

The Equitable Life Assurance Society Principles and Practices of Financial Management

April 2019

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1. Introduction

This document sets out the Principles and Practices of Financial Management (the “PPFM”) applied in managing the with-profits business of Equitable Life Assurance Society (“Equitable Life” or “the Society”). The document has been approved by the Society’s Board of Directors (“the Board”).

The aims of this document are:

- (a) To set out the key features of the governance of the Society’s with-profits business, with particular reference to the use of discretion in managing that business; and
- (b) To provide information on the possible risks, rights and rewards attaching to the Society’s with-profits policies.

The document differentiates between “Principles” and “Practices”. The Principles are intended to be high-level statements that reflect the general approach adopted in managing the Society’s with-profits business and are expected to be enduring. If the Society feels it is appropriate to alter any of the Principles detailed in this document, with-profits policyholders will normally be notified, in writing, at least three months before any changes are implemented. The Society’s Principles can only be changed by the passing of a resolution of the Board.

The purpose of the Practices is to describe the Society’s current approach to managing its with-profits business and to responding to changes in the business and economic environment in the shorter-term. These Practices may have to be changed to reflect changes in the circumstances of the Society and the business environment. Information about any changes to the Practices will be communicated to with-profits policyholders at the same time as annual statements are distributed or by way of separate correspondence, if this is considered appropriate by the Board.

The current version of the Society’s PPFM can be found on the Society’s website (www.equitable.co.uk) and paper copies can be obtained, free of charge, by with-profits policyholders of the Society by contacting the Society’s Call Centre on 0330 159 1530.

None of the contents of this document is intended to form part of, or vary, the terms or conditions of any policy issued or to be issued by the Society. In the event of any inconsistency between the contents of this document and any policy, the terms and conditions of the policy prevail.

This document is intended to assist knowledgeable observers to understand the way in which the with-profits business of the Society is conducted and the material risks and rewards involved in effecting or maintaining a with-profits policy with Equitable Life. It is not a comprehensive explanation either of the management of the with-profits business of the Society or of every matter which may affect that business. In addition, no part of the document should be read as a recommendation or advice to policyholders or potential policyholders or their advisers in relation to the effecting or maintaining of a with-profits policy. Accordingly, any person considering whether to effect or maintain a with-profits policy with Equitable Life should seek independent financial advice.

Statements in this document in relation to the risks and rewards involved in effecting and maintaining a with-profits policy with Equitable Life are by their nature forward-looking statements that are subject to a variety of uncertainties. Readers of this document should read such forward-looking statements in that context.

The contents of this document may be amended as a result of a change in the circumstances of the Society or the business environment. The document may also be amended to reflect changes made by the Society to the management of the with-profits business. The Society intends to give notice of any such change as explained above, although in exceptional circumstances (such as to preserve solvency), changes could be made without notice.

Readers of this document should read the whole document. Reading only selected sections or paragraphs in isolation may result in a misleading impression of the way in which the with-profits business of the Society is conducted and the material risks and rewards involved in effecting and maintaining a with-profits policy with Equitable Life. The principles set out in this document and their associated practices should in particular be read together. Certain matters contained in this document are subject to continuing analysis and review by the Society and the regulators and may change as a result of that ongoing process.

The Society’s Board has arrangements in place for an annual review to confirm that the with-profits fund has been managed in accordance with the Principles and Practices laid out in this document. The Board also

produces an annual report for with-profits policyholders on the management of the with-profits fund. This can be found on the Society's website.

This version of the document is dated April 2019 and replaces the version dated June 2018.

2. Strategy of the Society

In June 2018, the Society announced its new strategy, with the aim of both mitigating the risk of a reduction in Capital Distribution Amount, and releasing capital to with-profits policyholders earlier than might otherwise be possible. Under these plans, with-profits policyholders who currently benefit from investment guarantees will be asked, among other things, to surrender those guarantees and their membership rights in the Society in consideration for an increase in Capital Distribution Amount. If the plans are successful the with-profits policies will, at the same time, be converted into unit-linked contracts and transferred to Utmost Life and Pensions Limited. This change in strategy was communicated to policyholders in June 2018 and the PPFM should be read by policyholders in the context of this revised strategy.

The change in strategy will be put into effect by a Scheme of Arrangement and by an insurance business transfer under Part VII of the Financial Services and Markets Act 2000. It will be subject to the approval of with-profits policyholders and members and the sanction of the High Court. The change in strategy is consistent with the long-standing Principles applied in managing the with-profits business.

3. Background Information on Equitable Life

3.1 Constitution and membership of the Society

a) Members of the Society

The Society is a mutual company and accordingly has no shareholders. Under the Articles of Association of the Society, its members essentially comprise persons who have taken out with-profits policies with the Society which remain in force and invested in with-profits. However, not all with-profits policyholders are members of the Society. For example, only a person to whom a with-profits policy was originally issued can be a member in respect of that policy - a person to whom a with-profits policy is subsequently assigned cannot be a member of the Society in respect of that policy. In addition, where a with-profits policy is held jointly by more than one person, only the first-named person on the policy can be a member in respect of that policy. In practice, most with-profits policyholders are also members of the Society.

Where the trustees of an occupational pension scheme take out a with-profits policy, only the first-named trustee on the policy can be a member of the Society in respect of that policy. Members of, or beneficiaries under, the occupational pension scheme will not be members of the Society by virtue of that policy.

b) Participation in the profits and losses of the Society

Although members of the Society have the right to attend and vote at general meetings of the Society, membership does not confer the right to share in the profits of the Society's business. Only with-profits policyholders participate in the profits and losses of the Society.

c) Liability of members for the debts of the Society

The Society is an unlimited company and accordingly the members of the Society are liable for its debts. However, the policies issued by the Society state that the Society's liabilities to its policyholders cannot exceed its assets. The purpose of this provision is to prevent members being called upon to meet the liabilities of the Society to its policyholders (whether under with-profits or non-profit policies).

Any liquidation of the Society would be governed by a statutory framework that is untested in the context of a life insurance company. That statutory framework gives the claims of insurance policyholders priority over the claims of other creditors. There is considerable legal uncertainty over how the statutory framework would operate in relation to a liquidation of the Society in the light of the provisions included in policies issued by the Society which state that the Society's liabilities to its policyholders cannot exceed its assets.

