Reliance Mutual Insurance Society Limited

Principles and Practices of Financial Management

1 February 2010

Reliance Mutual Insurance Society Limited

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1 Introduction

1.1 These Principles and Practices of Financial Management are available on request. Throughout this document a distinction is drawn between **Principles** and **Practices** of Financial Management.

1.2 **Principles** are intended to reflect the underlying and enduring approach that Reliance Mutual ("the Society") adopts in managing its *with profits* business. Policyholders will be given three months notice of any change to the Principles.

1.3 **Practices** reflect the ongoing management of the business and are expected to adapt to changes both in economic conditions and in the Society's business, while continuing to reflect the underlying Principles. Policyholders will receive notice of any changes to the Practices.

1.4 Terms shown in *italics* in this report are defined in the Glossary in section 9.

1.5 The Society's business is written in six *sub funds*, which were created following the transfer of various other companies' business to the Society in 2004 and 2007:

- Reliance Mutual With Profits Sub Fund (RM WPSF)
- With Profits Sub Fund Nos. 2, 3, 4. 5. 6 (WPSF2, 3, 4, 5, 6)

1.6 In general, the same **Principles** apply to each of the six *sub funds*. Variations only exist where it is appropriate to reflect the fact that only RM WPSF is open to new business. Because of their different history and composition, there are a number of areas where different **Practices** apply to each *sub fund*. These are made clear below.

Reliance Mutual With Profits Sub Fund

1.7 This *sub fund* contains all the *with profits* business originally written by the Society. It also contains *with profits* business, principally in the *industrial branch*, that was originally written by other companies, all of which were acquired prior to 1972. RM WPSF also contains all the Society's unit linked business, including that originally written by other companies. The *sub fund* also contains without profits, non-linked, business originally written by the Society and other companies.

1.8 RM WPSF includes *with profits* business in both *industrial* and *ordinary branches*. The *industrial branch* was closed to new business at the end of 1987. *With profits* business continued to be written in the *ordinary branch* until the end of 1999, although little *with profits* business was written in this branch after 1987.

1.9 RM WPSF contained only seven *with profits* pension policies in force at the end of 2006. There are no policies where there is a guaranteed method of calculating early *surrender values*. RM WPSF contains some policies written on a unitised basis, where there are

provisions to apply market value adjustment factors. However the investment risks in these policies are reinsured to WPSF6 (see paragraph 1.24)

With Profits Sub Fund No. 2

1.10 This *sub fund* contains all the business previously contained in the Criterion Life Assurance *with profits fund*. This business was transferred to the Society in June 2004.

1.11 Criterion Life Assurance Limited wrote *with profits* policies for both life assurance and pensions business. No new *with profits* policies have been written since June 1975. A few policies commenced sharing in profits after this date following the exercise of options contained in existing policies. Some policies in the *sub fund* ceased to participate in profits in accordance with the policy conditions on, for example, ceasing to pay premiums. The *with profits* business was originally written by a number of insurance companies, including principally Lifeguard Assurance Limited. Lifeguard Assurance Limited changed its name to Criterion Life Assurance Limited in 1984.

1.12 No business in WPSF2 has been written on a *unitised* basis and there are no *with profits* policies with provisions to apply market adjustments when a claim arises, or where there is a guaranteed method of calculating early *surrender values*.

With Profits Sub Fund No. 3

1.13 This *sub fund* contains the business previously contained in the Family Assurance Time Ordinary Benefit Fund. This business was transferred to the Society in September 2004.

1.14 The Family Assurance Time Ordinary Benefit Fund was originally part of Time Assurance Society. The Ordinary Benefit Fund contained with-profits and non-profits life assurance business, but no pensions business. In 1990 Time Assurance Society converted from a friendly society to a private limited company named Templeton Life Assurance Ltd and was acquired by Templeton Global Investors Ltd. The Ordinary Benefit Fund was closed to new business at the conversion date. In 1994 Family Assurance Friendly Society acquired Templeton Life Assurance Ltd and transferred its business into Family Assurance.

1.15 No business in WPSF3 has been written on a *unitised* basis and there are no *with profits* policies with provisions to apply market adjustments when a claim arises, or where there is a guaranteed method of calculating early *surrender values*.

With Profits Sub Fund No. 4

1.16 This *sub fund* contains the business previously contained in the Family Assurance Time Retirement Annuity Fund. This business was transferred to the Society in September 2004.

1.17 The Family Assurance Time Retirement Annuity Fund was originally part of Time Assurance Society. The Retirement Annuity Fund contained with-profits and non-profits pensions business, but no life assurance business. In 1990 Time Assurance Society converted from a friendly society to a private limited company named Templeton Life Assurance Ltd and was acquired by Templeton Global Investors Ltd. The Retirement Annuity Fund was closed to new business at the conversion date. In 1994 Family Assurance Friendly Society acquired Templeton Life Assurance Ltd and transferred its business into Family Assurance.

1.18 No business in WPSF4 has been written on a *unitised* basis and there are no *with profits* policies with provisions to apply market adjustments when a claim arises, or where there is a guaranteed method of calculating early *surrender values*.

With Profits Sub Fund No. 5

1.19 This *sub fund* contains the business previously written by University Life Assurance Society. The Society acquired this company in May 2007 and the business was transferred to the Society in July 2007.

1.20 University Life principally wrote *with profits* pension policies for the staff of universities and other similar institutions, although there are a small number of other classes of both life and pensions assurances, on both a *with profits* and a without profits basis. Since 1976, new business has been written as a consequence of options in, or using the maturity proceeds of existing policies. University Life had been a subsidiary of Equitable Life Assurance Society since 1919.

1.21 No business in WPSF5 has been written on a *unitised* basis and there are no *with profits* policies with provisions to apply market adjustments when a claim arises, or where there is a guaranteed method of calculating early *surrender values*.

With Profits Sub Fund No. 6

1.22 This *sub fund* contains the *with profits* business transferred to the Society from Hearts of Oak Friendly Society in July 2007.

1.23 Hearts of Oak Friendly Society was originally founded as Hearts of Oak Benefit Society. The Society wrote a wide range of life assurance pensions and sickness policies on both a *with profits* and a without profits basis. During the 1970s, 1980s and 1990s, Hearts of Oak was the recipient of transfers of engagements from a number of other smaller friendly societies. No new business has been written since 2000.

1.24 The without profits business of Hearts of Oak was transferred into RM WPSF by the Scheme of Transfer. The Scheme also provided that the *unitised with profits* policies should be transferred to RM WPSF, but that the investment risk of these policies should be taken by

WPSF6, through an inter-fund reassurance structure. Thus WPSF6 effectively has *unitised* policies with provisions to apply market adjustments when a claim arises and with a guaranteed method of calculating early *surrender values*.

1.25 Practices relating to *unitised with profits business* are set out under WPSF6.

All sub funds

1.26 The Society maintains separate accounts for each of the *sub funds*. All the *surplus* distributed in each of the *sub funds* is allocated to the *with profits* policies in the respective funds. The Schemes of Transfer that established the *sub funds* WPSF2, 3, 4, 5, and 6 provide that, in various circumstances, the Society may (but need not) cease to maintain a separate fund, but may merge the assets and liabilities of that *sub fund* with RM WPSF. At the time of any such merger, the Schemes of Transfer define a method of utilising any *surplus* in the *sub fund* to provide guaranteed annual increases to policy values in lieu of future bonus additions. WPSF3 will reach the size at which this action is possible in 2010 or 2011, but the Society has not determined whether it will implement the action. It is not envisaged that the circumstances will arise where the merger of any other *sub fund* can take place before 2013. The circumstances referred to above are:

- WPSF 2, WPSF3 and WPSF4: total assets are valued at less than £5m
- WPSF5: total assets less liabilities in respect of without profits policies are valued at less than £5m
- WPSF6; total assets are valued at less than £25m, or no discretionary bonuses have been added to policies for a period of at least five years.

1.27 The Society is a mutual insurance company. There are no shareholders and consequently there are no issues of equity between *with profits* policyholders and shareholders.

1.28 The Society has some overriding principles that must be considered above any of the other principles and practices in this document. These are:

- To meet contractual obligations to policyholders in all reasonably foreseeable circumstances;
- To treat policyholders fairly;
- To meet the tests of *solvency* and capital adequacy required by regulatory bodies

2 The amount payable under a with-profits policy

Principles

2.1 The Society aims to treat its customers fairly, having regard to statements made in marketing literature and communications to policyholders.

