Society;
- investments in subsidiary companies; these are made to further The Society's objectives or to generate profits or a contribution towards overhead costs.

Administrative requirements notwithstanding, the office premises would normally be retained to avoid disruption to the day-to-day management of The Society, although the Board reserves the right to effect a sale-and-leaseback arrangement. The scale of such investment is not significant within the context of The Society's investment portfolio and hence is unlikely to present any liquidity issues.

Monies deposited with the Investment Associations are repayable on demand but are normally only redeemable at face value. However, the assets of the Investment Associations show substantial appreciation against purchase costs. Income generated by the Investment Associations is distributed in a way that the resulting return to The Society is a high yield on a fixed capital value. No further capital investments in Investment Associations will be made although interest can be allowed to accumulate.

Subsidiary companies would not normally be traded, but the Board, after receiving advice from the With-profits Advisory Arrangements and the With-profits Actuary, would consider the possibility of external investment in the subsidiary companies so as to limit The Society's exposure. If necessary it would also consider the disposal of subsidiaries, but would not normally regard them as tradeable.

B7.5 New types of assets

The Society is willing to consider the use of new types of investment in furtherance of its core objectives. However, before doing so the Board will seek advice and guidance from the With-profits Advisory Arrangements and the With-profits Actuary and other appropriately skilled people. If appropriate it will also consult with the regulatory authorities before investing in such assets.

B7.6 Reliance on assets outside the WP funds

The OIF relies on assets outside the Fund

(i) to cover the potential costs of the pensions annuity guarantee;
(ii) to support capital requirements including those in respect of adverse market conditions; and
(iii) to meet members' expectations in respect of the management costs attributable to the Fund, to the extent that the other assets of The Society permit.

The PEF relies on assets outside of the Fund

(i) to support capital requirements including those in respect of adverse market conditions; and
(ii) to meet members' expectations in respect of the management costs attributable to the Fund, to the extent that the other assets of The Society permit.

All funds except Court Funds and the CRF can rely on the support of other long-term business Funds of The Society in order to meet claim payments as they fall due to the extent that it is necessary and appropriate for that support to be given. This support should only be necessary in exceptional circumstances. Support would first be provided by the Group Capital Fund and then

by the non-profit Funds. The support would be limited to the excess of assets over the liabilities of each Fund.
.

B7.7 Use of derivatives

The Society reserves the right to use derivative vehicles in a variety of circumstances such as:

- to stabilise the capital value of the fund, and
- to implement change to its investment portfolio as efficiently as possible.

Any exposure would not exceed 25% of the total value of The Society's investment portfolio.

B7.8 Constraints on investment strategy in regard to parts or generations of a fund

B7.8.1 OIF

In the OIF, certain liabilities require special consideration in determining investment strategy.

Members holding Series 1 accumulating with-profits single premium policies were led to expect that a significant proportion of the backing investments would be in real property.

B7.8.2 PEF

Holders of former District Pure endowment policies also have an expectation that a significant part of the assets backing their policies will be invested in property. However, as the number of policies in the Fund declines and the remaining policies approach maturity the investment strategy will change to reflect both the liquidity requirements and the level of guarantees within the Fund.

B7.8.3 TF

The communications to members of the TF during the transfer process held the expectation of an increased exposure to equities over the level current at the time (approximately 10% of the total fund).

B7.8.4 LF

The communications to members of the LF during the transfer process, in particular with regards to the investment levels, did not mention any restrictions with regards to the investment mix.

B7.9 Constraints on counterparty exposure

Counterparties are organisations with whom The Society has a commercial arrangement such as reinsurers, deposit takers, etc. A default by the counterparty would lead to a loss being incurred by The Society and in consequence, The Society imposes limits on the financial exposure to the counterparty and holds capital to protect against the risk of counterparty default.

B8 Business risk

B8.1 Business risk exposures

As a mutual insurer undertaking long-term insurance business, all activities of The Society potentially impact on the benefits of The Society's with-profits policyholders.

B8.2 Decision Procedures for undertaking business risk

As a mutual Society all the risks to which the insurance business is exposed are ultimately borne by the members. Accordingly, The Society actively monitors all activities so as to identify the risks involved and if appropriate, takes the appropriate mitigating action. Such action will be taken in the best interest of its members to ensure The Society:

- abides by any change in regulation;
- owns sufficient assets to meet liabilities as they fall due (remains solvent);
- manages The Society as a going concern into the future;
- meets the reasonable expectations of its new and existing members;
- seeks to maintain excellent relations with other companies, professional advisors and regulators;
- upholds the values of The Society.

Identified risks will be split by the area of the business they may impact, be it Operational, Strategic or Financial, and their perceived importance. The risks will take account of such factors as:

- new regulation,
- new business ventures and opportunities,
- changes in the economic climate,
- changes within The Society, and
- changes within the commercial environment.

B8.3 Procedures for reviewing and limiting the scale of risks

Each identified risk will be monitored and any changes identified will lead to a consideration of what further action is appropriate.

Mitigating action seeks to gain control of the risk either through eliminating it altogether or by limiting The Society's exposure. In this regard, the Board has the discretion to act in a number of ways including to:

- continue to monitor the risk at the same or higher level of vigilance,
- change the level or mix of assets held,
- close a line of insurance business to new policyholders, and
- undertake reinsurance to dilute the risk, if available.

B8.4 Procedures for reflecting profits/losses in with-profits payouts

The Board after receiving advice from the With-profits Advisory Arrangement and the With-profits Actuary, will decide where any business risks will be carried and hence where any profits or losses from those risks will accrue. To the extent that such risks relate to a particular with-profits fund, the profits or losses from those risks will accrue to that fund unless the Board has deemed that such business risk will in part or full be met by the Group Capital Fund. If the latter applies and the scale of losses exceeds the assets of the Group Capital Fund not otherwise allocated, then those losses will impact on the discretionary benefits of relevant with-profits policyholders.

B9 Charges and expenses

B9.1 Approach

B9.1.1 TF

For TF, the basis of charging is set out in the Instrument of Transfer and further details are given in Appendix B. Here the expenses of running the TF may be either more or less than amounts which can be charged to the Fund. Any surplus or shortfall is carried to or taken from the Group Capital Fund.