Should the Society go into liquidation, policyholders may have recourse to the Financial Services Compensation Scheme (the "FSCS") for the whole or part of the Society's liabilities to them depending upon the nature and quantum of their claims. The FSCS can also initiate measures should the Society be in default but not go into a formal insolvency process.

3.2 Types of with-profits policies issued by the Society

The Society closed to new business in 2000. This means that new policies are generally only issued where there is a regulatory or contractual obligation on the Society to do so in connection with existing policies.

The Society now has in issue two basic types of with-profits policy:

a) Recurrent single premium policies (“RSP policies”)

In aggregate, RSP policies account for the great majority of the Society's with-profits business. Under these policies, each premium, after deduction of any charges, secures a guaranteed benefit. The aggregate of these guaranteed benefits is the minimum amount payable on the occurrence of specified events such as retirement or death. On the majority of RSP policies, the value of the guaranteed benefit is increased by a guaranteed investment return (the “GIR”), typically at the rate of 3.5% each year for policies issued before 1 July 1996, and 0% p.a. for policies issued after that date (meaning that the guaranteed benefits can never reduce except in the circumstances described in section 3.1(c)). A small number of RSP policies have GIRs at different rates. The guaranteed benefit is also increased by any reversionary bonuses declared, over and above the GIR.

The payout on the maturity of any RSP policy cannot be less than the guaranteed benefits, unless it is required to be reduced in the circumstances described in section 3.1(c).

b) Other with-profits policies

These policies include endowments and whole life policies and, in aggregate, account for a very small minority of the Society's with-profits business. Under these policies, an amount of guaranteed benefit is payable at a specified date or over a series of dates, or on the occurrence of a specified event. The guaranteed amount can be increased during the term of the policy through reversionary bonuses. A non-guaranteed final bonus may also be added at exit.

A small proportion of the Society's with-profits business is denominated in currencies other than Sterling. The products are similar to those described above.

3.3 The concept of “Policy Values”

For RSP policies, the Society has for many years used the concept of the “Policy Value” and the Society's administration system will generate a Policy Value in respect of each policy. A Policy Value normally represents a smoothed investment return (net of charges and other adjustments) applied to the premiums paid into a policy and is used to determine payout levels in relation to with-profits benefits. Over the medium to long term, the increase in a Policy Value would, all other things being equal, be related to the growth on the underlying investments. Types of policy that do not use the concept of the Policy Value apply methodologies that are designed to have a similar effect.

The Policy Value is not a guaranteed amount - it can be reduced as well as increased, and it can be more or less than the value of guaranteed benefits under a policy. Policy Values are calculated at benefit level and each premium, net of any explicit charges, adds to the Policy Value. Withdrawals reduce the Policy Value. Each year, and sometimes more often, the Board may decide to increase (or reduce) Policy Values, by a particular rate, or set of rates.

Policy Values are kept under regular review and may be changed at any time with immediate effect and without prior notice to policyholders. Changes to Policy Values are primarily influenced by the Society's outlook for long term investment returns. However, many factors are taken into account and these factors are explained in section 5.2.1 below. The Society aims to smooth the effect of these factors.

The Society expects that Policy Values will only be decreased to protect solvency or as a result of poor investment conditions.

Changes to Policy Values, and to the method of calculating Policy Values, are determined by the Board. The methodology for the calculation of Policy Values is described in this document and the Appendix summarises the most significant assumptions used in calculating Policy Values over the last 25 years.

3.4 The concept of “Capital Distribution”

The Society is required by the regulators to hold back 'solvency capital' to protect the Society against adverse economic and other events. This capital obligation must be seen against the Society's intention to distribute all of the Society's assets among with-profits policies as fairly and as soon as possible over the lifetime of those policies. In order to ensure fairness between policies leaving and remaining in the with-profits fund, the Society needs to ensure that payout levels not only distribute a fair share of the solvency capital of the fund as soon as possible, but also leave sufficient solvency capital for those policies remaining.

Unlike Policy Values which, all other things being equal, tend to grow in line with underlying investment performance, the Society's need for capital is determined by the level of risk that it faces from time to time. If the Society's risks increase, it needs to hold more capital in case things do go wrong, for example,

if the costs of running the Society turn out to be higher than anticipated. Equally, if the Society's risks decrease, as was the case following the reassurance of the annuity business in 2015 prior to its transfer to Canada Life, it needs to hold less capital.

The success of the Society's strategy of getting capital back into policyholders' hands, therefore, is very much dependent on how successful it is in reducing the risks it faces. As risks are reduced or eliminated, capital becomes available to be returned to policyholders.

Currently, the Society calculates a Capital Distribution Amount, also referred to as an enhancement, as a proportion of Policy Values at a certain date. This enhancement is paid on top of Policy Values to determine payouts. The Capital Distribution Amount and the way it is applied represent the Board's view of the prudent share of solvency capital to be earmarked for policyholders. The level of the Capital Distribution Amount is reviewed and determined at least annually. The two key considerations in setting the rate are:

- It should be low enough to result in an acceptably low likelihood of reducing payouts in future adverse scenarios; and
- It should be high enough to avoid an excessive accumulation of capital in the fund over time.

The enhancement is paid at the time policyholders take their benefits, and is not guaranteed.

The method of capital distribution is at the discretion of the Society. The way the Board determines the Capital Distribution Amount may be changed at any time and the Capital Distribution Amount can be removed, reduced or increased at any time, with immediate effect and without prior notice to policyholders.

When RSP policies are terminated on contractual terms, the greater of the Policy Value plus Capital Distribution Amount, and the guaranteed benefits, is paid.

3.5 Other with-profits business

Types of policy that do not use the concept of Policy Value will apply methodologies that are designed to have a similar effect. Payouts on these policies will also take account of the level of Capital Distribution Amount applicable at the time of exit.

