THE ANCIENT ORDER OF FORESTERS FRIENDLY SOCIETY LIMITED (“the Society”)

PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT

February 2020

Issue 14

Contents

1. Version history

Version	Date
13	June 2018
14	February 2020

1. (cont) Introduction

1.1 This document (known as the "PPFM") sets out the Principles and Practices by which the Society conducts its with-profits business. It has been approved by the Society's *Board* at their meeting on 12 February 2020 and will become effective on 1 November 2020.

1.2 The purpose of the PPFM 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. This improved understanding is intended to protect the interests of and promote confidence among with-profits *policyholders*.

1.3 Principles describe the enduring statements of the standards the Society adopts in relation to with-profits business and are not expected to change often. Practices, on the other hand, describe the Society's current approach and will be subject to more frequent change whilst remaining within the principles. The format of this report considers each key area where discretion is applied.

Changes to the PPFM

1.4 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.

1.5 No notice may be given if the Society considers that any change is necessary to correct an error or omission, if the change would improve clarity or presentation without materially affecting the PPFM's substance, or if the change is immaterial.

About the Society

1.6 The Society was established in 1834 and incorporated under the Friendly Society Act in 2000. It made the following acquisitions: in 2003, the Tunstall Assurance Friendly Society Limited ("Tunstall"); in 2005, the Leek Assurance Collecting Society ("Leek"); in 2014, the Post Office Insurance Society ("POIS").

1.7 The Society is a mutual organisation with no shareholders' interests to be considered. As a mutual, the with-profits *policyholders* share the business risk in full.

What business is covered by this PPFM?

1.8 The Society operates several funds covering a range of with-profits insurance contracts including:

- Traditional regular and single premium with-profits.
- Stocks and shares *ISA*, Lifetime *ISA*, Junior *ISA* and Inherited *ISA*.

1.9 This PPFM covers the Society's with-profits business only. The funds that the Society operates for with-profits business are as follows:

- Order Insurance Fund. Open to new business, the fund comprises the accumulated assets backing policies specifically allocated to it, which includes business in older funds such as the High Court Annuity Fund and the Scottish Exemptor policies previously issued through the Scottish and Northern *District.*

- Pure Endowment Fund. Closed to new business, this is a long-term business fund comprising the assets 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 on 1 January 2003.

  The *Board* after taking advice from the *WPA* and *WPAA* reserves the right to merge the Pure Endowment Fund into the Order Insurance Fund, or such other fund as it deems appropriate, when it deems it is appropriate to do so.

- Tunstall Fund. Closed to new business, the fund was transferred to the Society on 31 December 2003 following the transfer of the Tunstall Assurance Friendly Society Limited.

- Leek Fund. Closed to new business, the fund was transferred to the Society on 31 December 2005 from the Leek Assurance Collecting Society.

- POIS Fund. Closed to new business, the fund was transferred to the Society on 26 September 2014 from Family Assurance Limited. It comprises both with-profits and non-profit policies.

1.10 This PPFM covers the Order Insurance Fund, the Pure Endowment Fund, the Tunstall Fund and the Leek Fund. The POIS Fund has its own PPFM.

1.11 The assets of each fund are primarily for the benefit of the specific fund policies respectively but may be used, in exceptional circumstances and only when the resources of the *Non-Profit Fund* have been exhausted as described in paragraphs 4.1 – 4.4, to support other long-term insurance funds.

Overarching financial objectives.

1.12 The financial objectives of the Society that affect *with-profits policies* are:

(a) to meet the contractual liabilities to its *policyholders;*
(b) to treat *policyholders* fairly and meet the reasonable expectations of with-profits *policyholders;*
(c) to meet the required tests of solvency and capital adequacy as needed by regulatory bodies;
(d) subject to (a), (b) and (c) to maximise the financial returns to with-profits p*olicyholders* without incurring an undue level of risk.

Governance arrangements

1.13 The Society has in place governance arrangements to ensure that the conduct of its with-profits business complies with this PPFM. These include:

(a) A With-Profits Advisory Arrangement ("*WPAA*") whose role is to provide independent judgement to the *Board* in assessing compliance with the Society's PPFM and in addressing conflicting rights and interests of *policyholders* within a with-profits fund.
(b) The *Board* oversees compliance with the PPFM in terms of its Investment Strategy, reviewing its continuing appropriateness in the light of changing circumstances with consideration to the needs of with-profits *policyholders*.
(c) Publication of an annual report from the *Board* to with-profits *policyholders* that confirms the Society's belief that it has complied with its obligations relating to its PPFM and setting out its reasons for that belief.
(d) Publication of an annual report from the Society's With-profits Actuary ("*WPA*") to with-profits *policyholders* on the key aspect of discretion exercised by the *Board* on matters affecting with-profits policyholders.
(e) Publication of any statement or report that the *WPAA* requires to be made available to with-profits *policyholders*.