B9.1.2 LF

For LF, the basis of charging is set out in the Instrument of Transfer and further details are given in Appendix C. Here the expenses of running the LF may be either more or less than amounts which can be charged to the Fund. Any surplus or shortfall is carried to or taken from the Group Capital Fund.

B9.1.3 OIF and PEF

Expenses incurred in running The Society are apportioned to the relevant fund on the basis of an expense analysis which aims to be both fair and appropriate i.e. proportionate to the level of cost and complexity. Where it is considered appropriate to do so, the level of expenses charged to the OIF and PEF may be set at a level below those incurred with any resulting shortfall being supported by the GCF.

B9.2 Change to basis/exercising discretion

The allocation of expenses to Funds necessarily involves a number of assumptions and allocations. The Society uses its best endeavours to ensure that the allocation is as accurate as possible.

The basis upon which expenses are apportioned seeks to reflect the activities that give rise to such expenses. Accordingly, a basis change might be introduced to reflect changes to these activities (e.g. new outsourcing arrangements). It might also be introduced to accommodate new business methods and practices (e.g. new distribution outlet). It may simply be introduced to improve the current apportionment basis in the light of new information.

B10 Management of inherited estate

B10.1 Definition

The inherited estate is defined as:

> "the excess of assets maintained within a with-profits fund over and above the amount required to meet liabilities (including liabilities which arise from the regulatory duty to treat customers fairly in setting discretionary benefits)"

B10.2 TF

For the TF, the method of determining policy payouts described in B5 aims to ensure that any surplus is extinguished as the portfolio of business declines. The inherited estate can be considered to be negligible.

B10.3 LF

For the LF, the method of determining policy payouts described in B5 aims to ensure that any surplus is extinguished as the portfolio of business declines. The inherited estate can be considered to be negligible.

B10.4 PEF

For the PEF, the size of the fund established post incorporation included a full entitlement to any inherited estate. Much of this estate has been distributed by way of bonuses consequent on incorporation. Accordingly the inherited estate can be considered to be negligible.

B10.5 OIF

For the OIF, being the with-profits fund open to new business, the inherited estate is used to support new business and other business risks within the fund.

There are no constraints on The Society's freedom to deal with the inherited estate as a result of previous dealings.

B11 Volumes of new business and arrangements on stopping taking new business

The Board, after receiving advice from the Chief Actuary (and the With-profits Advisory Arrangement and the With-profits Actuary if appropriate), must be satisfied that it is in the interests of the policyholders for a fund to continue to remain open to new business against the alternative of closure and the options available for managing the closed book of business.

Considerations as to setting the maximum volumes of business are the level of capital and the processing capability that are required and to what extent mitigating options (such as reinsurance and outsourcing of administration) are possible.

Considerations are also given to the nature of products, their suitability for customers, the methods by which they are sold, the terms on which they are sold and the financial and business risks involved.

B12 Equity between with-profits funds and shareholders

As a mutual organisation, The Society has no shareholders and thus the issue does not arise.

C. PRACTICES OF FINANCIAL MANAGEMENT

COURTS

Note: UK Courts do not offer Long-term Insurance Business. One Court based in the Channel Islands offers Long-term and General Insurance Business but is not covered in this document.

C1 Courts - Investments

The Courts are required to invest their funds in the Court Investment Fund except for the following:

- cash required for immediate expenditure needs may be held in a bank account in the Court's name;
- direct investments through properties held since before incorporation on 31st December 2002, subject to the continuing agreement of the Board;
- existing deposits with Investment Associations. No new capital may be invested in such accounts, although interest may be allowed to accumulate.

C2 Court Reserve Fund (CRF)

The CRF comprises:

- accumulated assets held for the benefit of Courts not otherwise distributed to them;
- investment income arising from the Court Investment Account which is not distributed;
- transfers from GCF, as appropriate ;
- any other source as is appropriate.

The use of the CRF is under the sole discretion of the Board to meet the objectives set out in B2.3. The with-profits policyholders have no rights to participate in the CRF, nor to support from the fund.

C3 Court Investment Fund (CIF)

The Court Investment Fund is a fund held by The Society for the purposes of investing the assets of The Society's Courts.

The current objective of the CIF is to generate a level of investment income to meet Court requirements; this means focussing on income in preference to capital gains. Historically there has been a high proportion of investment in real property and, depending on changes in the investment markets, the intention is to maintain such a proportion, subject to a broad spread of individual holdings.

The cost of managing the CIF investments is charged to the CIF.

Investment income arising from the Fund is distributed to Courts through the CRF. Some is distributed to Courts as a percentage of the amount invested in the CIF and some as a per capita allowance. The CIF has been unitised so that the change in value is passed back to each Court by adjusting their CIF balance. In this way Courts benefit from any capital appreciation and suffer any capital depreciation arising since 1 January 2004.

The CIF will hold predominantly property investments. Given this investment mix, the Board reserves the right to refuse a withdrawal or to delay it, if this would necessitate the sales of assets from the fund in adverse market situations.

The Board will examine all requests for withdrawal of funds and at their sole discretion approve or reject the application.

LONG-TERM INSURANCE BUSINESS

C4. Amounts payable under with-profits policies (applies to OIF, PEF, TF and LF except where otherwise indicated)

C4.1 Methods used to determine amounts

The payout from an insured event under a with-profits policy is the sum of the guaranteed benefits, annual bonuses and final bonuses. The methods used to determine the amounts payable under a with-profits policy will follow the methods used to determine annual and final bonuses.

The current approach is to seek to reduce the proportion of the total benefit payable by way of annual bonuses in favour of an increase in the proportion payable by way of final bonuses. This reduces the level of guaranteed benefits during the policy lifetime and thereby enables The Society to pursue a wider investment policy.

In any review of bonus levels, the starting point is the current levels of annual bonuses and current payouts on policies becoming a claim. These are examined for fairness and supportability in current financial conditions.

Changes to rates are considered in relation to changes that have occurred in various matters such as mortality rates and expenses, but primarily in response to changes in investment conditions.