4. Principles

The Society's with-profits business is managed in accordance with the following principles:

a) Management of the Society

The Society aims to manage its business in a sound and prudent manner for the benefit of all policyholders and in particular so that it can continue to meet its contractual obligations to policyholders and other creditors as they fall due.

b) Distributing all of the Society's assets

It is the intention of the Society that all of its assets, after providing for its contractual liabilities (including those to holders of non-profit policies and other creditors), will be distributed as fairly and as soon as possible among the holders of its with-profits policies over the lifetime of those policies. This means that amounts distributed amongst with-profits policies can exceed the contractual guaranteed entitlements of with-profits policyholders. Any amounts distributed among with-profits policies in excess of contractual guaranteed entitlements are decided after allowing for the requirement to meet the Society's contractual obligations as they fall due, and the need for the Society to maintain an appropriate level of solvency capital to operate its business.

The appropriate level of capital it needs to maintain will depend on both the Society's own assessment of the capital needed to manage its business and the requirements of the statutory solvency regime in force from time to time. In addition, the regulator may require the company to hold additional capital in excess of that calculated under the solvency regime in force, based on its assessment of the specific risks in the company's business. This could affect how the company distributes its assets.

c) Bonus policy

In determining bonus policy, the Society aims to balance the objectives of continuing to meet its obligations to policyholders and other creditors as they fall due and of distributing the Society's assets over the lifetime of its policies as fairly and as soon as possible. Consideration is given to the overall financial position of the Society which is affected by many things including, inter alia, investment returns and outlook, actual and expected expense levels, the expected cost of guarantees, miscellaneous profits and losses (including those from the non-profit business) and changes in the level of provisions. The rate at which surplus is distributed

may vary depending on the Society's requirement for solvency capital, and the general level of uncertainty (for example, in the various provisions).

For the foreseeable future, any new distributions of surplus will be made in non-guaranteed form, and there is no expectation of any further reversionary bonus being awarded in the near to medium term. This applies across all product types and all territories. This approach aims to maximise the likelihood of the Society being able to meet all its future contractual liabilities.

The Society aims to set bonuses and payout levels which are fair across different groups and generations of policyholders. Profits and losses are typically shared across the whole of the with-profits business, not just among the policies concerned. For example, the cost of administration is shared across the whole of the with-profits business. Changes to Policy Values plus any Capital Distribution Amount and their equivalents are often the same for all policies within a particular class, but it is possible that they will vary between different groups and generations of policyholders.

d) Smoothing

The Society has a preference that changes in levels of bonuses and payouts should be gradual whenever circumstances permit, and reflect the underlying trend of investment returns. However, in adverse scenarios, especially when investment returns are poor, there is limited scope for smoothing. In particular, smoothing considerations will be over-ridden by the Society's need to be able to meet its contractual obligations to policyholders and other creditors as they fall due and any solvency capital requirements that the Society may have.

The Society considers smoothing in the context of its reviews of Policy Values plus any Capital Distribution Amount, rather than comparing the payout value of one policy with an equivalent one taken out a year earlier. This principle has been established over many years. It helps to avoid the amount paid under a policy being unduly distorted by reference to the experience of the fund in the year before the policy commenced.

e) Payouts on early surrenders

Where a policyholder surrenders his policy (or switches to a unit-linked fund) before maturity, contractual obligations in respect of payouts under the policy generally do not apply. The intention is that the amount paid to surrendering policies should be fair, but that it should not disadvantage continuing policyholders. In particular, the amounts paid to surrendering policyholders should not reduce the payout prospects of the continuing policyholders.

f) Investment policy

The Society operates a conservative investment policy investing mainly in fixed interest securities (such as gilts and corporate bonds).

Close matching of assets with guaranteed liabilities is maintained to reduce the risk to solvency from changes to interest rates.

By limiting exposure to asset classes such as property and equity, with-profits policyholders are protected from the worst effects of falling stock markets. This approach also limits the returns that will be achieved in rising stock markets.

This approach to investment management reduces the solvency capital required, enabling earlier capital distribution.

g) Exposure of with-profits policyholders to business risk

With-profits policyholders share in all the profits and losses of the Society. These are passed on through the Policy Value system. The Board aims to manage risk where possible to minimise any negative impacts on policy payouts and so that the Society can continue to be able to meet its contractual obligations to policyholders and other creditors as they fall due.

The Society's strategy in respect of business risks, some of which are outside the control of the Society, is to seek opportunities to reduce and/or limit the risks, whilst being fair to all policyholders.

There are limited circumstances in which the Society would accept new business risks, being either where it is satisfied that the rewards are sufficient and the risks are not high, or where the taking of a new (lower) risk would mitigate an existing business risk.

5. Bonus Policy

5.1 Principles

In determining bonus policy, the Society aims to balance the objectives of continuing to meet its obligations to policyholders and other creditors as they fall due and of distributing the Society's assets over the lifetime of its policies as fairly and as soon as possible. Consideration is given to the overall financial position of the Society which is affected by many things including, inter alia, investment returns and outlook, actual and expected expense levels, the expected cost of guarantees, miscellaneous profits and losses (including those from the non-profit business) and changes in the level of provisions. The rate at which surplus is distributed may vary depending on the Society's requirement for solvency capital, and the general level of uncertainty (for example, in the various provisions).

For the foreseeable future, any new distributions of surplus will be made in non-guaranteed form, and there is no expectation of any further reversionary bonus being awarded in the near to medium term. This applies across all product types and all territories. This approach aims to maximise the likelihood of the Society being able to meet all its future contractual liabilities.

The Society aims to set bonuses and payout levels which are fair across different groups and generations of policyholders. Profits and losses are typically shared across the whole of the with-profits business, not just among the policies concerned. For example, the cost of administration is shared across the whole of the with-profits business. Changes to Policy Values plus any Capital Distribution Amount and their equivalents, are often the same for all policies within a particular class, but it is possible that they will vary between different groups and generations of policyholders.

5.2 Practices

5.2.1 Setting the level of payouts

The sum of the Policy Value plus any Capital Distribution Amount and their equivalents will determine payouts.