2.2 For *with profits* policies, the bonus policy aims to provide a fair return on premiums paid.

2.3 The bonus policy aims to distribute to *with profits* policyholders *surplus* from both with and without profits business within each *sub fund*. The board determines the amount of *surplus* arising in each *sub fund* that it is appropriate to distribute. All the *surplus* distributed in each *sub fund* is allocated to policyholders in that *sub fund*. It may be necessary for some *surplus* to be retained to ensure the continued sound financial management of the ongoing business within the *sub fund*, particularly in the case of RM WPSF, which is open to new business. In the case of WPSF2, WPSF3, WPSF4, WPSF5 and WPSF6, which are closed to new business, the bonus policy aims to distribute to *with profits* policyholders all the surplus in those *sub funds* by the natural expiry of the policies concerned.

2.4 Any changes in bonus policy required to fulfil the above principles should be implemented gradually unless this would conflict with the sound financial management of the Society.

2.5 Bonus is distributed by means of annual additions to the *guaranteed benefit*s ("*annual bonus*") and by an additional sum added to the *guaranteed benefit*s when a claim arises ("*final bonus*").

2.6 The principles above, especially 2.3, introduce some conflicts. The Society is prepared to allow a degree of approximation in implementing the practices set out below, to achieve an acceptable balance between conflicting principles. In particular the need to ensure the sound financial management of the Society is considered paramount, and may act as a constraint on *annual* and *final bonuses* in changing economic circumstances.

2.7 The *actuary* reviews the methods, assumptions and parameters used to implement these principles at least annually. Proposals for change to the methods or assumptions may be initiated by the board or the *with profits actuary*. In either case, the *actuary* will report to the board on the implications of the proposed change, and the board will decide whether it should be implemented.

2.8 Different classes of *with profits* policy have had different bonus rates for many years. It is not envisaged that any new series of *annual bonus* rates will be necessary for the existing classes of policy.

2.9 *Final bonuses* are determined so that the total payout on a policy becoming a claim is consistent with the principles set out above. The Society's approach to *smoothing* the value of *with profits* policy payouts is implemented by adjusting *final bonus* rates. By this means a similar approach to *smoothing* applies to all types of claim. The Society's intention is that

smoothing is neutral over the long term, but the principle of implementing changes gradually means that this will not necessarily be the case over the shorter term. There is no specific principle relating to the maximum short-term cost of *smoothing* other that that implied by the principles of fairness and sound economic management set out above.

2.10 The principle underlying the calculation of *surrender values* is that a reasonable balance should be achieved between the interests of policyholders leaving the fund and those remaining in it. The *surrender value* basis may be altered to reflect more than changes in market values, provided any such alteration is in accordance with this principle.

Practices – Reliance Mutual With Profits Sub Fund

amounts payable

2.11 The Society uses an *asset share* approach to determine the basic amount payable to *with profits* policyholders. The basic amounts payable are increased by distributing *surplus* arising from without profits business and from the *inherited estate*. This is achieved by augmenting *final bonus* rates and is discussed in paragraph 2.25 below.

2.12 The *asset share* is the accumulation of premiums less commission, expenses and the cost of life cover at a rate of investment return intended to mirror the performance of the assets backing the *with profits* liabilities. The types of investment backing *with profits* policies are discussed further in section 3 below.

2.13 *Asset shares* provide a good basis for achieving a fair distribution of *surplus* between the varied types of policy in the *sub fund. Asset shares* calculated for each policy are particularly appropriate for endowment assurances and other policies with a pre-determined maturity date. A disadvantage of the *asset share* approach is the volume of historical data needed. A large proportion of the *with profits* business in the *sub fund* was written many years ago, and the assumptions used in the *asset share* calculations for the early years are only estimates.

2.14 For whole life assurances an individual policy *asset share* is not appropriate. Additional assumptions need to be made about future investment returns, expenses and mortality rates. The *asset share* approach, taking the portfolio as a whole, is combined with a *bonus reserve valuation* method to determine appropriate amounts payable.

2.15 Calculations are carried out for policies taken out in each past entry year and, in the case of endowment assurances, maturing in the current calendar year. The calculations are aggregated for six categories of policy. In the *ordinary branch*, whole life and endowment assurances are treated separately. In the *industrial branch* separate calculations are performed for whole life and endowment assurances and for *with profits* and *mortuary bonus* policies in each of these categories.

2.16 Expense assumptions for years prior to 1986 are based on incomplete data derived from a number of sources. A number of approximations have been used to arrive at a full set of parameters. For subsequent years the expense analyses described in section 5 below have been used. The Society apportions all its expenses (excluding development expenses as described in paragraph 5.5 below), fully between all the policies in all six of the *sub funds.*

2.17 Deductions for the cost of mortality are based on industry experience from appropriate published tables.

2.18 Separate assumptions are made for the investment return from *equities* and *fixed interest* securities. For *equities* the performance of The British Life Unit Trust is used to mirror the performance of the *equities* backing *with profits* business. This Trust is a general UK *equity* unit trust managed within the Reliance Mutual group by the same investment team as manage the assets backing the *with profits* business. For *fixed interest* securities the returns from UK government securities indices are used, adjusted to allow for additional yields from any non-government securities held, together with the actual returns achieved on mortgages, loans and deposits.

2.19 The investment return attributed to *asset share*s is taxed as if the *with profits* business were the only business written by the Society. Hence investment income and gains are fully taxed at the rates applicable to policyholders, and expenses are fully tax relieved. Tax is deducted in the calculations at the same point as the income or gain arises.

2.20 The Society allows for the building up of guarantees from the basic *guaranteed benefit* and accumulating *annual bonuses* by maintaining a notional split of the assets backing each policy into *fixed interest* and *equity* portfolios. At the end of each year the apportionment between these categories is reassessed, in order to hypothecate an increasing proportion of the value of the *guaranteed benefit*s to be backed by *fixed interest* assets as the maturity date approaches. The proportions of *fixed interest* and *equity* assets that result from this hypothecation are adjusted to match the actual backing assets, defined by the methods in section 3 below.

2.21 The Society has documented the methods used and assumptions made in determining bonus rates since 1988. Records are also kept of the historical assumptions used in the calculations.

annual bonus

2.22 *Annual bonus* rates are reassessed once a year. The Society uses the rates that have been declared for the various classes of policy over many years as a starting point. These are adjusted in line with the yields available on *fixed interest* securities, subject to a gradual implementation of changes in line with paragraph 2.4 above. A change of more than 0.5 percentage points in a year (i.e. a change in the bonus rate from 4.0% to 3.5%) would only be made if it were necessary to secure the sound financial management of the society.

2.23 *Annual bonus* rates are determined using the *asset share* model with the assumption that all investment is in *fixed interest* assets. The model is projected into the future to assess the durability of the bonus rates that result. This approach leads to generally stable rates.

2.24 An *interim bonus* is paid on claims arising before the next declaration of bonus. *Interim bonus* rates are normally at or slightly below the last declared *annual bonus* rate. Movements in *interim bonus* rates can be used to signal a possible change in *annual bonuses* at the forthcoming declaration.

final bonus

2.25 The basic unsmoothed *final bonus* is derived by deducting the *guaranteed benefit*, including *annual bonuses*, from the amount payable described in paragraphs 2.12 to 2.15 above. The *final bonus* is expressed as a percentage of the *guaranteed benefit*s, including *annual bonus*es, to determine a *final bonus* rate.

2.26 *Final bonus* rates depend on the category of *with profits* policy and on the year of inception. Calculations are performed for endowment assurances close to maturity. For whole life policies, calculations are based on the whole portfolio, as described in paragraph 2.14 above. The resulting *final bonus* rates are also used on surrender or early death, based on the year of inception.

2.27 There are some policies where an *asset share* cannot be calculated, mostly because of data inadequacies, and these are excluded from the calculations. Excluded policies include paid-up policies where the sum assured has been reduced and old *industrial branch* policies transferred to the Society from other companies (all before 1972). Excluded policies are given the *final bonus* rate for the nearest equivalent policy.

2.28 Because of approximations made in the assumptions for very old policies, the same rates of *final bonus* are used for all policies with durations longer than forty years.

2.29 *Final bonuses* are then augmented to allow for distribution of *surplus* from without profits business and from the *inherited estate* within the RM WPSF. The augmentation is implemented by multiplying all the unaugmented *final bonus* rates by the same factor. Any significant augmentation may be smoothed in over a period as determined by the board. The resultant augmented *final bonus* rates are then smoothed as discussed below.