Payouts are also generally set with reference to asset shares. The asset share is broadly an accumulation of the premiums allowing for returns on the underlying investments and profits from miscellaneous sources less various deductions. The profits from miscellaneous sources include profits arising from lapses and a share of the profits on non-profits business associated with the specific fund. The deductions include items such as expenses or explicit policy charges, the cost of life cover, any taxation if applicable and charges for the cost of guarantees.

C4.2 Methods used to determine parameters

As noted in section B3.2 extensive approximations have been used, and this applies to assumptions used in the asset share calculations applicable for calendar years up to 2006 for OIF and PEF and 2007 for TF.

The assumed cost of life cover is based on recent mortality experience, with allowance for mortality improvements.

Further information in respect of the assumed investment return, expenses and taxation is set out in sections C4.6 to C.4.8 below.

C4.3 Approximations across time/classes

<u>C4.3.1 OIF</u>

Business written in the OIF is split into separate categories by the following criteria:

- Taxable and tax-exempt
- Life assurance or pensions
- Regular or single premium
- Accumulating with-profits

Some of these categories are further split when considering the amounts payable. This is to ensure appropriate consideration is given across different types of policy.

Approximations apply within each category reflecting the lack of detailed historical information especially on incurred expenses.

<u>C4.3.2 PEF</u>

Before incorporation and centralisation at 1 January 2003, each District ran a separate bonus pool for its own Pure Endowment business. On centralisation, the former District Pure Endowment business was brought into the PEF and an equalisation bonus was paid during 2004 such as to bring all with-profits business onto a common footing.

Subsequent bonus distributions pool the entire portfolio of business, distinguishing only between categories by the implicit guaranteed interest rate described in section B2.8 and between endowment and whole of life business.

<u>C4.3.3 TF</u>

The business of the TF is characterised by the longevity of some of the business, the very small size of many policies and the absence of historical information relating to the expenses and the way they have been apportioned across the business. Accordingly it has been necessary to utilise some very broad approximations as to each policy's share in any surplus within the fund.

<u>C4.3.4 LF</u>

The business of the LF is characterised by the longevity of some of the business, the very small size of many policies and the absence of historical information relating to the expenses and the way they have been apportioned across the business. Accordingly it has been necessary to utilise some very broad approximations as to each policy's share in any surplus within the fund.

C4.4 Formality of documentation

The methodology of bonus distribution is documented herein but its periodic application is considered in the circumstances at the time in the papers presented to the Board and the minutes of their meetings.

C4.5 Procedures for changing assumptions

Assumptions can be varied from time to time by the Board following the advice of the With-profits Actuary and With-profits Advisory Arrangements in the light of the information available.

C4.6 Inclusion of investment return

As noted in section C4.2, extensive approximations have been used to determine the assumptions for the asset share calculation and this includes the investment return assumptions. For the period up to 2006, a level investment return, less any applicable taxation, has been assumed, based on the estimate of the historical returns to the end of 2006, plus an allowance for profits arising from miscellaneous sources.

For 2007 onwards the investment return is calculated more accurately with regard made to the total investment return from that apportionment of assets appropriate to the business under consideration. An explicit allowance for profits arising from other sources will also be determined.

C4.7 Inclusion of expenses

In the asset share calculations, allowance has been made for expense charges to the end of 2006, chosen to be reasonably consistent with historic pricing assumptions. These charges are possibly lower than historic expenses, so that an element of miscellaneous profits is recognised in this component of the asset share calculation.

For 2007 onwards the expense charges are determined more accurately.

Expenses cover the acquisition of business (including commission) and the administration of existing business including claims and investment costs as well as other structure costs.

The Society seeks to attribute the expenses of any particular category of business to that business in determining bonuses, to the extent that the appropriate information is available.

This is affected by means of an expense analysis which allocates costs to particular functions and then to broad groupings of business. Where the costs incurred in respect of the business in each fund can be identified the appropriate charge to the fund will be made.

Some costs will be directly attributable to specific categories of business, whereas others will require apportionment according to appropriate bases. Such bases may include numbers of policies, amounts of premium or size of funds. Bases used from time to time are designed to have regard for ease of application and consistency of results.

In general all costs incurred will be included. However, where appropriate certain costs may be spread over subsequent years if it is fairer to policyholders to do so. Such costs will normally be non-recurrent charges of a significant amount (usually greater than £50,000) where the benefit of the expenditure will be recouped over a number of years e.g. by developments in data processing.

The Society may decide to restrict the expenses ultimately included in the calculation of asset shares to an amount lower than would be otherwise be the case. Any excess expenses over and above this amount will be borne by the relevant inherited estate or by the GCF. This decision will be reviewed by the Board at least annually having taken advice from the With-profits Advisory Arrangement and the With-profits Actuary.

C4.8 Inclusion of taxation

Tax is apportioned between the various benefit funds having regard to the tax position of each fund as if it were a stand-alone entity. Any differences between the total tax payable and the aggregate of individually calculated amounts is apportioned between the funds by the Board after considering the advice of the With-profits Actuary. The Instrument of Transfer determines the specific requirements applicable to the Tunstall and Leek Funds (see Appendix B, paragraph 10).

The asset share calculation allows for taxation where appropriate.

C4.9 Other items

C4.9.1 OIF

Where appropriate, the deductions from asset shares include a charge for the cost of maturity guarantees. This charge applies to those policies which provide guaranteed benefits on maturity. Currently the charge is set at a level of between 0% and 5% of asset share, depending on product type and policy commencement date. The size of these charges may vary from time to time depending upon the expected cost of guarantees and consistent with the fair treatment of policyholders.

The Board has determined that the cost of provision of the pensions annuity guarantee will fall to the Group Capital Fund.

The amounts of miscellaneous surplus arising in the fund, not otherwise taken into account in the bonus process, largely from non-profit business, are currently considered to be small. These initially go to the fund's inherited estate to be subsequently distributed to asset shares as decided by the Board on the advice of the With-profits Advisory Arrangement and the With-profits Actuary.