5.2.1.1 Setting the level of Policy Values

The levels of Policy Values are kept under regular review, and the Board may change them at any time if circumstances require it, though efforts are made to avoid frequent changes. There is a formal annual review process, and the levels of Policy Values are re-set after that review. The results are published on the Society's website, and included in the Report and Accounts. This review will often result in all Policy Values within a particular class being increased (or decreased) by a rate or rates determined by the Board. Different rates can apply to different policy classes where it is judged fair to do so (for example, applying a net of tax rate for life policies). The Board may at its discretion choose to vary the rates awarded according to other factors (such as age or term or level of guarantee) if this is judged to result in a fairer allocation.

An increase to Policy Values does not constitute an increase in guaranteed benefits and Policy Values can be reduced at any subsequent time.

The aim is to increase Policy Values based on the Society's view on the expected sustainable long-term return, net of deductions for expenses, tax and the expected cost of guarantees. The smoothed increases to Policy Values that result will require support from, or add to, capital at different points in the smoothing cycle. The expected long-term return is based on holding assets to maturity, since assets and guaranteed liabilities are well matched. Increases to Policy Values are therefore independent of short-term capital gains or losses arising from changes in market yields.

If there are material investment losses, or if the Society's desired level of solvency capital increases, there is a possibility that Policy Values may be reduced.

The change in the level of individual Policy Values from year to year may also be influenced, among other things, by the following factors:

- The Society's requirement to maintain an appropriate level of solvency capital;
- Miscellaneous sources of profits and losses, including those from the non-profit business; and
- Changes in the level of provisions.

Consideration of these items may involve many variables; for example, prevailing economic conditions, regulation and the uncertainty surrounding the level of the provisions the Society has made. Any adjustment made for these items will be at the discretion of the Board, who may consider it more appropriate for such factors to influence the distribution of capital rather than the levels of Policy Values.

The levels of solvency capital required and available for the Society are strongly influenced by financial conditions and, over the longer term, by the level of claim payments, including capital distribution, as the fund runs-off. It would generally be expected that Policy Values and the Capital Distribution Amount would be kept at such a level that paying claims would not lead to the ratio of available capital to the solvency capital requirement from falling to an unacceptable level. This ratio is based on both the Society's own assessment, and the assessment of the regulator allowing for the statutory solvency regime in force at that time. To maintain a reasonable margin over the assessed level, the Society expects the ratio of the available capital to the required capital on both measures to exceed 120%. To enable timely action if this limit is in danger of being breached, if either ratio fell below 150%, consideration would be given to reducing Policy Values and the Capital Distribution Amount to restore the solvency position. Should either ratio fall below 120%, such action would be almost certain. These parameters may be amended by the Society if that is considered appropriate.

5.2.1.2 Setting the level of Capital Distribution Amount

The level of the Capital Distribution Amount and the way it is applied is at the discretion of the Society and the Board keeps both under regular review so as to be as fair as possible to those policies leaving the with-profits fund and those remaining in it. On completion of the annual valuation each year, the percentage rate that determines the level of Capital Distribution Amount is re-set. The results are published via the Society's website and included in the Report and Accounts. The capital distribution included in a policy's claim value is shown in annual benefit statements, and included in any claim value illustration.

The Capital Distribution Amount can be removed, reduced or increased at any time, with immediate effect and without prior notice to policyholders.

The change in the level of Capital Distribution Amount from year to year will depend, among other things, on the following factors:

- The amount of solvency capital available to be distributed;
- The likelihood that future payouts will need to be reduced;
- Any changes in the level of current or anticipated regulatory capital requirements;
- The level of uncertainty about and expected volatility of future investment conditions and other factors that contribute to profits and losses on the with-profits fund;
- The Board's requirement to maintain an appropriate, but not excessive level of solvency capital for remaining policyholders; and
- The degree of smoothing the Board feels is appropriate.

The method of capital distribution is at the discretion of the Society and the way the Board determines the Capital Distribution Amount may be changed at any time.

5.2.2 Expenses and taxation

All of the expenses and taxation of the with-profits business falls to the with-profits policyholders, and directly reduces the amount available for distribution to with-profits policies. In addition, any profits and losses arising from expenses or tax on the rest of the business, that is not reassured, also flow through to with-profits policyholders.

Expenses and tax will typically be applied to with-profits policies by an appropriate deduction from investment returns otherwise available to increase Policy Values and their equivalents. This allows all with-profits policies to share in the expense performance, profits and losses, roughly in proportion to their share of the with-profits fund. The expense deduction has been 1% per annum for many years, and this level is reviewed regularly to ensure it remains appropriate. This level charge has funded an expense reserve. The intention is that this reserve plus future 1% per annum deductions will be sufficient to meet future expenses, even as these become a higher percentage of the fund over time. This approach allows the costs of administration to be spread across different generations of policyholders fairly.

5.2.3 Charge for capital and cost of guarantees

When setting Policy Values, the Society currently makes a charge of 0.5% per annum to provide solvency capital and to meet the expected cost of guarantees (i.e. the additional cost where a policy's guaranteed benefits exceed its Policy Value, now or in the future). This means that a charge will typically be retained each year before making future increases to Policy Values and their equivalents.

For the short-term at least, changes to Policy Values and their equivalents are expected to be net of a charge for solvency capital and cost of guarantees of 0.5% each year. This charge can be expected to increase if

the cost of guarantees increases significantly (for example as a result of adverse investment conditions), or solvency capital requirements increase. The level of the charge for capital and cost of guarantees will be kept under regular review by the Board before deciding any changes to Policy Values and their equivalents. If the expected charge exceeds 1.5% per annum, the change would be communicated to policyholders.

5.2.4 The Society's requirement for solvency capital

In common with all other UK insurers, Equitable Life requires a certain amount of solvency capital to operate its business, to provide for risks and for the purpose of smoothing. This solvency capital is to meet statutory and risk based capital requirements. Risk based capital requirement measures are most important when determining payouts.

The Society has no wish to build up and retain excessive amounts of solvency capital. The intention is to distribute capital among with-profits policyholders as fairly and as soon as possible. If the projected levels of solvency coverage indicate that excessive amounts of capital are being accumulated, the Society is likely to distribute some of the surplus capital by increasing Capital Distribution Amounts. If the solvency coverage ratio, based on either the Society's own assessment or that of the regulator, falls below 120%, Policy Values and Capital Distribution Amounts are very likely to be reduced so that future claims help solvency ratios to recover rather than further reducing them.