1.14 All relevant documents noted above, including the *WPAA*'s Terms of Reference, are available on the Society's website at www.forestersfriendlysociety.co.uk.

Glossary

1.15 Section 9 defines the key words and phrases used in this report.

2. The amounts payable under a With-profits contract

Principles – General

2.1 Pay-outs are 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, where applicable, less various deductions.

2.2 The pay-out from an insured event under a with-profits policy is the sum of the guaranteed benefits, *annual bonuses*, interim bonus and *final bonuses* less an *MVR*.

2.3 The methods used to determine the amounts payable under a with-profits policy will follow the methods used to determine annual and *final bonuses*.

2.4 The bonus methodology aims to meet the objectives set out in 1.12.

2.5 The bonus methodology allows for extensive approximations as the portfolio is not sufficiently large to justify detailed and extensive investigative work and historical information has not been rigorously collected over the lifetime of the existing business.

2.6 The methodology and any changes to the methodology used by the *WPA* in advising on bonus recommendations is reported to and discussed by the *WPAA* and the *Board* before any bonus decisions are made by the *Board*. The *WPAA* annually reviews the performance of the Society against the PPFM and reports to the *Board*. The *WPAA* is empowered to obtain such assistance as it needs e.g. the services of an independent actuary in formulating its opinion.

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

Practices – General

2.8 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.

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

2.10 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.

2.11 Business written in the Order Insurance Fund is split into separate categories by the following criteria:

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

2.12 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.

2.13 For the Pure Endowment Fund, after incorporation and centralisation at 1 January 2003, all with-profits business was brought onto a common footing. Subsequent bonus distributions pool the entire portfolio of business, distinguishing only between categories by the implicit guaranteed interest and between endowment and whole of life business.

2.14 The business of the Tunstall and Leek funds 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

2.15 Methodology and assumptions can be varied from time to time by the *Board* following the advice of the *WPA* and *WPAA* in light of current practices and the information available.

Practices – Asset share

2.16 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.

2.17 Extensive approximations have been used in the *asset share* calculations reflecting the lack of detailed historical information especially on incurred expenses and the investment return assumptions.

2.18 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.

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

2.20 Allowance has been made for expenses charged 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, consistent with the approach set out in Section 5.

2.21 The *asset share* calculation allows for taxation where appropriate. 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 *WPA*.

2.22 The amounts of miscellaneous surplus arising in the funds, not otherwise taken into account in the bonus process, largely from non-profit business, is currently considered to be small.

Principles – Annual and interim bonuses

2.23 *Annual bonuses* are reviewed and set annually by the *Board*, following advice from the *WPAA* and the *WPA*.

2.24 The interim bonus rate is set at the anticipated bonus rate at the next declaration.

2.25 The bonus policy seeks to meet reasonable expectations of *policyholders* and to maintain equity between different classes and generations. Where possible an appropriate level of free assets within the fund shall be maintained to allow flexibility of response to changing conditions

2.26 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.

2.27 If the change in circumstances is extreme, then the *Board* may decide to pay no bonus at all, or to restructure the way in which it declares bonuses, following advice from the *WPAA* and the *WPA*. 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.

Order Insurance Fund and Pure Endowment Fund

2.28 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.

Tunstall fund

2.29 The rates of *annual bonus* are generally lower than described in 2.28 as it is intended to limit the guaranteed liabilities 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.

Leek fund

2.30 The rates of *annual bonus* are lower than described in 2.28 as it is intended that as the business of the fund runs off, the assets will progressively be exhausted.

Practices – Annual and interim bonuses

2.31 In determining any *annual bonus*, the *Board* firstly considers 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*.

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

2.33 The interim bonus is normally limited to the annual rate last declared.

Principles – Approach to setting final bonus rates

2.34 *Final bonus* rates are declared at the discretion of the *Board* on the advice of the *WPAA* and the *WPA*.

2.35 The purpose of the *final bonus* is to ensure that the *accumulated fund* or *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 *WPAA* and the *WPA*.

2.36 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. Such a change would be a significant macro-economic event occurring since the previous declaration of *final bonus*. Particular regard is paid to the level of the capital values of the investments held to back the fund.