C4.9.2 PEF

Where appropriate, the deductions from asset shares include a charge for the cost of maturity guarantees. This charge applies to those policies which provide guaranteed benefits on maturity. Currently the charge is set at a level of between 0% and 4% of asset share, depending on product type and policy commencement date. The level of this charge may vary from time to time depending upon the actual cost of guarantees.

The amounts of miscellaneous surplus arising in the fund, not otherwise taken into account in the bonus process, largely from non-profit business, are considered to be very small.

C4.9.3 TF

Under the terms of the Instrument of Transfer of Engagements, all surplus arising in the fund is distributable to the members of the fund. The amounts of miscellaneous surplus arising in the fund, not otherwise taken into account in the bonus process, largely from non-profit business, are considered to be small.

Members with mortgage endowment policies have been offered a guarantee in regard to the maturity value of their policies. The cost of this guarantee, if any, will fall on the fund.

C4.9.4 LF

Under the terms of the Instrument of Transfer of Engagements, all surpluses arising in the fund are distributable to the members of the fund.

C5 Approach to setting annual bonus rates

C5.1 Description of approach

C5.1.1 OIF, PEF, TF and LF

Annual bonuses are guaranteed benefits over and above those set out in the policy document.

In any review the starting point is to consider the sustainability of the current scale of annual bonus rates having regard to both the current level, and the prognosis for future levels, of investment, expense and mortality conditions. Annual bonuses are then determined in the light of these investigations setting the rates below the levels that emerge to provide a margin for final bonus.

The Board, after receiving advice from the With-profits Advisory Arrangement and the With-profits Actuary, reserves the right not to declare an annual bonus should circumstances so determine. For example this may arise where the investment return is below the guaranteed level implicit in the premium basis.

C5.1.2 Additional special considerations for the TF

For the TF, the rates of annual bonus are set at a low level so as to maximise the investment flexibility of the Fund.

C5.1.3 Additional special considerations for the LF

For the LF the rate of annual bonus is set at a low level so as to maintain an appropriate solvency level in the fund.

C5.2 Frequency of setting/re-setting bonus rates

Annual bonuses are generally reviewed and set annually. However, the Board reserves the right to amend rates of interim bonus at any time and also to defer any bonus declaration or not to make a declaration. It would look to do so in the circumstances of a major adverse change in The Society's financial position and/or outlook from a wide range of causes especially, though not exclusively, as regards to its investments and the income there from.

C5.3 Maximum change (if any)

The Society sets no limits to the maximum change that can be applied.

C5.4 Approach to interim bonus rates

The interim bonus rate is set at the anticipated bonus rate at the next declaration. It is normally limited to the rate last declared.

C6 Approach to setting final bonus rates

C6.1 Description

C6.1.1 OIF, PEF, TF and LF

For most policies, the amount of final bonus added to a policy is such as to increase the sum of the guaranteed sum assured in the policy plus accumulated annual bonuses to the desired total payout. In practice a simple scale is adopted, expressed in relation to guaranteed benefits and/or declared annual bonus and varying by policy term or premium payment date as appropriate.

At maturity, the difference between the asset share and the guaranteed sum assured and accumulated annual bonuses, if positive, is a guide to the appropriate level of final bonus.

The results are then assessed in comparison to current scales, the desire to smooth results between one year and the next and between policies of similar term, and the ability of the Society to afford them. A scale is then determined which aims to give policyholders a fair and reasonable share of the relevant fund.

Whilst The Society cannot guarantee to pay 100% of asset share for the primary reason that our policy is to restrict the movement in payouts from one year to the next, we aim that the payout will fall within the range from 70% to 130% of asset share. In a number of circumstances, for example where the Society's solvency position is at risk or would be at risk, it may not be possible to make payouts which fall within this range.

The position is slightly different for regular premium whole of life policies with guaranteed death benefits but no maturity date. As the asset share for these policies will build up over time as premiums are paid in, we would naturally expect some members to die while their asset share is lower than their guaranteed benefit. Final bonus rates are therefore set so that the estimated future cost of providing the benefits payable on death is equal to the asset share for this group of plans.

C6.1.2 Additional special considerations for the PEF

The equalisation bonus described in section C4.3.2 aims to bring all PEF policies onto an equal footing as at that date. Equalisation bonuses will be included in the calculations used to determine future bonus levels (both annual and final).

C6.1.3 Additional special considerations for the PEF, TF and LF

Final bonuses for the TF reflect the low level of annual bonus described in section C5.1.2.

As the with-profits policyholders in the PEF, TF and LF are entitled to all the surplus within the PEF, TF and LF respectively, the level of any final bonus determined by the method in C6.1.1 will be adjusted in order to ensure that the fund is exhausted as the business runs off.

C6.2 Market value reduction (MVR)

C6.2.1 OIF

The only business affected by MVRs are accumulating with-profits policies in the circumstances of policy surrender and unless otherwise stated within the policy literature. Here the investment performance of the asset backing is monitored against the accumulating policy values, subject to such guarantees as have been extended to members and regulatory requirements. Any policyholder who would be affected by an MVR will be notified by The Society prior to any surrender payment being made.

C6.2.2 TF

MVRs may be applied on accumulating with-profits business written on either a single premium or regular premium basis. Here the investment performance of the asset backing is monitored against the accumulating policy values, subject to such guarantees as have been extended to members and regulatory requirements. Any policyholder who would be affected by an MVR will be notified by The Society prior to any surrender payment being made.

C6.2.3 PEF and LF

No MVRs are applied to the PEF or LF business of The Society.

C6.3 Allowance for final bonuses in with-profits policy surrender values

The Society makes allowance for final bonuses, if appropriate, in determining policy surrender values at the discretion of the Board after receiving advice from the With-profits Advisory Arrangements and the With-profits Actuary. The bases for calculating surrender values are reviewed at least annually. Such a review would not necessarily lead to a change in the basis of calculating surrender values.