5.2.5 Interim bonus on policy termination

Though Policy Values can be changed at any time, the regular review cycle operates annually. The Board may at its discretion set an interim bonus rate each year, with the aim that the Policy Value plus any Capital Distribution Amount on any exiting RSP policy would be increased at that rate for any part year since the last annual review of Policy Values. Interim bonus rates are set by the Board, and are usually announced as part of the Report and Accounts, or in the annual statements sent to policyholders. When setting any interim rate the Board will consider, inter alia, the desired level of solvency capital, and the outlook for future returns on the with-profits fund. The interim bonus rate does not increase the guaranteed benefits under a policy.

As for the other types of bonus, interim bonus rates may vary by policy class, and different rates can apply for different parts of the year. Subsequent changes to Policy Values plus any Capital Distribution Amount and their equivalents will not necessarily be at the rate implied by the interim bonus rate in force at the time.

5.2.6 Other with-profits business

Other with-profits policies do not have Policy Values, but the same principles and consistent practices are used to determine bonuses and payouts.

To determine payouts on maturity or death for other with-profits business, tables of final bonus rates are calculated by using representative policies with the aim of achieving a result comparable to similar RSP policies. Payouts are calculated by applying the relevant final bonus rate to the guaranteed benefits (including any reversionary bonus).

6. Smoothing

6.1 Principles

The Society has a preference that changes in levels of bonuses and payouts should be gradual whenever circumstances permit, and reflect the underlying trend of investment returns. However, in adverse scenarios, especially when investment returns are poor, there is limited scope for smoothing. In particular, smoothing considerations will be over-ridden by the Society's need to be able to meet its contractual obligations to policyholders and other creditors as they fall due and any solvency capital requirements that the Society may have.

The Society considers smoothing in the context of its reviews of Policy Values plus any Capital Distribution Amount, rather than comparing the payout value of one policy with an equivalent one taken out a year earlier. This principle has been established over many years. It helps to avoid the amount paid under a policy being unduly distorted by reference to the experience of the fund in the year before the policy commenced.

6.2 Practices

It is in the nature of with-profits policies that payouts are smoothed, and that there will be some cross-subsidies between policies, and between different generations of policyholders who invest in the fund and make claims from it at different points in the smoothing cycle. The Board attempts to avoid sharp reductions

or frequent changes to the level of payouts but the capacity of the Society to smooth out experience is affected by the level of solvency capital it has. Therefore, in adverse scenarios, especially when investment returns are poor, payouts and Policy Values and their equivalents may be changed quickly to protect solvency.

When determining Policy Values and any Capital Distribution Amount, the Board considers all aspects of the Society's financial position. Particularly important considerations are the longer-term expectation of returns, bearing in mind that the Society's assets and liabilities are matched, and also the expectations for the distribution of capital. When considering the level of Policy Values, the Board focuses on the expected sustainable long-term return on the with-profits fund rather than the actual investment return achieved. This reflects the close matching of the assets with guaranteed liabilities and passes on a smoothed return to policyholders.

If the level of Policy Values and Capital Distribution Amounts means that the ratio described in 5.2.1.1 moves below its target range, they are very likely to be reduced.

If successfully implemented, the change in strategy of the Society, summarised in section 2 above, will cause an increase in payouts although these will not be smooth as described above. This is a direct consequence of the proposed changes to policy terms and the Board consider the change in strategy overall to be consistent with the Society's Principles.

7. Payouts on early surrender

7.1 Principles

Where a policyholder surrenders his policy (or switches to a unit-linked fund) before maturity, contractual obligations in respect of payouts under the policy generally do not apply. The intention is that the amount paid to surrendering policies should be fair, but that it should not disadvantage continuing policyholders. In particular, the amounts paid to surrendering policyholders should not reduce the payout prospects of the continuing policyholders.

7.2 Practices

Payouts on policies which have been surrendered early (or where benefits are being switched from with-profits to unit-linked funds) are determined by reference to Policy Values plus any Capital Distribution Amount and their equivalents. The guaranteed benefit, explained in section 3.2(a), is only available on specified events such as retirement and death and does not apply on early surrender. The Policy Value plus any Capital Distribution Amount may be less than the guaranteed benefit. Where appropriate to avoid prejudice to remaining policyholders, the Society may apply a Financial Adjustment to reduce the amount payable on surrender of the with-profits benefits. For example, if the Financial Adjustment on UK individual pension policies was 5%, payouts on surrender would be 95% of the sum of the Policy Value plus any Capital Distribution Amount.

A Financial Adjustment does not apply to withdrawals of income from managed pension policies or to some regular withdrawals up to a certain amount on some life policies.

Different Financial Adjustments may apply for different classes of policy, for example as between life and pensions business, or between Individual and Group pension policies, or between policies denominated in different currencies. The rate could also vary within a class, if this was thought by the Board to improve fairness or provide a more effective means of protecting solvency as measured by risk based capital requirements. For RSP policies, a Financial Adjustment has historically been applied as a percentage reduction, but alternative methods could be used. For example, if it was required in order to protect solvency, the Financial Adjustment could be calculated to produce surrender payouts equal to the discounted value of the guaranteed benefits.

The level of the Financial Adjustment depends on the overall financial position of the Society, and it can therefore be affected by many factors. The following considerations apply when determining the Financial Adjustment:

- The Financial Adjustment should be set at a level which enables the Society to maintain an adequate level of solvency, allowing for any additional capital that the regulator requires the Society to hold, as described in section 4 (b) above.
- Policyholders surrendering their policies early should also contribute toward the cost of guarantees for those policies remaining in force. It may also be appropriate to allow for the additional risk that in adverse circumstances in the future the cost of guarantees may increase significantly for policies with a GIR of 3.5% per annum.