2.30 This augmentation is made as an addition to *final bonuses* rather than as an enhancement in the calculation of the *asset shares* because the *surplus* from without profits business and from the *inherited estate* is very large and some *surplus* has still to emerge. This method enables an equitable distribution of these *surpluses* to all *with profits* policies.

2.31 Profits from pre-2000 without profits business are used to augment with profit policy payouts. When the augmentations commenced, in 2001, the *embedded value* of the business, after

making the intended augmentations was calculated. This *embedded value* was projected into the future to generate an anticipated embedded value in each future year. The level of augmentation possible is determined annually, and is set so that the *embedded value* of the pre-2000 business, after making the augmentations, is equal to the anticipated figure established in 2001.

2.32 Acquisition of blocks of business increases the number of policies in force, and consequently reduces expenses per policy, as overhead expenses are spread over a larger number of policies. The benefits of these economies of scale are reflected in the *asset share* calculations.

2.33 Other *surpluses* arising from acquired blocks of business and from other new business ventures are not distributed until the conditions set out in paragraph 4.7 below have been satisfied. Thereafter, a similar process of bonus augmentation to that described in paragraph 2.31 above will be followed.

2.34 The *final bonus* rates described above are used in the determination of early *surrender values*, which are calculated using a formula approach. A proportion of the rate is used on surrender within the first ten years from commencement of the policy. *Surrender values* thus reflect investment returns and any augmentations being granted.

2.35 The method of calculating bonus augmentations does not permit *surrender values* to be compared with an augmented *asset share.* Future *surpluses* are uncertain and the level of augmentation appropriate for surrendering policies is lower than would be applied to death or maturity payments. *Surrender values* using *final bonus* rates prior to augmentation are compared to *asset shares*. The basis used in the formula is set so that overall the two calculations give similar results. Rates of surrender are low and the variability among contract types and durations is high which makes comparison of individual *surrender values* with individual *asset shares* difficult.

2.36 *Final bonuses* are calculated annually, along with the *annual bonus* declaration. When a *final bonus* scale is implemented, the total return from *equity* investments that is required for the scale to be maintained for the following year is calculated. If the actual performance of the British Life Unit Trust deviates by more than 10% from this expected return a reassessment of *final bonuses* is triggered.

smoothing

2.37 The Society smoothes amounts payable on *with profits* policies in two ways:

- Within each year of commencement and contract type the amounts payable are averaged between policies of different sizes. Within each contract type, a smooth scale of *final bonus* rates by year of commencement is set.
- From year to year, changes in amounts payable on similar policies are smoothed.

2.38 Much of the expenses incurred by the Society are related to the numbers of policies being administered, rather than the size of the policy. This is reflected in the *asset share* calculations. The *asset shares* for each contract type are grouped by issue year (and, for endowment assurances, maturity year) and the *final bonus* rates are based on the difference between the aggregate *asset shares* and the aggregate sum assured and attaching *annual bonus* for all contracts in each group.

2.39 Within each policy type, the *final bonus* rates determined by the process in paragraph 2.38 are adjusted to provide a smooth progression in the *final bonus* rates as a percentage of sum assured and attaching *annual bonus*.

2.40 From year to year the Society operates a single *smoothing* strategy for all generations and types of *with profits* policy within RM WPSF. *Final bonus* rates are adjusted so that the maximum change in the value of similar maturing policies from one year to the next is restricted to 10%. In the event of the Society being in a process of implementing augmentations to policy values, as described in paragraphs 2.29 above, increases in policy values in excess of 10% may apply through this process.

2.41 *Smoothing* is expected to be neutral over a long period. *Final bonus* rates are determined annually unless the investment performance trigger described in paragraph 2.36 above comes into play. *Final bonus* rates are projected for a five-year period allowing for a constant return from *fixed interest* and *equity* investments. If the operation of the *smoothing* process described in paragraph 2.40 above is not expected to remove any overpayments or underpayments compared with the unsmoothed level of policy values within this period, the maximum change in policy values from one year to the next can be increased to 20%. In very adverse circumstances, where operation of the *smoothing* policy would be inconsistent with securing the sound financial management of the *sub fund,* the restrictions on annual changes would be reviewed.

2.42 As the *surrender value* basis uses the *final bonus* rates in the calculation formulae, *smoothing* is automatically applied to early surrender payments. Other than surrendering *annual bonuses*, there are no options available to surrender part of a *with profits* policy.

target ranges for amounts payable compared with *asset shares*

2.43 As discussed in paragraph 2.14, only the maturity payments on endowment assurances can be compared to *asset shares*, because whole life policies always contain an element of life assurance cover. As discussed in paragraph 2.30 the method of allowing for *surplus* from without profits business in the *sub fund* means that comparison of the amount payable with an *asset share* is not appropriate. It is, however, possible to compare the amount payable under a *with profits* endowment assurance prior to the bonus augmentations with the *asset share.*

2.44 For *industrial branch* endowment assurances with *mortuary bonuses,* the range of policies maturing each year is large because many of the policies were sold to mature at a fixed age

rather than for a fixed term. The policies are of very long durations where *asset shares* are unreliable. Because the range of maturing policies is so varied the target range refers to the average amount payable for all policies expected to mature in a particular year.

2.45 For *ordinary branch* endowment assurances and *with profit industrial branch* endowment assurances the target ranges apply to policies maturing after terms of ten, fifteen, twenty and twenty five years. The majority of maturing policies are of these durations. The target range refers to the average amount payable for all policies expected to mature at each duration.

2.46 Prior to bonus augmentations, amounts payable are expected to be within the following percentages of *asset share:*

- *Ordinary branch* endowment assurances - 80% to 120%.
- *Industrial branch with profit* endowment assurances - 80% to 135%.
- *Industrial branch mortuary bonus* endowment assurances - 80% to 135%.

2.47 After augmentation amounts payable are a significantly higher proportion of *asset share*. The range of amounts payable starts from 80% of *asset share* for short duration policies but increases to 400% and above at long durations.

2.48 These target ranges apply in normal situations. Where significant movements in market conditions have occurred and the year on year smoothing limit is above 10% as set out in paragraph 2.41 the target ranges will be widened by a further 15% in the appropriate direction.

Practices – With Profits Sub Fund No. 2

amounts payable

2.49 The Society uses a *bonus reserve valuation* approach to determine the basic amount payable to *with profits* policyholders. The valuation basis uses a rate of interest based on the yield on the assets held by the *sub fund*, after adjustment for risk. Future expenses are allowed for at the rates charged to the *sub fund*, with allowance for tax relief if appropriate. The Society has separate mortality bases for the regulatory valuation and for use in more realistic liability projections such as for bonus setting and investment management. The mortality assumption is based on industry experience, as actual experience does not have statistical credibility. The valuation does not allow for early termination of policies, nor for other business risks that may fall on the fund.

2.50 Tax calculations for the *sub fund* are carried out as part of the Society's annual tax computations, on a stand-alone basis. This determines the tax charged to the fund and the allowance for tax used in the *bonus reserve valuation* basis.

2.51 The current method of calculating *annual bonuses* is taken into account. Rates of *final bonus* can then be calculated so that the value of liabilities, including the *final bonus* equals the value of the assets in the *sub fund*. Further details of the approach are given below. Calculations are carried out for the *sub fund* as a whole, and are designed to fulfil the aim that all emerging *surplus* is distributed within the lifetime of the existing policies.

2.52 Under this approach, the principal factor that drives whether a change in policy values is appropriate is the difference between the investment return on the assets held in the *sub fund* and the risk free rate used in the valuation basis described in paragraph 2.49 above. Other items such as differences between actual mortality experience and the valuation basis assumption, surrender *surpluses*, *surpluses* from without profits business, and business risks also contribute to the experience that is recognised in determining policy values. The *bonus reserve valuation* method explicitly allows for the building up of guarantees from the basic *guaranteed benefit* and accumulating *annual bonuses.*

2.53 The Society has documentation of methods used and assumptions made in determining bonus rates since 1992.

annual bonus

2.54 *Annual bonus* rates are reassessed once a year.