C6.4 Frequency of (re)setting final bonus and the circumstances which would drive change

Final bonuses are declared at the discretion of the Board after receiving advice from the With-profits Advisory Arrangements and the With-profits Actuary. They are reviewed and determined at least annually, but the Board reserves the right to change them, or cease to pay them, at any time. In particular, it will normally perform a review if there was a fall of 15% or more in the value of its investments compared to the level at which rates were last set, especially if there is evidence of a significant number of policyholders, who by surrendering their policies, are benefiting unfairly at the expense of those remaining.

C7 Approach to smoothing (OIF, PEF, TF and LF unless otherwise indicated)

C7.1 Description of current approach to smoothing

When determining rates of annual bonus and final bonuses, The Society aims to smooth the pattern of results both from one set of bonus scales to the next and between similar policies where claims arise during the same period.

Subject to the policy on smoothing set out in B6, the practice for smoothing, for each major class of business, can be summarised as:

If there is a less than (or equal to) 10% change in the amounts payable for the class based on targeting relevant aggregate asset shares, the amounts payable are set equal to the amounts based on targeting the relevant aggregate asset share for the class;

If there is a greater than 10% change in the amounts payable for the class based on targeting relevant aggregate asset shares, the amounts payable are adjusted by 10%; unless

If there is a greater than (or equal to) 20% change in the amounts payable for the class based on targeting relevant aggregate asset shares, the amounts payable are adjusted by individual consideration.

C7.2 Rapidity of adjustment

C7.2.1 OIF

The Society aims to limit the change in payouts from one review to the next to no more than 10% at a policy class level while ensuring that the principles set out in B6.1 are not broken, but The Society reserves the right to change by a greater amount should that be necessary in the face of changing position and outlook such as a changing legislative and regulatory environment or a significant change in the market value of assets.

C7.2.2 PEF, TF and LF

The framework in C7.2.1 also applies, however as the objective of payouts is to exhaust the funds when the last payment is made, greater fluctuations in payouts can be expected here. The Board will make such decisions, after receiving advice from the With-profits Advisory Arrangements and the With-profits Actuary, in order to meet the objective.

C7.3 Limits to cost/surplus from smoothing

No explicit limits are set for the cost in any period from making payouts in excess of the value of assets backing the policies, nor the amount of surplus arising should this value of assets exceed payouts. Decisions will take into account a number of factors, including expectations for future asset price movements, the guarantees given to members implicit in sums assured and previous bonus declarations, and the availability of resources to support the business.

C7.4 Single/multiple smoothing strategies to various types/generations of policy and new entrants

The scale of The Society's business within each of the various categories and the lack of detailed historical analyses of costs and investment returns do not support other than the most simple of smoothing strategies. Differentiation is made between regular premium accumulating with-profits policies and accumulating with-profits policies written on a single premium (or repeated single premium) basis.

C7.5 Application to surrender values

The surrender value basis is such that ordinarily the smoothing applied to payouts on death or maturity is also followed in calculating surrender values. However the Board reserves the right, after receiving advice from the With-profits Advisory Arrangements and the With-profits Actuary, to apply a lesser degree of smoothing to surrender values in order to balance the interests of remaining policyholders.

C7.6 Accuracy of the application of MVRs

MVRs are applied as described in section C6.2. They are intended to provide only a broad measure of equity as the scale of The Society's business within each of the various categories and the lack of detailed historical analyses of costs and investment returns do not support other than the most simple of strategies.

C8 Investment Strategy

C8.1 Asset Class Ranges

The current target investment percentages for the Society's with-profits funds are:

Fund	**OIF**		**PEF**	**TF**		**LF**
	Asset Share	Other	Fund	Asset Share	Other	Fund
Asset class						
Equities	20-50%	0%	0-10%	10-40%	0%	0-10%
Properties	0-30%	0%	0-10%	0-20%	0%	0-10%
Fixed Interest	30-60%	60-90%	50-80%	40-70%	60-90%	65-95%
Cash & Other	0-10%	10-40%	0-30%	0-30%	10-40%	5-35%

The "Fixed Interest" category includes fixed interest and index-linked government bonds, as well as corporate bond holdings.

The target investment percentages should be regarded as a benchmark, and at any time the actual holding may be different from the percentages shown. The target investment percentages have regard to expectations of members in relation to the nature of asset-backing.

These target investment percentages are for the funds/parts of funds in aggregate. Certain policy types may have different asset class mixes dependent on various factors such as the level of guarantees and any specific considerations as stated in policy literature.

C8.2 Investment strategy

Investment strategy is reviewed at least annually and at such other time as investment conditions necessitate a further review.

The Society has within its investment strategy a process which requires the automatic sale and/or repurchase of equity investments when certain market conditions are met, in order to preserve capital values. The level of the FTSE All Share index is used to define a series of trigger points at which varying proportions of the equity holdings will be sold.

C8.3 Degree of matching between assets/liabilities

The investment strategy for each With-profits Fund aims to broadly match the assets and liabilities. This means that in general for funds where liabilities have short durations or high levels of guarantees, particularly in the funds not open to new business, a greater proportion of the assets are invested in fixed interest securities. For the OIF and TF, assets are hypothecated so that the asset shares have a different asset mix to the remainder of the fund.

C8.4 Approach to investment in different classes of assets and assets of different credit/liquidity

The Society makes use of external investment managers, particularly relating to fixed interest, property and equity assets. The Society's investment strategy allows for the use of both passive and active investment management approaches.

Where the Society uses a passive investment management approach it makes use of index tracking funds for both equity and fixed interest asset classes and in so doing takes professional advice where appropriate.

Where active investment management is outsourced to approved fund managers, they are given discretion to select investments in line with the target investment percentages set out in C8.1 and other constraints which include limits as to the amounts which may be invested in any one counterparty. For fixed interest investments, the rating of permissible securities at time of purchase is as stated in section B7.3.

Property assets are overseen by external specialist surveyors who advise The Society on the spread and mix of its holdings both in regard to purchases and sales but also to any other matter which may arise during the course of The Society's ownership.

C8.5 Approval process before investing in new instruments

The Board will consider and approve or reject proposals for different types of investment after receiving advice from the Investment Committee, the With-profits Advisory Arrangement and the With-profits Actuary.