2.37

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

Pure Endowment Fund, Tunstall and Leek funds

2.38 The level of *final bonus* is monitored to ensure that the resources of the funds are distributed fairly as the portfolio of business runs off the books.

Practices – Approach to setting final bonus

2.39 For conventional with profits 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 pay-out. 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.

2.40 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*.

2.41 The *final bonuses* are then assessed in comparison to current scales, the desire to smooth pay-outs between one year and the next and between policies of similar term. A scale is then determined which aims to give *policyholders* a fair and reasonable share of the relevant fund.

2.42 For accumulating with- profits policies, the amount of *final bonus* added to a policy is such as to increase the *accumulated fund* to the desired total pay-out. In practice, the *final bonuses* are set based on year of contribution.

2.43 Whilst the Society cannot guarantee to pay 100% of *asset share* for the reasons of restricting the movement in pay-outs from one year to the next and to cross subsidise expenses between small and larger policies, the Society's policy is that the pay-out 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 pay-outs which fall within this range.

2.44 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 *WPAA* and the *WPA*. 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.

Regular premium whole of life policies

2.45 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, the Society would naturally expect some *members* to die while their *asset sha*re 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.

Pure Endowment Fund, Tunstall and Leek funds

2.46 As the with-profits *policyholders* are entitled to all the surplus within the respective funds, the level of any *final bonus* determined will be adjusted in order to ensure that the fund is exhausted as the business runs off.

2.47 *Final bonuses* for the Tunstall Fund reflect the low level of *annual bonus*.

2.48 For the Pure Endowment Fund, the equalisation bonus aims to bring all 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).

2.49 The *Board* reserves the right, following advice from the *WPAA* and the *WPA*, to change the *final bonuses*, 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.

Principles – Market Value Reduction ("*MVR*")

2.50 For accumulating *with-profits policies* issued in the Order Insurance Fund and the Tunstall Fund, a *MVR* may be applied where there could otherwise be a payment in excess of the value of the assets underlying the policy. The application of a *MVR* is subject to the policy terms and conditions.

2.51 No *MVRs* are applied to the Pure Endowment Fund or Leek funds.

Practices – *MVRs*

2.52 The only business affected by *MVRs* are accumulating *with-profits policies* within the Order Insurance Fund and Tunstall Fund.

2.53 Any decision on applying an *MVR* will take into account the investment performance of the backing assets relative to the accumulating policy values, subject to such guarantees as have been extended to *members* and regulatory requirements. The application of any *MVR* will be applied after the application of any *final bonus*.

2.54 For surrenders, any *policyholder* who would be affected by an *MVR* will be notified by The Society prior to any surrender payment being made.

Order Insurance Fund

2.55 For policies written before February 2018, *MVRs* may be applied in the circumstances of policy surrender unless otherwise stated within the policy literature. No *MVR* is applicable on death.

2.56 For policies written from February 2018, *MVRs* may be applied both in the circumstances of death and surrender.

2.57 *MVRs* applied to death benefits are limited by the guaranteed minimum death benefits specified in the Policy Conditions.

Tunstall fund

2.58 *MVRs* are only applied in the circumstances of policy surrender unless otherwise stated within the policy literature.

Principles – Determination of the range over which a single bonus rate is appropriate and when a new bonus series is appropriate

2.59 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 pay-outs.

2.60 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 *WPAA* and the *WPA*, agree to revise the basis of pooling.

2.61 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 *WPAA* and the *WPA*, 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;*

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

Principles – Smoothing

2.62 The Society seeks to smooth the pay-outs 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 pay-out may be less than the corresponding change in asset value.

2.63 Traditionally the Society has attempted to limit the size of the change in pay-outs on policies of a similar type to no more than 10% from year to year. However, where there are significant changes in current conditions or outlook, for example, where market movements are significantly greater than this, the *Board* may impose bigger changes on pay-outs, after receiving advice from the *WPAA* and the *WPA*.

2.64 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 of the fund.

2.65 For the Tunstall and Leek funds, the amount of smoothing may be more limited to ensure that exiting *policyholders* receive a fair share of the available assets of the funds.

Practices – Smoothing

2.66 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. For each major class of business, the practice is summarised as follows:

- If there is a less than 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% but less than 20% change in the amounts payable for the class based on targeting relevant aggregate *asset shares*, the amounts payable are adjusted by 10%.

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

2.67 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.