2.55 For most classes of policy, policyholders have the option to take *annual bonuses* in cash. A rate of 55% of the premiums paid since the last valuation has been paid for many years. Where this option is not exercised, or is not available, 55% of premiums paid since the last bonus declaration is calculated and converted to a bonus addition to the *guaranteed benefits.* The basis for this conversion is not guaranteed, but the same basis has been used for many years, and the only reason for altering it would be to satisfy the principle of sound financial management of the *sub fund*. Policies not subject to a regular premium throughout the policy term are assessed on the basis of a notional regular premium that the *actuary* considers to be equivalent to the premiums actually paid.

2.56 It is not envisaged that it will be necessary to change the method of calculating *annual bonus* rates within the lifetime of the existing *with profits* policies, except in circumstances where the sound financial management of the *sub fund* might be at risk.

2.57 An *interim bonus* is paid on claims arising before the next declaration of bonus at the last declared *annual bonus* rate.

final bonus

2.58 The *final bonus* rates are determined as a result of the method used to determine the policy value, set out in paragraph 2.49 – 2.51 above. The basic structure of the *final bonus* rates is left unaltered when rates change.

2.59 Policies that commenced participating in profits after 1 July 1975 receive a given percentage of *guaranteed benefits* plus attaching *annual bonus.* Policies that commenced participating in profits before 1 July 1975 receive an additional percentage for each year that the policy shares in profits prior to the year 1975/6. Pension policies are not entitled to any *final bonus.*

2.60 The *final bonus* rates are also used in the determination of early *surrender values*, which are calculated using a formula approach. The *surrender value* basis is reviewed infrequently, and rates of surrender are low.

smoothing

2.61 The structure of final bonus rates described in paragraph 2.59 leads to amounts payable that are a smooth progression between policies of varying durations. In addition *final bonus* rates are adjusted so that the maximum change in the value of similar policies from one year to the next is normally restricted to 10%.

2.62 *Smoothing* is expected to be neutral over a long period. *Final bonus* rates are normally determined annually. Significant changes in investment market conditions would trigger an interim review of *final bonus* rates. If the operation of the *smoothing* process in paragraph 2.61 above is not expected to remove any overpayments or underpayments compared with the unsmoothed level of policy values within a five-year period, the maximum change in policy values from one year to the next can be increased to 20%. In very adverse circumstances, where operation of the *smoothing* policy would be inconsistent with securing the sound financial management of the *sub fund,* the restrictions on annual changes would be reviewed.

2.63 As the *surrender value* basis uses the *final bonus* rates in the calculation formulae, *smoothing* is automatically applied to early surrender payments. Other than cashing the *annual bonus*, or surrendering accumulated *annual bonuses,* there are no options available to surrender part of a *with profits* policy.

Practices – With Profits Sub Fund No. 3 and With Profits Sub Fund No. 4

amounts payable

2.64 In each of these *sub funds*, the Society uses a *bonus reserve valuation* approach to determine the basic amount payable to *with profits* policyholders. The valuation basis uses a rate of interest based on the yield on the assets held by the *sub fund*, after adjustment for risk. Future expenses are allowed for at the rates charged to the *sub fund*. The Society has separate mortality bases for the regulatory valuation and for use in more realistic liability projections such as for bonus setting and investment management. The mortality assumption is based on industry experience, as actual experience does not have statistical credibility. In WPSF4, policies have the option to draw benefits at a range of ages. Clients select an intended retirement age at outset, although in many cases the policy document is written with a retirement age of 75. In the *bonus reserve valuation* retirement is assumed at the pre-

selected retirement age unless this has passed, in which case it is assumed at the next policy anniversary. Other than for these early retirements, the valuation does not allow for early termination of policies, nor for other business risks that may fall on the fund.

2.65 Tax calculations for WPSF3 are carried out as part of the Society's annual tax computations, on a stand-alone basis. This determines the tax charged to the *sub fund* and the allowance for tax used in the *bonus reserve valuation* basis. As WPSF4 only contains pensions business, no tax is charged to this *sub fund*, and none is allowed for in the valuation basis.

2.66 The current method of calculating *annual bonuses* is taken into account. Rates of *final bonus* can then be calculated so that the value of liabilities, including the *final bonus* equals the value of the assets in the *sub fund*. Further details of the approach are given below. Calculations are carried out for the *sub fund* as a whole, and are designed to fulfil the aim that all emerging *surplus* is distributed within the lifetime of the existing policies.

2.67 Under this approach, the principal factor that drives whether a change in policy values is appropriate is the difference between the investment return on the assets held in the *sub fund* and the risk free rate used in the valuation basis described in paragraph 2.64 above. Other items such as differences between actual mortality experience and the valuation basis assumption, *surpluses* on early termination, *surpluses* from without profits business, and business risks also contribute to the experience that is recognised in determining policy values. The *bonus reserve valuation* method explicitly allows for the building up of guarantees from the basic *guaranteed benefit* and accumulating *annual bonuses.*

2.68 The Society has documentation of methods used and assumptions made in determining bonus rates since 1990.

annual bonus

2.69 *Annual bonus* rates are reassessed once a year. Current practice is to preserve the structure and rates of *annual bonus* established prior to the transfer of the business to the Society unless this is inconsistent with the principle of fairness. It is not envisaged that it will be necessary to change the method of calculating *annual bonus* rates within the lifetime of the existing *with profits* policies, except in circumstances where the sound financial management of the *sub fund* might be at risk.

2.70 An *interim bonus* is paid on claims arising before the next declaration of bonus at the last declared *annual bonus* rate.

final bonus

2.71 The *final bonus* rates are determined as a result of the method used to determine the policy value, set out in paragraph 2.64 – 2.66 above. The structure of the *final bonus* rates is left

unaltered when rates change; the whole scale is increased or reduced by the same percentage, leaving the shape unchanged.

2.72 (WPSF3 only) A given percentage of *guaranteed benefits* plus attaching *annual bonus* is paid for all policies entitled to share in profits. The *final bonus* is paid in the same manner as the *guaranteed benefits*.

2.73 (WPSF4 only) A given percentage of *guaranteed benefits* plus attaching *annual bonus* is paid. There are two terminal bonus rates that depend on the class of *with profits* contract. The *final bonus* is paid in the same manner as the *guaranteed benefits*. When a deferred annuity comes into payment, the terminal bonus element accrued during the deferred period is only guaranteed for the first year of annuity payments. The amount of terminal bonus on annuities in payment may be varied for subsequent years, consistent with the practices on smoothing below.

2.74 (WPSF4 only) The Society's current approach is to adjust the *final bonus* rates for policies in deferment, before making adjustments to annuities in payment. *Final bonus* rates for annuities in payment are only changed if it is necessary in order to meet the principles of treating all policyholders fairly, or securing the sound financial management of the *sub fund*. As the number of policies in deferment reduces in future, it will not be appropriate to follow this practice throughout the run-off of the *sub fund.*

2.75 The *final bonus* rates are also used in the determination of early *termination value*s, which are calculated using a formula approach. The *termination value* basis is reviewed infrequently, and rates of surrender are low.

smoothing

2.76 The structure of final bonus rates described in paragraph 2.72 and 2.73 leads to amounts payable that are a smooth progression between policies of varying durations. In addition *final bonus* rates are adjusted so that the maximum change in the value of similar policies from one year to the next is normally restricted to 10%.

2.77 *Smoothing* is expected to be neutral over a long period. *Final bonus* rates are normally determined annually. Adverse investment market conditions would trigger a mid-year review of *final bonus* rates. If the operation of the *smoothing* process in paragraph 2.76 above is not expected to remove any overpayments or underpayments compared with the unsmoothed level of policy values within a five-year period, the maximum change in policy values from one year to the next can be increased to 20%. In very adverse circumstances, where operation of the *smoothing* policy would be inconsistent with securing the sound financial management of the *sub fund,* the restrictions on annual changes would be reviewed.

2.78 As the termination *value* basis uses the *final bonus* rates in the calculation formulae, *smoothing* is automatically applied to early termination payments. There are no options available to surrender part of a *with profits* policy.

Practices – With Profits Sub Fund No 5

amounts payable

2.79 The Society uses a *bonus reserve valuation* approach to determine amounts payable under *with profits policies.*

2.80 Before the Society acquired the business, University Life Assurance Society used an *asset share* approach to determine the relative amounts payable under *with profits* policies of different classes and durations. As the number of contracts remaining in the *sub fund* is now small and policies are clustered round a few entry years, there is no material benefit in repeating the *asset share* calculations.