C8.6 Non-tradeable assets

C8.6.1 Description

A small proportion of the assets backing the long-term business of The Society include office premises in Southampton and Tunstall. A small proportion of assets are held as deposits with Investment Associations. These assets do not back the with-profits funds.

C8.6.2 Application in claim values

In the calculation used to determine the value of claims, assets are taken at their values prescribed by the asset valuation regulations. Properties are included at their market value at the date of the last valuation; every property is valued annually.

C8.6.3 Constraints imposed by non-tradeable assets

Office premises are considered to be tradeable, but recognition of the potential disruption to the effective administration of The Society hinders such a move. However, The Society would be willing to consider a sale and leaseback arrangement.

Deposits made with the Investment Association are withdrawable on demand but only at face value, whereas the underlying assets of the Association belong to the generality of depositors, so withdrawing the funds would lose the accumulated share of capital gains which can be very significant in terms of the deposits themselves.

It is not currently expected that further capital will be required by any current subsidiary company. However, further subsidiaries may be formed to enable The Society to take advantage of business opportunities or tax efficiencies.

C9. Business Risks (applies to OIF, PEF, TF and LF unless otherwise indicated)

C9.1 Current limits

The Society is exposed to a variety of risks which may affect the amount of bonuses payable to members holding with-profits policies. These risks may be external to The Society or inherent within its business arising from such events as:

- Legislative and regulatory change affecting the amount of surplus available for distribution to members
- Changes to the way taxation impacts on the funds

- Changes to the market value of, and yields from, The Society's asset portfolios
- Changes in the pattern of mortality and morbidity
- Calls on The Society to contribute to central compensatory funds
- Defaults by counterparties
- Non-profit business being loss-making
- Failure of systems of control resulting in administrative or governance issues which necessitate expensive remedial action
- Expenses greater than margins within the policies. This may be particularly relevant in cases where sales of new business fail to achieve anticipated levels necessary to cover fixed costs.

The Society aims to limit the extent of risk by a process of mitigation where possible at an economic cost.

C9.2 Approach to managing exceptional losses within with-profits funds

Exceptional losses incurred within the OIF, PEF, TF or LF will, in the first instance, be charged to the fund itself. If the fund is unable to support the charge then some or all of the exceptional losses will be charged to the GCF.

To the extent that the resources in the GCF are exceeded then further arrangements will be made. Potentially this will mean drawing down on surplus otherwise available in other Society funds such as is necessary and appropriate.

Note that even if the resources of the GCF can bear the demands upon it, to the extent that its resources are weakened then it will no longer be able to support other Funds as appropriate.

C9.3 Impact of particular risks

C9.3.1 General

The Board will, after receiving advice from the With-profits Advisory Arrangements and the With-profits Actuary, decide where the impact of such diminution of surplus will fall, having regard to the extent of underlying policy guarantees. Certain specific practices are set out below.

C9.3.2 TF and LF

The Instrument of Transfer in respect of the TF and LF provided for that Fund to be charged on a prescribed basis. If the charges fail to meet the costs incurred in running the Fund then the GCF in the first instance will be adversely affected.

If the TF or LF is unable to cover the Minimum Solvency Margin in respect of its own long-term business liabilities from its own surplus, or cover its own mathematical reserves with allowable assets of the TF or LF, then the respective fund will be charged for the implicit capital support provided by the other Long-term Funds of The Society, but no actual transfer of funds will be made under this arrangement.

C10. Charges/expenses

C10.1 General description of charges currently applied/apportioned

Where expenses are fund-specific they are charged directly to that fund. All other expenses incurred in administering the business of each fund are apportioned to that fund using the society's cost allocation model. This model involves making a number of judgements as to the way various items of costs are allocated to different funds and classes of business.

The exception to this is in respect of the TF and LF, where the allowable charges are defined by the transfer agreements.

As The Society undertakes a range of social, fraternal and benevolent activities not all of the expenses incurred by The Society are apportioned to the long-term business.

C10.2 Circumstances where expenses may be charged other than at cost

Certain expenses may be of an exceptional nature, or relate to capital investments for future benefits. In such circumstances, the Board reserves the right to charge expenses to policies other than at cost in order to maintain equity between different categories of members.

From time to time for any fund the Board may decide to limit the charge to policies to less than the actual expenses incurred. In this situation, the difference may be borne by the Inherited Estate of the Fund in which the business is written or by the GCF.

Such decisions will be made by the Board after receiving advice from the With-profits Advisory Arrangements and the With-profits Actuary and having regard to the interests of with-profits policyholders.

C10.3 Interval for review arrangements for outsourced services and indication of terms on which it can terminate such agreements

The Society has a number of outsourcing arrangements which may include professional services, the provision of information systems, and for the promotion, selling and administration of certain classes of business. Generally such agreements are reviewed at least annually. Such agreements contain clauses permitting termination after a period of notice, not normally exceeding six months.

C11. Inherited Estate

Sections B10.2 to B10.4 state that the inherited estate for each of the TF, LF and PEF is considered to be negligible. As a result of this, distributions to policyholders in these funds in respect of the inherited estate, if any, are not expected to be significant. For the OIF, miscellaneous profits or losses initially go into the inherited estate rather than directly to asset shares.

From time to time, The Society will review whether the surplus assets within a with-profits fund are more than is needed to meet the prudent management of the fund. If it is determined that there is an excess surplus, then the Board, after receiving advice from the With-profits Advisory Arrangements and the With-profits Actuary, will decide at the time how it will be best utilised in the interests of the fund's with-profits policyholders.

C12. Volumes of new business and arrangements on ceasing new business

There are no specific practices regarding the setting of limits on new business volumes other than those implied by the principles set out in section B11.

D. Process affecting the PPFM

D1. Annual report to with-profits policyholders

The Society is required to produce an annual report within six months of the financial year end to with-profits policyholders stating whether it believes that it has complied with its obligations in relation to the PPFM and the reasons for that belief. The Society also maintains an arrangement which involves some independent judgement in assessing its compliance with its PPFM.