2.68 The surrender value basis is such that ordinarily the smoothing applied to pay-outs on death or maturity is also followed in calculating surrender values.

2.69 The *Board* reserves the right, after receiving advice from the *WPAA* and the *WPA*, to apply a lesser degree of smoothing in order to balance the interests of remaining *policyholders* or 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.

3. Investment strategies

Principles

3.1 The overall aim of the Society's investment strategy is to maximise, as far as is reasonably practicable and without undue level of risk, the returns to with-profits *policyholders* in line with their reasonable expectations. These reasonable expectations may differ between groups of *policyholders*, across and within individual with-profits funds.

3.2 The Society's *Board* reviews and approves the asset classes that the Society is permitted to hold in pursuit of its investment strategy, taking recommendations from the *Investment Committee*. Details of the currently approved asset classes are included in paragraph 3.16.

3.3 The Society makes use of external investment managers. Where management is outsourced, the individual investment managers are subject to specific objectives and portfolio constraints.

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

3.5 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.

3.6 The Society requires its appointed portfolio managers to invest in fixed income instruments where risks are appropriately rewarded. The Society maintains a preference for investing in securities rated investment-grade by an *ESMA*-approved rating service. However, the Society also recognises the importance of broadening its eligible asset universe by including sub-investment grade as well as non-rated assets when their risk profile is properly analysed and understood, and it offers attractive levels of expected return for unit of risk. In selecting its deposit-taking institutions, the Society applies maximum prudence.

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

3.8 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.

3.9 A maximum level of derivative exposure has been set by the *Board*. The limit may be reviewed and changed by the *Board* from time to time, taking recommendations from the *Investment Committee*.

3.10 The Society imposes constraints on the financial exposure to the *counterparty* and holds capital to protect against the risk of *counterparty* default.

3.11 As the number of policies in a fund declines and the remaining policies approach maturity the investment strategy will reflect both the liquidity requirements and the level of guarantees within the fund

3.12 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 *Investment Committee*, the Chief Actuary, the *WPAA* and the *WPA*.

3.13 The investment strategy does not rely on assets outside of the funds.

Practices

3.14 The Society sets target investment percentages for each of the with-profits funds. These percentages are set in relation to each asset class and on a fund by fund basis. The asset classes that the *Board* has currently approved for investment are as follows:

- Government Bonds
- Corporate Bonds
- Equity
- Property
- Commercial Real Estate Debt
- Convertible Bonds
- Infrastructure Debt
- High yield bonds
- Cash and cash equivalents

Details of the asset classes held by each fund are available on the Society's website https://www.forestersfriendlysociety.co.uk/

3.15 The *Board* may decide to invest a level of the funds' assets into asset classes which are not normally traded, these asset classes will include commercial real estate debt, infrastructure debt and high-yield bonds. The allocation to these asset classes will be chosen, in a prudent manner within the overall investment strategy, to achieve a higher level of long-term return for the fund.

3.16 The *Board* sets target investment percentages as a strategic asset allocation benchmark, and at any time the actual holding may be different from the percentages shown due to tactical positions taken by the Society or its investment managers. The target investment percentages have regard to expectations of *members* in relation to the nature of asset-backing in the long term.

3.17 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.

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

3.19 For the Order Insurance Fund and Tunstall Fund, assets are hypothecated so that the *asset shares* have a different asset mix to the remainder of the fund. Hypothecation to *asset shares* favours assets which are expected to earn higher returns over the longer term. The remaining assets, after hypothecation are allocated to the inherited estate and are used for the purposes described in Section 6.

3.20 The Society's investment strategy allows for the use of both passive and active investment management approaches.

3.21 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.

3.22 Where active investment management is outsourced to approved fund managers, they are given discretion to select investments in line with the target investment percentages and other constraints.

4. Business Risks

Principles

4.1 Each identified risk will be monitored and any changes identified will lead to a consideration of what further action is appropriate. The *Board* after receiving advice from the *WPAA* and the *WPA* will decide where any business risks will be carried and hence where any profits or losses from those risks will accrue.

4.2 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 *Non-Profit Fund*. If the latter applies and the scale of losses exceeds the assets of the *Non-Profit Fund* not otherwise allocated, then those losses will impact on the discretionary benefits of relevant with-profits *policyholders*.

4.3 The *Non-Profit Fund* will provide support to the with-profits funds in respect of the management costs, capital requirements, including those in respect of adverse market conditions and to meet *members'* expectations, to the extent that the other assets of the Society permit.