2.81 The final bonus scale that applied when the business was acquired (called the "basis final bonus scale") is adjusted by a factor, K. The adjustment is calculated by using a *bonus reserve valuation* approach, and is designed to ensure that the whole of the *sub fund* is distributed to policyholders by the natural expiry of the policies in the *sub fund.* There are now fewer than 1,300 *with profits* policies in WPSF5

2.82 The *bonus reserve valuation* determines a factor K such that:

value of assets = K x value of with profits policies, incorporating the basic final bonus scale defined in paragraph 2.81,

\+ value of without profits policies.

The valuation basis uses a rate of interest based on the yield on the assets held by the *sub fund*, after adjustment for risk. No credit is taken for capital appreciation of equity investments. Future expenses are allowed for at the rates charged to the *sub fund*, with allowance for tax relief if appropriate. The mortality assumption is based on industry experience, as actual experience does not have statistical credibility. The Society has separate mortality bases for the regulatory valuation and for use in more realistic liability projections such as for bonus setting and investment management. The valuation does not allow for early termination of policies, nor for other business risks that may fall on the fund. The valuation allows for a take up rate of guaranteed annuity options that is consistent with recent experience.

2.83 Tax calculations for the *sub fund* are carried out as part of the Society's annual tax computations, on a stand-alone basis. This determines the tax charged to the fund and the allowance for tax used in the *bonus reserve valuation* basis and the *asset share* calculations.

2.84 Rates of *final bonus* are then calculated to express "K x value of with profits policies, incorporating the basic final bonus scale" as calculated in paragraph 2.82, in the form of a *final bonus* scale expressed as a percentage of the *guaranteed benefits.*

2.85 Under this approach, the principal factor that drives whether a change in policy values is appropriate is the difference between the investment return on the assets held in the *sub fund* and the interest rate used in the valuation basis described in paragraph 2.82 above. In particular, because the interest rate does not allow for capital appreciation on equities, this flows directly into *final bonus* rates, through the factor 'K'.

2.86 Other items such as differences between actual mortality experience and the valuation basis assumption, surrender *surpluses*, *surpluses* from without profits business, and business risks also contribute to the experience that is recognised in determining policy values. The *bonus reserve valuation* method explicitly allows for the building up of guarantees from the basic *guaranteed benefit* and accumulating *annual bonuses.*

2.87 The Society has detailed documentation of methods used and assumptions made in determining bonus rates at the time the business was acquired in 2007. Less detailed information exists for earlier years.

annual bonus

2.88 University Life Assurance Society had announced that it had set all *annual bonus* rates to zero two years before the Society acquired that company. Under the former ownership policyholders had been advised that it was not the intention to declare *annual bonuses* in future.

2.89 It is not envisaged that it will be appropriate to change this practice in future.

final bonus

2.90 The *final bonus* rates are determined as a result of the method used to determine the policy value, set out in paragraph 2.79 – 2.84 above.

2.91 Separate bonus scales are calculated for:

- Life fund whole life and endowment assurances
- Retirement annuity policies
- Other pension fund policies.

2.92 The *final bonus* rates are also used in the determination of early *surrender values*, which are calculated using a formula approach. The *surrender value* basis is reviewed infrequently, and rates of surrender are low.

smoothing

2.93 The basic *final bonus* scales described in paragraph 2.81 were set to achieve a smooth scale between contracts of different durations. There is no *smoothing* applied to restrict the maximum change in the value of similar policies from one year to the next in this *sub fund.* This is in part a consequence of the very small number of policies remaining in this *sub fund.*

2.94 The absence of smoothing from one year to the next means that reviews of final bonus rates will be more frequent than would otherwise be necessary, especially in times of significant movements in equity markets.

2.95 As the *surrender value* basis uses the *final bonus* rates in the calculation formulae, *smoothing* is automatically applied to early surrender payments. There are no options available to surrender part of a *with profits* policy.

Practices – With Profits Sub Fund No. 6

2.96 Specific practices relating to *unitised with profits business* are set out at the end of this section.

Benefit restructure

2.97 At the time that the business in WPSF6 was transferred into the Society, benefits were restructured. The High Court approved a scheme that reduced *guaranteed benefits* by 12.5% for the majority of policies. For some policies a smaller reduction was implemented. Benefits of *unitised with profits* policies and with profits annuities in payment were not altered.

2.98 As part of the transfer arrangements, a special non-guaranteed *final bonus* is payable at the time of a claim, equal to the reduction in *guaranteed benefits.* In the remainder of this section 2, this additional *final bonus* is referred to as the *special final bonus.*

amounts payable

2.99 In this *sub fund*, the Society uses a *bonus reserve valuation* approach to determine the basic amount payable to *with profits* policyholders. The valuation basis uses a rate of interest based on the yield on the assets held by the *sub fund*, after allowing for risk. Future expenses are allowed for at the rates charged to the *sub fund*. The mortality assumption is based on industry experience modified taking into account the actual experience of the portfolio. The Society has separate mortality bases for the regulatory valuation and for use in more realistic liability projections such as for bonus setting and investment management. The valuation does not allow for early termination of policies, nor for other business risks that may

fall on the fund. The valuation allows for a take up rate of guaranteed annuity options that is consistent with recent experience.

2.100 Tax calculations for the *sub fund* are carried out as part of the Society's annual tax computations, on a stand-alone basis. This determines the tax charged to the *sub fund* and the allowance for tax used in the *bonus reserve valuation* basis.

2.101 Rates of *final bonus* can then be calculated so that the value of liabilities, including the *final bonus* equals the value of the assets in the *sub fund*. Further details of the approach are given below. Calculations are carried out for the *sub fund* as a whole, and are designed to fulfil the aim that all emerging *surplus* is distributed within the lifetime of the existing policies.

2.102 Under this approach, the principal factor that drives whether a change in policy values is appropriate is the difference between the investment return on the assets held in the *sub fund* and the interest rate used in the valuation basis described in paragraph 2.99 above. Other items such as differences between actual mortality experience and the valuation basis assumption, *surpluses* on early termination and business risks also contribute to the experience that is recognised in determining policy values. The *bonus reserve valuation* method explicitly allows for the nature of the *guaranteed benefits.*

2.103 The Society has detailed documentation of methods used and assumptions made at the date the business was acquired in 2007 and thereafter. For prior years less detailed information is available, particularly in respect of policies that had previously been acquired from other friendly societies.

annual bonus

2.104 Hearts of Oak Friendly Society had set all discretionary *annual bonus* rates to zero some years before the Society acquired the business. Policyholders had been advised that it was not the intention to declare *annual bonuses* in future.

2.105 It is not envisaged that it will be appropriate to change this practice in future.

final bonus

2.106 The *final bonus* rates consist of three components, although not all policies have all three components:

- The *special final bonus*, as discussed in paragraph 2.98 above.

- A non-guaranteed reversionary bonus in respect of years after 2001 inclusive. This bonus operates like an *annual bonus*, save that the rate of bonus for each year may be altered at any time. Once announced, these bonuses are not guaranteed and may be reduced or removed.

- An additional amount that depends on the duration the policy has been in force. Currently this applies to life assurance policies only.

2.107 The *final bonus* rates are determined as a result of the method used to determine the policy value, set out in paragraph 2.99 to 2.101 above, and are set to equate the value of liabilities, including *final bonus,* to the value of assets.

2.108 The Board determined *final bonus* rates to apply from 1 March 2009. It was necessary to remove the second and third components described in paragraph 2.106 entirely, and to reduce the first component, the *special final bonus*.

2.109 If an increase in *final bonus* rates is justified, this will be implemented by increasing the first component described in paragraph 2.106, up to the level that applied when the business was acquired. Otherwise increases in final bonus will be granted in the form of an additional amount that depends on the duration the policy has been in force.

2.110 *Final bonus* is normally expressed as a percentage of *guaranteed benefits* plus attaching *annual bonus,* depending on the number of years the policy has shared in profits. The *final bonus* is paid in the same manner as the *guaranteed benefits*.

2.111 WPSF6 contains some annuities in payment that are with profits policies. All non-guaranteed elements of the annuity payments were removed from 1 March 2009.

2.112 The *final bonus* rates are also used in the determination of early *termination value*s, which are calculated using a formula approach. The *termination value* basis is reviewed infrequently, and rates of surrender of with profits policies are low.

smoothing

2.113 The structure of final bonus rates leads to amounts payable that are a smooth progression between policies of varying durations. In addition *final bonus* rates are adjusted so that the maximum change in the value of similar policies from one year to the next is normally restricted to 10%.