- Those surrendering their with-profits benefits early or switching from with-profits to unit-linked funds should contribute their full share of the cost of provisions (including an allowance for the uncertainty associated with these).
- Large volumes of surrenders can cause forced sale of illiquid assets at impaired values. Any such losses will be recouped through the Financial Adjustment.
- Where the Society is forced to sell fixed-interest securities before their relevant maturity dates, in order to make payments to surrendering policyholders, the matching by term of assets and liabilities is broken. If this is to the disadvantage of continuing policyholders, the Society will recoup any value lost through a higher Financial Adjustment
- If solvency is threatened, for example by large volumes of early surrenders and switches from with-profits to unit-linked funds, the terms for exit will be set so that the solvency position is improved (or at least unaffected).
- Surrenders can cause diseconomies of scale in the operating costs of the Society, so a contribution to future anticipated expenses may also be allowed for in surrender values.

Similar considerations apply when setting surrender values for other with-profits policies.

8. Investment Policy

8.1 Principles

The Society operates a conservative investment policy investing mainly in fixed interest securities (such as gilts and corporate bonds).

Close matching of assets with guaranteed liabilities is maintained to reduce the risk to solvency from changes to interest rates.

By limiting exposure to asset classes such as property and equity, with-profits policyholders are protected from the worst effects of falling stock markets. This approach also limits the returns that will be achieved in rising stock markets.

This approach to investment management reduces the solvency capital required, enabling earlier capital distribution, all other things being equal.

8.2 Practices

8.2.1 Asset allocation and choice of asset holdings

The Society operates one with-profits fund. Apart from different arrangements for policies denominated in different currencies, the same asset allocation applies to all with-profits policyholders, including those with different underlying policy guarantees. Life assurance policies are subject to different tax rules from those applying to pension policies, and hence different bonus levels, but they share in the same underlying mix of assets.

The Society reserves the right to adopt different investment mixes for different groups of policyholder, or for the solvency capital of the Society, where this would be fair to the different groups and where it would be beneficial to the operation of the long-term fund as a whole. Such a change would require the approval of the Board.

The vast majority of the Society's assets are denominated in sterling. It is expected that the exposure to asset classes backing the sterling with-profits business will remain in the range shown in the table below, with current low levels of equity and property investment persisting.

Asset class	Range as a Percentage of fund
Gilts and Corporate Bonds	65-100%
Cash	0-35%
Property related investments	0-5%
Equity-type assets	0-5%

Implementation of the Society's revised strategy may lead to changes to the asset mix of the with-profits fund. For example, fixed-interest assets may be reduced and invested into cash in advance of the transfer to Utmost Life and Pensions Limited.

8.2.2 Investment Strategy and Governance

Investment strategy is determined by the Board. The Asset and Liability Committee, a committee of executive management, has delegated authority from the Board to oversee the implementation of that strategy. The Board judges the merits of current and alternative investment policies, and new types of asset or liability instrument. The Board receives advice from the Asset and Liability Committee and decides if new instructions should be passed back to that Committee. In deciding if investment policy should be amended, or new types of instrument used, the Board considers whether such a change would strengthen the with-profits policyholders' position, by improving their potential payouts or reducing risks, without having a detrimental impact on the Society's ability to meet its regulatory obligations or its contractual obligations to other policyholders and creditors.

The Asset and Liability Committee defines the investment objectives for the investment managers and the parameters within which the investment managers may manage the assets of the with-profits fund. Those instructions include:

- Details of acceptable ranges (in percentage terms) for each main asset category.
- Details of cashflow matching requirements.
- Details of acceptable credit or liquidity quality.
- Limitations on investments in relation to counterparty exposure and credit exposure.
- Limitations on exposure in respect of derivatives and other instruments that may alter the economic out-turn from assets.

The Asset and Liability Committee meets regularly to review investment performance and controls and the Executive Committee regularly reviews investment risks. Solvency and the desire to have a close match of asset and liability proceeds are key drivers of investment strategy, so it is kept under regular review, and reported formally to the Board at least every six months. A more thorough and formal review of the Society's financial position, the risks it faces, including investment risk and the solvency capital required, is carried out at least once a year, and reported to the Board. Any changes to the investment strategy resulting from these reviews would be implemented by the Asset and Liability Committee on behalf of the Board.

8.2.3 Investment managers

The Society employs the services of specialist investment management companies to carry out its asset management. The Society's Asset and Liability Committee oversees the activities of these providers on behalf of the Society. The Society regularly reviews the provision of its investment services.

The investment managers are required to report regularly on investment performance, to have appropriate controls in place to ensure compliance with the various objectives set by the Society, and to report to the Asset and Liability Committee where there are any breaches of these requirements.

The investment managers are expected to demonstrate to the Asset and Liability Committee, as and when required, that processes are in place to ensure that the portfolios are being managed in an appropriate manner with respect to risk.

8.2.4 Asset types held in the with-profits fund

The following sections go into more detail about the different types of assets held in the with-profits fund.

a) Gilts and corporate bonds

Gilts provide the most certain future cashflows for the with-profits fund, and the guaranteed future income and maturity proceeds help the Society to match some of the guaranteed liabilities. Gilts are therefore a natural investment for the with-profits fund, and are expected to remain the core investment class.

Corporate bonds share many of the attributes of gilts, providing relatively predictable cashflows and relatively high income yields. The wide choice of corporate bonds, offering a wider spread of maturity dates than gilts, is helpful in improving the matching by term of assets and liabilities. Corporate bonds also offer the potential for modest out-performance compared with gilts, providing the with-profits fund with an opportunity to pass on slightly higher returns to policyholders. This upside potential comes with downside risk - the Society's investment policy is to limit this by regularly reviewing its bond holdings and ensuring that they are predominantly investment grade bonds.

b) Cash

The other main asset class is cash, including deposits and short-dated gilts. The Society generally uses cash to fund day-to-day expenses, to provide sufficient liquidity to meet expected claims volumes and to meet any obligations in respect of derivative holdings. Cash may also be held in periods where changes to

investment strategy are being considered, periods of greater volatility in the markets or as part of a strategy to reduce regulatory solvency requirements so that capital can be fairly distributed to exiting policyholders.

c) Property

The Society is unlikely to hold any significant property investment. Although property investment potentially offers relatively high levels of annual income on direct holdings, and the potential for returns in excess of gilts, the high capital requirements restrict the appetite to hold a large property portfolio.

d) Equity type assets

The Society is unlikely to hold any significant equity investment. Though the prospect of long-term out-performance from this asset class can be attractive, the associated investment risks and capital required are not consistent with the objective of returning capital to policyholders as fairly and as soon as possible.

e) Derivatives

The Society's policy is that it would not expect to invest in any such asset as a speculative investment. It would, however, consider using derivative-based assets where these offered a cost-effective means of managing a specific risk (for example to help manage interest rate risk, currency risk or improve cashflow matching), managing exposure to different asset classes or of smoothing out potential volatility in returns.