4.4 All funds to which the PPFM applies 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 *Non-Profit Fund*. This support would be limited to the excess of assets over the liabilities of each Fund.

Practices

4.5 The Society aims to limit the extent of risk by a process of mitigation where possible, allowing for the Society's risk appetite and subject to the economic cost. The *Audit Risk and Compliance Committee* regularly reviews the business risks on an ongoing basis.

4.6 Exceptional losses incurred within a with-profits fund 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 *Non-Profit Fund*.

4.7 To the extent that the resources in the *Non-Profit Fund* 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. Even if the resources of the *Non-Profit Fund* 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.

Order Insurance Fund

4.8 The *Board* has determined that the costs associated with pensions annuity guarantees will fall to the *Non-Profit Fund*.

Tunstall and Leek funds

4.9 The Instruments of Transfer in respect of the Tunstall and Leek Funds provide for each Fund to be charged on a prescribed basis. If the charges fail to meet the costs incurred in running the Fund then the *Non-Profit Fund* in the first instance will be adversely affected.

4.10 If the Tunstall and Leek Funds are unable to cover the *Solvency Capital Requirement* in respect of their own long-term business liabilities from their own surplus, or cover their own *Technical Provisions* with assets of the Tunstall or Leek funds, 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.

5. Charges and Expenses

Principles

5.1 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.

5.2 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.

5.3 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.

5.4 For conventional *with-profits policies*, expenses are charged to the *asset share*. For accumulating *with-profits policies*, charges are applied as described in the policy terms and conditions, as varied from time to time.

In the event that the *Non-Profit Fund* cannot meet the expenses allocated to the with-profits funds, the Society's *Board* may amend the with-profits funds' expense arrangements, having taken advice from the *WPAA*, the *WPA* and *Chief Actuary*.

Order Insurance Fund and Pure Endowment Fund

5.5 Where it is considered appropriate to do so, the level of expenses charged to the Order Insurance Fund and Pure Endowment Fund may be set at a level below those incurred with any resulting shortfall being supported by the *Non-Profit Fund*.

Tunstall and Leek funds

5.6 The basis of charging is set out in the Instruments of Transfer. Here the expenses of running the funds may be either more or less than the maximum amounts which can be charged to the Fund. Any surplus or shortfall is carried to or taken from the *Non-Profit Fund*.

Practices

5.7 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.

5.8 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.

5.9 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.

5.10 Where expenses are fund-specific they are charged directly to that fund, to the extent that the appropriate information is available. 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.

5.11 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.

5.12 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*.

5.13 The *Board* may decide to restrict the expenses ultimately included in the calculation of *asset shares* through the use of an expense cap. Any excess expenses over and above this amount will be borne by the relevant inherited estate or by the *Non-Profit Fund*. This decision will be reviewed by the *Board* at least annually having taken advice from the *WPAA* and the *WPA* and having regard to the interests of with-profits *policyholders*.

5.14 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.

Order Insurance Fund and Pure Endowment Fund

5.15 Where appropriate, there is 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 the levels described below. 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*.

- For the Order Insurance Fund: the charge is between 0% and 5% of *asset share*, depending on product type and policy commencement date.
- For the Pure Endowment Fund: the charge is between 0% and 4% of *asset share* depending on product type and policy commencement date.

Tunstall and Leek funds

5.16 The allowable charges are defined by the transfer agreements.

5.17 For the Tunstall Fund, *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 be met by the fund.

6. Management of surplus

Principles

6.1 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)".

Order Insurance Fund

6.2 Being the with-profits fund open to new business, the inherited estate is used to provide capital, enable investment freedom and 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.

Pure Endowment Fund

6.3 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.

Tunstall and Leek funds

6.4 The inherited estate is considered to be negligible. The method of determining policy payouts described aims to ensure that any surplus is extinguished as the portfolio of business declines

Practices

6.5 Annually, 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 *WPAA* and the *WPA*, will decide at the time how it will be best utilised in the interests of the fund's with-profits *policyholders*.

Order Insurance Fund

6.6 The miscellaneous profits or losses initially go into the inherited estate rather than directly to *asset shares*.

Pure Endowment Fund, Tunstall and Leek funds

6.7 As a result of the negligible estate, distributions to *policyholders* in these funds in respect of the inherited estate, if any, are not expected to be significant.

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

Principles

7.1 The *Board*, after receiving advice from the Chief Actuary (and the *WPAA* and the *WPA* 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.

7.2 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.

7.3 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.