2.114 *Smoothing* is expected to be neutral over a long period. *Final bonus* rates are normally determined annually. Adverse investment market conditions would trigger a mid-year review of *final bonus* rates. If the operation of the *smoothing* process in paragraph 2.113 above is not expected to remove any overpayments or underpayments compared with the unsmoothed level of policy values within a five-year period, the maximum change in policy values from one year to the next can be increased to 20%. In very adverse circumstances, where operation of the *smoothing* policy would be inconsistent with securing the sound financial management of the *sub fund,* the restrictions on annual changes would be reviewed.

2.115 As the termination *value* basis uses the *final bonus* rates in the calculation formulae, *smoothing* is automatically applied to early termination payments. There are no options available to surrender part of a *with profits* policy.

Capital support charge

2.116 The Scheme that transferred the business in WPSF6 into the Society provides that, in the event of WPSF6 being unable to meet its *capital resource requirements,* a capital support charge of 4% per annum on any shortfall between the excess assets and the *capital resource requirements* of the *sub fund* shall be transferred from WPSF6 to RM WPSF, in consideration of the latter making its capital available to finance such a shortfall.

2.117 If a capital support charge is necessary, any reduction in *final bonuses* up to the expected outgo on the capital support charge in the next twelve months shall be outside the smoothing criteria set out in paragraphs 2.113 and 2.114

Unitised with profits business

2.118 The Practices that follow set out the areas where the *unitised with profits* business is operated in a different manner from the other types of *with profits* policies.

2.119 As *unitised with profits* policies are written in RM WPSF and the investment element is reassured to WPSF6, all premiums are paid to and claims met by RM WPSF. Each quarter an amount equal to 95% of premiums received in respect of *unitised with profits policies* is paid by RM WPSF to WPSF6. The unit value of any claims paid during the quarter will be paid from WPSF6 to RM WPSF, to finance the claims actually paid. The annual management charge of 1.5% per annum of the average value of units allocated to policies during the quarter will also be paid from WPSF6 to RM WPSF.

2.120 Certain *unitised with profits* pension policies have a guaranteed rate of growth in price of 3% per annum. All policies have a discretionary growth rate that has been declared from time to time. It is possible for the discretionary additions added since 2001 to be removed retrospectively.

2.121 All *unitised with profits* pension policies provide that a market value reduction can be applied on termination other than on death or at the contractual vesting date (if any). Life assurance policies provide that a market value reduction can be applied on surrender or partial encashment of units, except where a scheme of partial encashments was set up at the time the policy commenced, in which case no reductions can be applied unless the scheme is varied. Market value reductions cannot be applied on death.

2.122 Market value reductions are applied as a percentage of policy value which depends on the type of policy and the policy duration. The amount of such reduction is at the discretion of the Society, having taken advice from the *actuary.*

3 Investment Strategy

Principles

3.1 The investment strategy is to maximise the returns to *with profits* policyholders provided always that:

- Sufficient *liquid assets* should be available to meet cash outgo on liabilities as they fall due.
- Exposure to investment risk should be consistent with the liability profile of the Society.
- The strategy should be consistent with the sound financial management of the Society.
- Regard should be had to any statements made to policyholders.

3.2 The Society has no assets outside the six *with profits sub funds* referred to in this document. The assets in each of the *sub funds* back all the policy and other liabilities in those funds equally. However, for the purposes of managing the five *sub funds*, there is a notional allocation of assets to back different types of liability within each *sub fund*.

3.3 *Derivatives* and similar instruments may be used as part of the investment strategy, provided their use is consistent with the above principles and that adequate documentation of the rationale for their use is maintained.

3.4 Implementation of the investment strategy, including maximum exposure to any counterparty, is governed by *investment guidelines* established by the board.

3.5 The Society's investments in its subsidiary companies are maintained in RM WPSF. These investments would not normally be traded. The material investments relate to general insurance, administrative services and unit trust management subsidiaries.

Practices – Reliance Mutual With Profits Sub Fund

3.6 A review of the actuarial constraints on investment policy is carried out annually and reported to the board and the *investment committee*. In addition the board considers a six-monthly review of strategy and performance, operating within the actuarial constraints specified, and six-monthly reports on compliance with the *investment guidelines*.

3.7 *Unit-linked* policy liabilities are closely matched by investments in the appropriate linked fund or authorised unit trust. The matching position is assessed monthly.

3.8 Mortality and expense reserves for *unit-linked* policies and reserves for other without profits policies, assessed on a realistic basis, are backed by *fixed interest* assets. The valuation

basis uses a rate of interest based on the yield on the assets held by the *sub fund*, after adjustment for risk. The basis excludes the explicit margins for prudence in the expense assumptions, and uses the "projection" mortality assumptions. The *fixed interest* assets include *fixed interest* securities of appropriate duration, mortgages and loans, and cash on deposit. The asset requirement is assessed at least annually.

3.9 Reserves for guaranteed annuity rate options on certain policies are backed by a portfolio of assets specifically earmarked and designed to mitigate the risks associated with these options. The *investment committee* reviews the portfolio annually. It is adjusted if the benefits from an adjustment outweigh the costs of rearranging the portfolio. The portfolio consists of interest rate swaptions and similar market instruments, cash, and units in the internal funds to which the options are linked.

3.10 For *with profits* policies a *bonus reserve valuation* on a market yield basis is performed. The Society establishes a target requirement that the *guaranteed benefit*s, less future premiums, together with 50% of the future *annual bonuses* at the last declared rate, is backed by *fixed interest* assets.

3.11 The balance of the assets is invested with the aim of achieving the best return within the framework of the likely volatility of asset values, and within the risk appetite of the Society as set out in the *investment guidelines*.

3.12 The existence of an *inherited estate* gives freedom to depart from the constraint set out in paragraph 3.10 above. The Society assesses the extent of this freedom by considering the statutory *solvency* position following a severe deterioration in investment conditions. However the *investment committee* must agree the extent of departure from the constraint, and the duration of any such departure, having taken the advice of the *actuary*.

3.13 Direct investment in real property must be approved by the board, and any investment in new or novel investment instruments must be approved by the *investment committee* before any commitment is made.

3.14 In determining bonus policy, investments in subsidiary companies are regarded as part of the *inherited estate* and do not affect the determination of pre-augmentation policy values.

Practices – With Profits Sub Fund Nos. 2, 3, and 4

3.15 A review of the actuarial constraints on investment policy is carried out annually and reported to the board and the *investment committee*. In addition the board considers a six-monthly review of strategy and performance, operating within the actuarial constraints specified, and six-monthly reports on compliance with the *investment guidelines*.

3.16 Reserves for without profits policies, assessed on the same *bonus reserve valuation* basis used in determining amounts payable as described in Section 2, are backed by *fixed interest* securities of appropriate duration, and cash on deposit. The asset requirement is assessed at least annually.

3.17 Reserves for *with profits* policies, assessed on the *bonus reserve valuation* basis, are also backed by *fixed interest* assets. The balance of the fund is invested in *fixed interest* securities and *equities.* Approximately half the balance is invested in *fixed interest* securities; the remainder is invested with the aim of achieving the best return within the framework of the likely volatility of asset values, and within the constraints set out in the *investment guidelines*.

3.18 Direct investment in real property must be approved by the board, and any investment in new or novel investment instruments must be approved by the *investment committee* before any commitment is made.

Practices – With Profits Sub Fund No 5

3.19 A review of the actuarial constraints on investment policy is carried out annually and reported to the board and the *investment committee*. In addition the board considers a six-monthly review of strategy and performance, operating within the actuarial constraints specified, and six-monthly reports on compliance with the *investment guidelines*.

3.20 Reserves for without profits policies, assessed on the same *bonus reserve valuation* that is used to determine amounts payable as set out in paragraph 2.82, are backed by *fixed interest* securities of appropriate duration, and cash on deposit. The asset requirement is assessed at least annually.

3.21 For *with profits* policies the same *bonus reserve valuation* is used. The Society establishes a target requirement that the *guaranteed benefit*s, including attaching *annual bonuses*, less future premiums, are backed by *fixed interest* securities of appropriate duration.

3.22 The balance of the assets is invested with the aim of achieving the best return within the framework of the likely volatility of asset values, and within the constraints set out in the *investment guidelines*.

3.23 Direct investment in real property must be approved by the board, and any investment in new or novel investment instruments must be approved by the *investment committee* before any commitment is made.