D2 Review

Changes to the PPFM may be made at any time; for example:

- to reflect the receipt of a transfer of engagements from another friendly society or other insurer;
- to reflect the development and launch of new products;
- to reflect the establishment of, or significant changes in, subsidiary companies;
- to reflect significant changes in the investment markets;
- to reflect changes in regulatory requirements;
- to reflect changes in bonus philosophy.

D3 Changes to Principles

Changes to Principles are subject to the requirement to give three months' notice to all affected with-profits members, except where the change is necessary to correct an error or omission, improves clarity or is immaterial.

Changes to Principles will be agreed by the Board, having taken the advice of the With-profits Advisory Arrangements and the With-profits Actuary.

D4 Changes to Practices

Changes to Practices will normally be notified to affected with-profits members in a statement issued alongside bonus notices (or such other documentation), although the Board reserves the right to make alternative arrangements as the circumstances shall demand.

Appendix A: Schedule of Business In Force (including non-insurance activities): Note only significant classes of business are shown

Fund	Business	Open to new business	Comments
Courts	Social, benevolent, fraternal activities	Yes	Not long-term insurance business
Order Insurance Fund (OIF)	**With-profits (conventional)**		
	- Series 1	No	
	- Golden Arrow	No	
	- Whole of Life Series 2	No	
	- Endowment Series 2	No	
	- Endowment Assurance	Yes	
	- Autumn Gold / 50+ Life Cover	Yes	
	- Personal Pensions	No	Top ups to existing pensions business permitted.
	With-profits (accumulating)		
	- Series 1 ISA/WPB	No	
	- Series 2 ISA	No	
	- Series 2 WPB	Yes	
	- Series 3 ISA	Yes	
	- Child Trust Fund	No	
	Non-profits		
	- Term assurances	No	
	- PHI	No	Increase in level of cover permitted.
	- Sickness & Accident	No	
	- Critical Illness (Lady Plan)	No	
Tunstall Fund (TF)	**With-profits** IB assurances - range of traditional endowment and whole life assurances including quinquennial bonus policies OB assurances - range of traditional endowment and whole life assurances Accumulating WP business - ISA/PP/WPB **Non-profits** IB - policies becoming paid up on cessation of premiums before the end of the payment term OB Term assurances	No	Tunstall Assurance Friendly Society closed to new business on 9/4/2003 and transferred to Foresters on 31/12/2003.
Group Business Fund (GBF)	Non-profits Group contracts with limited premium rate guarantees issued on groups of lives providing life, PHI and critical illness benefits.	Yes	

Fund	Business	Open to new business	Comments
Leek Fund (LF)	**With-profits** IB assurances - range of traditional endowment and whole life assurances including quinquennial bonus policies OB assurances - range of traditional endowment and whole life assurances **Non-profits** IB and OB policies becoming paid up on cessation of premiums before the end of the payment term	No	Leek Assurance Collecting Society closed to new business in March 2005 and subsequently transferred to Foresters on 31/12/2005.
POIS Fund	**With-profits** Whole Life and Endowment **Non-profit** All	No	POIS Assurance Limited closed to new business following the transfer to Family Assurance Friendly Society in 2002. The fund subsequently transferred to Foresters on 27/9/2014.
Non-Profit Fund (NPF)	**Unit-Linked** Endowments **Non-profit** Whole life	Yes No	POIS branded contracts written by Family Assurance were transferred to Foresters on 27/9/2014.
Sick & Death Fund (SDF)	Non-profit - range of contracts providing a variety of death and sickness benefits	No	
Discretionary Benefit Funds (DBF)	The business of the Society's main Discretionary Benefit Funds are detailed below.		Not long-term insurance business.
- Foresters Support Fund	The Foresters Support Fund is maintained for the following purposes: a) Granting assistance to Members, widows, widowers or children of Members when in distressed circumstances. b) Granting assistance to Members, widows, widowers or children of	N/A	Discretionary (non-contractual) membership benefit.

	Members on the occasion of a happening of an exceptionally disastrous nature.		
- Child Support Fund	The Child Support Fund is maintained by voluntary donations and legacies left to The Society for this fund. Its purpose is to provide grants in the following circumstances:– a) The relief, maintenance, or education of children of Members who are under 19 years of age and bereft of either parent. b) The relief or maintenance of children of totally incapacitated parent or parents. In every case provided that the Child, or a parent, was a Member before the death or total incapacity of the parent.	N/A	Discretionary (non-contractual) membership benefit.
- Convalescent Home Benefit Fund	The Convalescent Home Benefit Fund is maintained by levies upon Courts as determined by the High Court for the purpose of: a) Providing Convalescent Home stays for Members following hospital stays, long-term illness, recuperative breaks, bereavement, respite care and invalidity. b) Assisting in the maintenance of Convalescent Homes which maybe of benefit to Members of The Society.	N/A	Discretionary (non-contractual) membership benefit.
- 150th Anniversary Educational Awards Fund	The 150th Anniversary Educational Awards Fund is maintained by voluntary donations. From the Fund awards can be made to Members who have reached the age of 16 and are following, or are proposing to follow, a course of further education or training, either full or part-time, leading to a degree or other recognised professional or technical qualification.	N/A	Discretionary (non-contractual) membership benefit.
Group Capital Fund	Mutual capital of The Society belonging to Members.	N/A	

Appendix B: Basis of transfer for Tunstall Assurance Friendly Society Limited as specified in the Instrument of Transfer

The following is a brief précis of the basis of transfer. Reference should be made to the actual instrument for further detail.

Operation of the TF

Establishment of Fund

1. On transfer, a separate Fund, known as the TF, was set up in the Foresters.

2. The assets of Tunstall Friendly Society, except as noted below, were credited to the TF.

3. Tunstall Friendly Society's insurance liabilities and such other liabilities as noted below became liabilities of the TF.

Investment

4. The assets of the TF may be held separately from other assets of the Foresters or may be pooled with them in which case Foresters will maintain a system of apportionment to determine the appropriate amount belonging to the TF.

5. All investment income and capital appreciation or depreciation arising from Tunstall Fund assets shall be credited to the TF.

Policies

6. No new policies shall be issued in the TF.

7. The TF shall be credited with premium income arising from policies within the Fund and debited with claims on such policies.