7.4 In the event of the Society determining that it is not in the interests of with-profits *policyholders* for the Order Insurance Fund to remain open to new business, it will develop a run-off plan. This will include a strategy for managing the closed book of business and how the surplus will be distributed over the expected lifetime of the with-profits contracts.

Practices

7.5 The Society's *Board* annually reviews and approves the Society's business plan. The business plan forecasts the Society's financial position, based on expected new business volumes and allowing for expected future revenue streams, e.g. investment performance, premium income and costs.

As part of the business plan review, the *Board* will review the forecast financial position of the Society compared to approved risk appetite thresholds. The financial strength of any of the Society's funds will determine whether the projected volumes and mix of new business can be supported.

8. Management Actions

Principles

8.1 The Society has a future management actions plan which is approved by the *Board*, after receiving advice, where applicable, from the *WPAA* and the *WPA*.

8.2 These management actions are decisions that are available to the *Board* in order to manage the Society's risks and capital more efficiently and that can be taken in response to changing economic or non-economic conditions.

8.3 The plan will be reviewed annually and updated whenever there is a change to the actions evidenced in practice, or in the event of a material change to the nature and/or scale of the risks underwritten by the Society.

Practices

8.4 The following management actions have been agreed:

- Changes in *annual bonus* rates - the cost of guarantee calculation has embedded actions that future reversionary bonus rates on *with-profits policies* will be changed depending on the investment returns achieved.

- Reduction in market risk exposures - funds may be 'de-risked' by, for example, selling more volatile equity assets, where this does not impact on *policyholders'* reasonable expectations of investment returns.

- Closed with-profits fund management - management of the closed with-profits funds will be such that the estate is fully distributed and *asset shares* will be set each year such that the liabilities are equal to the assets held.

9. Glossary

Term	Meaning
Accumulated fund	The total amount invested (less any withdrawals, adjusted according to the investment conditions at the time of withdrawal) plus any *annual bonuses* declared
Annual bonus	A method of distributing surplus. *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.
Asset share	In relation to a policy, the accumulated value of premiums paid with deductions for expenses, mortality costs and any tax, where the accumulation rate is the rate of return achieved by the assets assumed to back the *asset shares* in question. Adjustments may be made for the cost of guarantees, capital and miscellaneous profits or losses if deemed appropriate.
Audit, Risk & Compliance Committee	The *Audit, Risk & Compliance Committee* is a sub-committee of the *Board* with specific Terms of Reference and reporting procedures. Its primary function is to consider the operational effectiveness of controls and the Annual Report and Accounts.
Board	The body, elected by the *Members* of The Society, in whom responsibility for the management of The Society is vested.
Chief Actuary	An actuary approved by the *PRA* who has responsibility for the actuarial function (whether internal or external) of the Society
Counterparty	An organisation with whom the Society has a commercial arrangement such as a reinsurer, deposit takers, etc. A default by the *counterparty* would lead to a loss being incurred by the Society.
District	A branch of the former unincorporated society (all *Districts* closed on 31 December 2002).
ESMA	European Securities and Markets Authority is an EU regulatory authority.

Term	**Meaning**
Final Bonus	A method of distributing surplus by a bonus which may be declared when a policy becomes a claim. It is also referred to in product literature as terminal bonus.
Guaranteed sum assured	The minimum amount specified in the policy conditions that will be paid upon claim.
Industrial Business	*Industrial business* is long-term insurance business where collectors originally collected the policy premiums in cash.
Individual Savings Account (ISA)	A scheme allowing individuals to hold cash, shares, and unit trusts free of tax on dividends, interest, and capital gains
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.
Market Value Reduction (MVR)	Refers to the practice whereby the amounts paid on death, surrender or maturity 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	Assets not held within the Society's with-profits funds or Court funds, used to support the Society's individual and group business and *solvency capital requirements*.
Policyholder(s)	The holder of an in-force Foresters Friendly Society policy.
Solvency Capital Requirement(s)	The capital set aside to ensure that the Society can withstand a range of adverse events as defined under insurance regulation.
Technical Provisions	The liability set aside to meet expected future insurance claims and expenses, net of future premiums, and other provisions as set out by insurance regulation.

Term	Meaning
WPA	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.
WPAA	The With-Profits Advisory Arrangement is a part of the Society's governance arrangements. The role of the *WPAA* is to provide independent judgement to the *Board* in assessing compliance with the Society's PPFM and in addressing conflicting rights and interests of *policyholders* within a 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 *annua*l and *final bonuses* (which may or may not be guaranteed).