Practices – With Profits Sub Fund No. 6

3.24 A review of the actuarial constraints on investment policy is carried out annually and reported to the board and the *investment committee*. In addition the board considers a six-monthly review of strategy and performance, operating within the actuarial constraints specified, and six-monthly reports on compliance with the *investment guidelines*.

3.25 Reserves for guaranteed annuity rate options on certain policies are backed by a portfolio of assets specifically earmarked and designed to mitigate the risks associated with these options. The *investment committee* reviews the portfolio annually. It is adjusted if the benefits from an adjustment outweigh the costs of rearranging the portfolio. The portfolio consists of interest rate swaptions and similar market instruments and cash.

3.26 For *with profits* policies a *bonus reserve valuation* on a market yield basis is performed. The basis is the same as that used in the determination of amounts payable, as described in paragraph 2.99. The Society establishes a target requirement that the *guaranteed benefit*s, less future premiums, are backed by *fixed interest* securities of appropriate duration.

3.27 Approximately half the balance of the assets, subject to a minimum of the *sub fund's capital resource requirements*, is invested in *fixed interest* securities; the remainder is invested with the aim of achieving the best return within the framework of the likely volatility of asset values, and within the constraints set out in the *investment guidelines*.

3.28 Direct investment in real property must be approved by the board, and any investment in new or novel investment instruments must be approved by the *investment committee* before any commitment is made.

Transitional arrangements

3.29 At the date of transfer of the business from Hearts of Oak Friendly Society, the *sub fund* held fixed interest securities, cash, and a portfolio of real property. The intention is to market the property portfolio actively, but there is no requirement to dispose of it within a specified time, particularly if this might involve acceptance of offers below the perceived market value. Proceeds from the sale of properties will be invested in accordance with paragraphs 3.26 and 3.27 above.

3.30 For a transitional period, pending completion of property sales, it might not be possible to meet the practice set out in paragraph 3.27. Reports on the position during the transitional period will be provided to the *investment committee* at each bi-monthly meeting.

4 Business Risk

Principles

4.1 As members of a mutual Society, *with profits* policyholders share in all the profits or losses arising from the Society's business, written in the appropriate *sub fund*. In addition to investment returns, *with profits* policyholders are exposed to all the business risks, including any compensation costs associated with those risks, undertaken by the Society, within their *sub fund*.

4.2 In the event that any of the *sub fund*s is unable to meet its guaranteed liabilities, the structure of the Society as a single legal entity means that recourse may be had to assets within other *sub fund*s. The principles of financial management of the Society are designed to ensure that this eventuality does not occur, but in extreme circumstances policyholders will be exposed to business risks outside the *sub fund* in which they have a policy.

4.3 The Society has a number of principles that must be satisfied in relation to new business risks.

- New business risks will only be taken by RM WPSF.
- Any new venture should at least maintain the bonus prospects of *with profits* policyholders at the same level as would have occurred had the Society not undertaken any such ventures after the end of 1999.
- A risk assessment for each significant new venture must be presented to the board.
- Any new venture must not tie up capital so that the bonus policy is compromised, and must generate an appropriate return on capital commensurate with the risks undertaken.
- No investment advice will be given.

4.4 New business must continue to meet the objectives in paragraph 4.3 above.

Practices – Reliance Mutual With Profits Sub Fund

4.5 The assessment of new and continuing ventures referred to above is carried out using the methods of the *actuary's* annual financial condition report to the board, and the tools used in determining the Society's internal capital assessment. Significant new ventures are assessed before implementation and continuing ventures are assessed annually.

4.6 A number of deterministic scenarios are modelled that make a range of assumptions as to the success or otherwise of any proposed venture. The process generates the following key indicators of the viability of any venture, which are used in the assessment:

- The projected *solvency* position and *inherited estate* at various future dates
- The *embedded value* of the venture, in conjunction with other activities of the Society
- Projected expense unit costs at various future dates.
- Any additional *capital resource requirements* generated by the venture.

4.7 Profits and losses arising from taking on additional business risks are initially offset against each other before determining whether, and to what extent, it is appropriate to apply them to determine the amount payable under a *with profits* policy. In addition the risks associated with any venture are assessed and allowance made for any adverse experience outturn that might arise before profits are used to augment *with profits* policy benefits. *Surpluses* arising from acquired blocks of business are not distributed until the costs of acquisition of the block of business have been recovered.

4.8 In order to reward different generations of policyholder for the risks they undertake, the longer duration policyholders, who contribute the greater working capital, receive the greater share of profits from both additional business risks undertaken and also *surplus* from without profits business. This is achieved by distributing any additional amounts in proportion to the unaugmented amount payable less the *guaranteed benefit*s.

4.9 Profits and losses arising from existing *with profits* and without profits business in the *sub fund* are reflected in the amounts payable to policyholders, using the methods described in section 2 above.

4.10 A significant number of policies in RM WPSF have been written with guaranteed annuity rate options. These pose a potential risk to the *sub fund*. An appropriate provision has been established for these risks, and a portfolio of assets designed to mitigate the risks has been purchased to back the provision.

Practices – With Profits Sub Funds Nos. 2, 3, 4, 5, and 6

4.11 Business risks resulting in profits or losses to these *sub fund*s will be recognised through the annual *bonus reserve valuation* referred to in section 2 above. This includes profits or losses from any without profits policies in the *sub fund*, where profits on early termination are likely to accrue.

4.12 Some policies in WPSF 2 and 4 have been written with guaranteed annuity options or guaranteed cash options on annuity policies. These pose a potential risk to the *sub fund*s, for which the board have established an appropriate provision. This provision has been adequate to meet costs arising in the past, and is expected to be so in the future.

4.13 A significant number of policies in WPSF5 and 6 have been written with guaranteed annuity rate options. These pose a potential risk to the *sub funds*. An appropriate provision has been established for these risks, and, for WPSF6, a portfolio of assets designed to mitigate the risks has been purchased to back the provision.

4.14 The assumptions made for the take up of guaranteed annuity rate options in WPSF5 and WPSF6, which are used in setting the amounts payable, as discussed in section 2, are unlikely to be borne out exactly in practice. This will generate profits or losses in these *sub funds.*

4.15 Some policies in WPSF6 provide options for the policyholder to invest in either unit-linked investment funds or in the *unitised with profits* fund. The terms of the policies and the marketing literature issued provide that the Society can cease to allow switches of investments or redirections of future premiums into the *unitised with profits* fund. The Society exercised this right with effect from the date of transfer of the business, and thus no new investments can be made into the *unitised with profits* fund. Existing instructions to allocate future premiums to *unitised with profits* business are not affected.

5 Charges and Expenses

Principles

5.1 All management expenses incurred by the Reliance Group are initially borne by the Society. The Society charges other Reliance Group companies with a share of the expenses incurred at cost, based on the proportion of costs incurred and work done in respect of each company.

5.2 All management expenses attributable to the Society are initially charged to RM WPSF. These expenses are offset by expense charges deducted from WPSF2, 3, 4, 5, and 6 and paid to RM WPSF. The basis for these charges is fixed and is set out in Section 8 below.

5.3 In allocating expenses or expense charges to different classes of *with profits* policies within RM WPSF for the purpose of calculating *asset shares*, the Society aims to reflect the administrative activity and overhead costs attributable to the policies concerned. There should thus be no factors that drive any change to the basis used to allocate expenses.

Practices – Reliance Mutual With Profits Sub Fund

5.4 An analysis of all the Society's expenses is carried out quarterly. The expenses are primarily analysed into expenses attributable to policy management, investment, and development expenses. The policy management expenses are further subdivided into expenses relating to acquisition of new business, renewal of existing business, and processing of claims. Based on levels of activity required for each category of policy, unit costs are determined separately for life and pension, *industrial* and *ordinary*, premium paying and non-paying policies.

5.5 The expenses derived from this analysis are used in the calculations that determine policy benefits set out in section 2 above. Development expenses are charged to the *inherited estate*.

5.6 Other than *smoothing* out any single abnormal result, there are no circumstances where expenses other than at cost will be used in the calculation of policy benefits.

Practices – With Profits Sub Fund No. 2, 3, 4, 5, and 6

5.7 The expense agreement that determines the expense charges deducted from these *sub fund*s is set out in section 8 below. It defines investment, maintenance, new business and claim charges for each category of policy, separately for premium paying and non-paying policies.