Since 2007, the Society has held interest rate swaptions as part of a strategy to manage the combined risks of a low interest rate economy and policyholders deferring their retirement.

In 2017, the Society purchased interest rate swaptions to mitigate the risk of the Society's assets falling in value as a result of interest rates rises. The swaptions protect the capital distribution amount available to with-profits policyholders on giving up their investment guarantees under the change in strategy.

The Society purchases currency futures to manage its exposure to currency risk.

8.2.5 Overseas assets

A small amount of business sold overseas is denominated in Euros or Dollars. This business is still part of the overall with-profits fund, and shares the same general risks. Investments have been made in assets that are denominated in the same currency, to limit currency risk. Overseas assets may also be purchased as part of a strategy to diversify the investment portfolio. Where those assets are not matching liabilities in the same currency, currency hedges may be used to mitigate currency risk.

8.2.6 Matching assets and liabilities by nature and term

An important aim in managing the investment portfolio is to achieve a close match in the term to expected maturity and nature of the assets and liabilities. Regular analyses are carried out to facilitate this. Matching by term and nature is important when interest rates (or yields) change. In that case, the market value of the assets changes, which can have implications for solvency.

Matching is achieved predominantly using gilts and bonds assuming that assets are held to maturity. If policy surrenders cause assets to be sold prior to maturity, the matching characteristics become unbalanced and the with-profits fund can be exposed to loss. Any loss in asset values will typically be charged to the surrendering policies through the Financial Adjustment, to protect remaining with-profits policyholders.

If the term of the liabilities changes for other reasons, for example through policyholders deferring their retirement, the Society would typically expect to change the term of some of the assets to stay in line. As far as possible this would be done by appropriate investment of cashflows such as continuing premiums, investment income and redemption proceeds, to minimise costs. If any costs (or surplus) arose from rebalancing the assets in this way, they would be shared across the whole fund.

Under the new strategy, it would be appropriate to reassess the matching assets that should be held in the with-profits fund.

The costs of running the business are expected to increase over time in line with inflation. Reserves for expenses are therefore backed by assets that are predominantly index linked, to match the nature and term of the liabilities.

8.2.7 Other investment matters

The Society holds various provisions in respect of potential payments to other creditors. The assets backing those provisions are held as part of the with-profits fund, the backing assets being largely cash and fixed interest securities.

The with-profits fund does not contain any investments that are non-tradable because of their importance to the Society. In particular, the head office premises are rented and are not held as an investment.

8.2.8 Unit-linked business

Unit-linked assets are held to match the policy liabilities for this business.

The with-profits policyholders provide the capital supporting the unit-linked business, and share in the profits and losses arising from it.

9. Business Risks

9.1 Principles

With-profits policyholders share in all the profits and losses of the Society. These are passed on through changes to policyholder payouts. The Board aims to manage risk where possible to minimise any negative impacts on policy payouts and so that the Society can continue to be able to meet its contractual obligations to policyholders and other creditors as they fall due.

The Society's strategy in respect of business risks, some of which are outside the control of the Society, is to seek opportunities to reduce and/or limit the risks, whilst being fair to all policyholders.

There are limited circumstances in which the Society would accept new business risks, being either where it is satisfied that the rewards are sufficient and the risks are not high, or where the taking of a new (lower) risk would mitigate an existing business risk.

9.2 Practices

9.2.1 Corporate Governance

The Society aims to meet the highest standards in corporate governance and voluntarily adopts the relevant provisions of the UK Corporate Governance Code.

The Board is ultimately responsible for the management of the Society and the operation of its business. A number of responsibilities are delegated by the Board, for example to the Chief Executive to implement strategy and manage the Society and to the Asset and Liability Committee to determine investment policy and monitor investment performance. The Directors are ultimately responsible for the Society's system of internal control and for reviewing its effectiveness. The Society operates a number of control procedures to safeguard its business and investments.

Appropriate to the size, complexity and nature of the with-profits fund, the Society's mutual status and the diverse and relevant skills of the Society's Board, the Board carries out the duties of the Society's With-Profits Committee. Acting in its capacity as the With-Profits Committee, the Board considers matters affecting with-profits policyholders (particularly risk and capital management, payouts, investment strategy and communication) and ensures decisions affecting with-profits policies are consistent with the PPFM.

A With-Profits Sub-Committee was established in 2017 which comprised two non-Executive Directors and an external member who is an actuary. The remit of this committee is to assess, report and advise the With-Profits Committee, as requested, on the fairness considerations affecting with-profits policyholders in regard to the new strategy.

Payouts on policies, bonus policy, capital distribution and smoothing are determined by the Board. The With-Profits Actuary provides advice to the Board on these and other matters affecting the Society's life insurance business.

In assessing a business risk the Board of the Society evaluates the potential impact and likelihood of any outcome for the risk. The factors considered when evaluating the risk impact include (but are not restricted to) financial and solvency, regulatory, reputational, client service issues and other operational risks.

9.2.2 Business risks environment

There are a large number of parties who have the ability to affect the environment in which the Society operates. These include policyholders, parliament, regulators, outsourcing and other suppliers, action groups, litigants and the media.

Life insurance business is subject to a number of inherent risks that arise from a range of factors which include interest rate changes, fluctuations in asset values and demographic changes.

The Society is exposed to particular risks resulting from its past business operations, particularly those resulting from the relatively high proportion of guaranteed liabilities and risks relating to control of expenses of administration.

Any financial gains or losses arising from business risks are attributable to the Society's with-profits policyholders.

The Society operates a risk management framework that is designed to identify, monitor and manage the risks the Society faces.