Expenses

8. The TF shall be debited, and the Foresters Management Fund credited, with a charge for expenses on the following formula:

- (i) All expenses attributable to the investment of the funds, plus
- (ii) an administration charge of £14 per policy per annum increasing at Retail Price Index (RPI), plus an allowance for integration costs of £90,000 in the first year after transfer, £60,000 in the second year and £30,000 in the third year, minus
- (iii) 50% of any cost saving, which is defined as the difference between the amount in (ii) and the actual costs attributable to the integration and running of the Tunstall business excluding investment costs.

9. The basis shall be the subject of review every fifth year or at such time when there is a significant change in the business portfolio or the cost structure, whichever is the earlier.

Taxation

10. Each year there shall be made a computation of the tax that would have been incurred had Tunstall remained as a separate entity, but taking account of actual cash flows to the Fund. The Board of Foresters, after taking advice from the With-profits Actuary, shall determine what transfer into or out of the TF shall be appropriate in regard to taxation. In giving advice, the With-profits Actuary will consider the respective tax situations of the Tunstall and Foresters Funds.

Other liabilities of the TF

11. The TF shall be liable for its appropriate share of any payments falling on Foresters by way of centralised compensation schemes e.g. Financial Services Compensation Scheme, or payments arising under the Policyholder Protection Acts.

12. Any liabilities in addition to the guarantees in the assurance policies arising in respect of the business of Tunstall Assurance or Tunstall General Insurance Services or example compensation for mis-selling of specific policies shall fall on the TF.

13. Without prejudice to the generality of the foregoing, the TF shall bear the cost of any deficit in the Tunstall Staff Pension Fund in respect of transferring members' service to the transfer date based on salaries as at that date, projected on the valuation basis.

Mutual Support

14. The TF shall not be called upon to support the other Funds of Foresters, or vice versa, unless the With-profits Actuary has advised the Board that such a course is both necessary and appropriate.

Bonus policy

15. Bonuses on the Tunstall policies will be determined in accordance with Foresters rules i.e. by the Board after taking advice from the With-profits Actuary.

16. The overriding principles will be
(i) that surpluses arising in the fund will be distributed by way of reversionary and final bonus such that as the business of the TF runs off then the assets of the fund are exhausted
(ii) whilst at all times seeking to meet the reasonable expectation of policyholders and maintaining equity between different classes and generations of policies
(iii) yet retaining an appropriate level of free assets to allow flexibility of response to changing conditions.

Fund merger

17. The Fund may, 10 years after the transfer, or if the number of premium paying policies falls below 1,000, or if the net assets fall below £2.5m, whichever is the first to arise, be merged with another Foresters Fund. The terms of the fund merger shall be certified by the Board, acting on the advice of the With-profits Actuary as being fair to both sets of policyholders.

Appendix C: Basis of transfer for Leek Assurance Collecting Society as specified in the Instrument of Transfer of Engagements

The following is a brief précis of the basis of transfer. Reference should be made to the actual instrument for further detail.

Operation of the LF

Establishment of Fund

1. On transfer, a separate Fund, known as the LF, was set up in the Foresters.

2. The assets of Leek Society, except as noted below, were credited to the LF.

3. Leek Society's insurance liabilities and such other liabilities as noted below became liabilities of the LF.

Investment

4. The assets of the LF may be held separately from other assets of the Foresters or may be pooled with them in which case Foresters will maintain a system of apportionment to determine the appropriate amount belonging to the LF.

5. All investment income and capital appreciation or depreciation arising from LF assets shall be credited to the LF.

Policies

6. No new policies shall be issued in the LF.

7. The LF shall be credited with premium income arising from policies within the Fund and debited with claims on such policies.

Expenses

8. The LF shall be debited, and the Foresters Management Fund credited, with a charge for expenses on the following formula:

(i) an administration charge of £100,000 per annum plus, for each year starting on or after the first anniversary of the Effective Date (31 December 2005), a percentage increase equal to the percentage increase in Retail Price Index (RPI) as at the first day of that year using the Effective Date as the base date, plus

(ii) the sum of £50,000 for the first year after the Effective Date in respect of integration costs; less

(iii) 50% of any cost saving, which is defined as the difference between the amount in (i) and (ii) above and the actual costs attributable to the integration and running of the Leek business excluding investment costs.

9. The basis shall be the subject of review every fifth year or at such time when there is a significant change in the business portfolio or the cost structure, whichever is the earlier.

Taxation

10. Each year there shall be made a computation of the tax that would have been incurred had Leek remained as a separate entity, but taking account of actual cash flows to the Fund. The Board of Foresters, after taking advice from the With-profits Actuary, shall determine what transfer into or out of the LF shall be appropriate in regard to taxation. In giving advice, the With-profits Actuary will consider the respective tax situations of the Leek and Foresters Funds.

Other liabilities of the LF

11. The LF shall be liable for its appropriate share of any payments falling on Foresters by way of centralised compensation schemes e.g. Financial Services Compensation Scheme, or payments arising under the Policyholder Protection Acts.

Mutual Support

12. The LF shall not be called upon to support the other Funds of Foresters, or vice versa, unless the With-profits Actuary has advised the Board that such a course is both necessary and appropriate.

Bonus policy

13. Bonuses on the Leek policies will be determined in accordance with Foresters rules i.e. by the Board after taking advice from the With-profits Actuary.

14. The overriding principles will be
(i) that surpluses arising in the fund will be distributed by way of reversionary and final bonus such that as the business of the LF runs off then the assets of the fund are exhausted
(ii) whilst at all times seeking to meet the reasonable expectation of policyholders and maintaining equity between different classes and generations of policies
(iii) yet retaining an appropriate level of free assets to allow flexibility of response to changing conditions.

Fund merger

15. The Fund may, 10 years after the transfer, or if the number of premium paying policies falls below 1,000, or if the net assets fall below £0.5m, whichever is the first to arise, be merged with another Foresters Fund. The terms of the fund merger shall be certified by the Board, acting on the advice of the With-profits Actuary as being fair to both sets of policyholders.