5.8 These expense charges are used in the basis for the *bonus reserve valuation*s that determine policy benefits set out in section 2 above.

6 Management of the Inherited estate

Principles

6.1 As set out in paragraph 2.3 above, the bonus policy aims to distribute all *surplus*, including excess *inherited estate*, to *with profits* policyholders within the relevant *sub fund*s. An important feature of RM WPSF is that most *with profits* policies are expected to reach their natural expiry before the without profits policies. This feature does not occur in WPSF2, 3, 4, 5, and 6.

6.2 Within RM WPSF, the Society aims to maintain an *inherited estate* of sufficient size to support the without profits business, so that there is low probability of the Society being unable to meet its liabilities to policyholders.

6.3 The principles set out in paragraph 4.3 above indicate that the *inherited estate* within RM WPSF can be used to finance new ventures provided that within the Society's risk appetite.

6.4 There are no restrictions on the Society's use of the *inherited estate* as a result of previous transactions.

Practices – all sub funds

6.5 The *inherited estate* is used to:

- *Smooth with profits* policy payouts (this *smoothing* is intended to be cost neutral over time).
- Finance new business risks as described in section 4 above. This is only applicable to RM WPSF.
- Provide augmentations to *with profits* policy values.
- Finance the tests of *solvency* and capital adequacy required by regulatory bodies.

6.6 The investment strategy for the *inherited estate* is implicitly determined by the practices described in section 3 above.

6.7 The principles above and the bonus policy described in section 2 control the size of the *inherited estate*.

7 Arrangements for taking on and ceasing new business

Principles

7.1 The principles for taking on new ventures are set out in section 4 on business risks above. These also cover the ongoing assessment of existing lines of new business.

7.2 The Society aims to determine a maximum volume of new business that is appropriate in both the annual planning cycle and over a longer period. This determination is based on the risk profile and capital requirements of each major line of business.

7.3 There are not expected to be any changes to the principles regarding distribution of the *inherited estate* if new business were to cease.

Practices

7.4 There are no Practices relating to these Principles that are not covered elsewhere in this document.

8 Expense charges deducted from sub funds WPSF2, WPSF3, WPSF4, WPSF5 and WPSF6

The charges in the table below were established by the Schemes of Transfer of the business of Criterion Life Assurance Limited, effective from 30 June 2004, certain business of Family Assurance Friendly Society, effective 30 September 2004, the business of University Life Assurance Society, effective 31 July 2007 and the business of Hearts of Oak Friendly Society, effective 31 July 2007.

WPSF2, WPSF3, WPSF4 and WPSF6

The figures in the table, with the exception of the investment expense charge, which is fixed, apply to the calendar year 2007 only. For subsequent years the charges increase in line with the increase in the index of National Average earnings. Charges are deducted quarterly at the end of each calendar quarter

Expense Charge	Basis Element	Charging Unit	Charge (per quarter)			
			WPSF2	WPSF3	WPSF4	WPSF6
Investment	Market Value of Invested Assets	Per £1,000 invested	62.5 pence	70 pence	70 pence	52.5 pence
Policy maintenance	Number of premium paying policies	Per policy	£5.89	£7.65	£8.41	£7.375
	Number of annuities in payment	Per annuity	£5.89	£7.65	£8.41	£7.375
	Number of life single premium bonds	Per policy	N/A	N/A	N/A	£5.531
	Number of other non paying policies	Per policy	£2.06	£2.68	£2.94	£2.581
Claims administration	Number of life claims	Per claim	£82.41	£91.85	N/A	£73.00
	Number of pension claims	Per claim	£176.59	N/A	£201.81	£200.75
	Number of annuities set up at vesting	Per annuity	£176.59	N/A	£269.08	N/A
New business	DWP rebate policy increments	Per increment	N/A	N/A	N/A	£30.00
	Other increments and new business	Per increment	N/A	N/A	N/A	£220.00

WPSF5

Expense Charges are be deducted and paid at the end of each calendar quarter.

The quarterly Expense Charges is the greater of:

a. 9% of the premium income received during the quarter

b. 0.075% of the average value of the total net sums insured at the beginning and end of the quarter.

9 Glossary

Actuary	The holder of the actuarial function as defined in the FSA Handbook SUP 4.3.1
Annual bonus	Discretionary additions to the *guaranteed benefits* that are added to a *with profits* policy once a year. Once declared, bonuses become guaranteed and cannot be taken away.
Asset share	An accumulation of premiums less allowances for expenses, tax and the cost of life assurance cover at a rate of return based on the actual income and growth of the assets backing the policy
Bonus reserve valuation	A method of determining the value of future liabilities under a life insurance policy. Future benefits, including *guaranteed benefits, annual bonuses* and *final bonuses,* where appropriate, plus future expenses and less future premiums are discounted at a rate of interest usually based on current market conditions.
Capital resource requirements	Legislation and regulation require an insurance company to maintain a specific excess of assets over liabilities known as the *capital resource requirements.*
Derivative	A financial instrument usually including an option to trade in securities at a fixed price at some future date.
Embedded value	The discounted value of the cash flows from a portfolio of insurance policies. Cash flows include premiums, the return on investments, payments to policyholders for claims, expenses of management, and taxation.
Equity	An investment in ordinary shares issued by a company.
Final bonus	A bonus that is added to the *guaranteed benefits* plus attaching *annual bonuses* on payment of a claim on a *with profits* policy, whether by maturity, death early termination, or vesting as a series of annuity payments.
Fixed interest	An investment in a security that carries a guaranteed rate of return payable at known intervals.
Guaranteed benefit	The minimum amount payable when a claim arises under a *with profits* policy. This is an amount determined when the policy is first taken out, supplemented by declarations of *annual bonus*.
Industrial branch	These are policies written under the provisions of the Industrial Assurance Acts. When taken out an agent, who called at least every four weeks,

collected premiums in cash.

Inherited estate	The difference between the market value of the assets of an insurance company and a market based valuation of its liabilities. For *with profits* policies in RM WPSF, the value of liabilities is taken as the accumulated *asset shares*. For without profits policies in RM WPSF and all policies in WPSF2, WPSF3 and WPSF4, a *bonus reserve valuation* using a discount rate derived from current market conditions is used to value the liabilities.
Interim bonuses	These are normally of similar structure to *annual bonuses*. They are paid when a claim occurs in respect of the period between the last declaration of *annual bonus* and the date of the claim.
Investment guidelines	A document agreed by the board that sets out the types of asset in which various funds within the company can invest. It includes limits on the proportion of various asset types, and restrictions on the maximum exposure to individual counterparties.
Investment committee	A committee of the board whose remit is to agree the investment policy of the company and monitor the performance of the investment department.
Liquid assets	Cash or assets that can be readily converted into cash at short notice, in particular UK government *fixed interest* securities.
Mortuary bonus	A type of *annual bonus* granted to without profits *industrial branch* policies. These are now indistinguishable from normal *annual bonuses.*
Ordinary branch	All life insurance and pensions business other than that written in the *industrial branch*.
Smoothing	A means by which returns on *with profits* policies are adjusted in order to avoid discontinuities in claim payouts. This applies between both policies of similar durations becoming claims, and also between claim values at successive points of time.
Solvency	Legislation and regulation require an insurance company to maintain a specific excess of assets over liabilities known as the *capital resource requirements* or solvency requirements. Solvency capital is the capital that the company has available to meet this margin.
Sub fund	One of a number of *with profits funds* that together comprise the whole of the business of the Society

Supervisory valuation	The value of the liabilities calculated in accordance with regulatory requirements, and published annually in supervisory returns to the regulator.
Surplus	The excess of premiums and investment return over claims, expenses, taxation and the increase in the provision for future liabilities, calculated using the *supervisory valuation* basis.
Surrender value *Termination value*	The claim value paid when a policy is voluntarily discontinued by the policyholder, prior to any maturity date.
Unitised	A type of *with profits* policy where the *guaranteed benefits* and accumulating *annual bonuses* are expressed in the form of a number of units.
Unit-linked	A type of policy where the benefit payable is linked to the performance of a specified investment asset or to a portfolio of such assets.
With profits	A type of policy where the *guaranteed benefits* are augmented from time to time, at the discretion of the insurance company, out of *surplus* emerging in the *with profits fund*.
With profits actuary	The holder of the with profits actuary function defined in the FSA Handbook SUP 4.3.1
With profits fund	An identified subset of the assets and liabilities of an insurance company, that includes an identified portfolio of *with profits* policies.