The Society operates a third party management framework to ensure that all arrangements for outsourced services meet the needs of the Society. Arrangements for outsourced services are actively managed and all contracts are reviewed at least annually. All contracts for outsourced services specify provisions for their termination.

9.2.3 Other Business Risks

Other business risks which may affect the environment in which the Society operates are noted below. The list is not exhaustive, but aims to highlight the more important issues.

a) Cost of guarantees

For some of the Society's policies, the guaranteed benefits will be higher than the Policy Value plus any Capital Distribution Amount at maturity. If this is the case, the higher guaranteed amount is payable. This extra amount is known as the cost of guarantees. When considering the level of payouts, the Board will take account of the cost of guarantees. This cost is a complicated function of many different factors - most notably interest rates, persistency and the ages at which policyholders decide to retire. These factors are not within the Society's control, so there are adverse scenarios where the cost of guarantees can increase. Any such increase will need to be met from solvency capital, and/or charges against the level of future payouts. This could mean having to vary the charge for capital and guarantees (as noted in section 5.2.3).

Successful implementation of the revised strategy will directly address this risk by removing the investment guarantees.

b) Administration services and expenses

The with-profits policyholders bear all the Society's profits and losses arising from expenses, with expenses (and taxation) deducted directly from the with-profits fund. Changes to the level of Policy Values are made after allowing 1% per annum to cover these costs, as explained in section 5.2.2. The control of operating costs, including outsourced operations, is a key business risk.

As there is only one with-profits fund, there is no apportionment of expenses and expense risk is pooled across all with-profits policies.

The Society has provided for expected levels of regular and exceptional non-recurring costs.

c) Reassurance

The Society's principal reinsurance agreement relates to its non-profit business, under which Scottish Widows Limited is the reinsurer. The profits and losses associated with this business are also reinsured.

Under the terms of the reinsurance contract, if the Society is insolvent, or is reasonably likely to become insolvent in the opinion of the reinsurer's Head of Actuarial Function, then the reinsurer can make claims payments directly to policyholders whose benefits have been reinsured. If Scottish Widows Limited were to become insolvent then the with-profits policyholders would bear any loss arising from the event.

Some group schemes have members with benefits that are invested in the Clerical Medical With-Profits Fund via another reinsurance agreement. The Principles and Practices of Financial Management for that fund issued by Scottish Widows Limited apply to these benefits and any additional premiums paid into that fund.

Other reinsurance arrangements are in place to protect against mortality and morbidity risks. These mitigate the risk of unfavourable experience harming the interests of with-profits policyholders. Regular premiums are paid for this protection, so in the event of one of these reinsurers defaulting, losses to the Society would be limited.

d) New business

The Society is closed to new business. Additional premiums are only accepted under existing policies where this is permitted under the contractual policy terms. The amount of these additional premiums is very small relative to the size of the fund.

On maturity of a pension savings contract, some policyholders may wish to purchase a new policy, such as an annuity, to provide a retirement income. Policyholders should purchase such policies with another provider, and the Society advises them to shop-around for the best price on the open market. Since April 2012, the Society has provided policyholders with retirement illustrations from Canada Life to indicate the prevailing cost of competitively priced annuities.

e) Run-off of the fund

Without a change in strategy being successfully implemented, the with-profits fund is expected to decline in size as policy payouts are made. In setting Policy Values plus any Capital Distribution Amounts and their equivalents the aim is to achieve a controlled and fair run-off of the fund, minimising a “tontine effect”, where the policies that leave in the later stages of the fund’s life do disproportionately well or badly.

In calculating Policy Values plus any Capital Distribution Amounts and their equivalents, the Society has already made allowance, as best it can, for the risks detailed above, so that they are shared by all current with-profits policies, not just those with the longest term to run. To the extent that the allowances are not matched by experience, the resulting profits and losses will fall to the with-profits policies in force at the time. These variances will be charged or credited as they are identified, without waiting for them to actually accrue - for example, if expected levels of future expenses change, the effect of the change will be provided for immediately. This approach helps avoid all of the profits or losses being loaded on to the last remaining policies.

The Society’s new strategy addresses both the risk of a reduction in Capital Distribution Amount, and the risk of an excessive accumulation of capital. While implementation of the new strategy is not without risk and is therefore not certain, the benefits to policyholders are potentially significant. The Board consider the new strategy to be a fair way to distribute all of its assets to its with-profits policyholders.

Appendix

Overall Rates of Return - UK RSP policies (%p.a.)

Calendar Year	Pensions ⁽¹⁾	Life (Bonds)	Life (Other contracts)
1994	10.00%	8.00%	8.00%
1995	10.00%	8.00%	8.00%
1996	10.00%	8.25%	8.00%
1997	13.00%	11.00%	10.75%
1998	10.00%	8.50%	8.50%
1999	12.00%	10.25%	10.25%
2000 ⁽²⁾	0.00% / 8.00%	0.00% / 6.75%	0.00% / 6.75%
2001 ⁽³⁾	0.00% / 4.00%	0.00% / 3.25%	0.00% / 3.25%
2002 ⁽⁴⁾	0.00%	0.00%	0.00%
2003	2.00%	1.50%	1.50%
2004	3.50%	2.80%	2.80%
2005	4.50%	3.60%	3.60%
2006	5.00%	4.00%	4.00%
2007	5.00%	4.00%	4.00%
2008 ⁽⁵⁾	0.00%	0.00%	0.00%
2009	5.50%	4.40%	4.40%
2010	0.00%	0.00%	0.00%
2011	2.00%	1.60%	1.60%
2012	2.00%	1.60%	1.60%
2013	2.00%	1.60%	1.60%
2014	2.00%	1.60%	1.60%
2015	2.00%	1.60%	1.60%
2016	2.00%	1.60%	1.60%
2017	2.00%	1.60%	1.60%
2018	2.00%	1.60%	1.60%

Notes:

- For the period up to 1 April 2016, the bonus rates for Equitable 2000 Personal Pension Plans were 0.4% p.a. lower than the rates shown for Pensions contracts. There were exceptions in 2002, 2008 and 2010, and for parts of 2000 and 2001 (see notes 2 to 5), when the rate was 0.0%.
- The overall rate for the first seven months of 2000 was 0% p.a. The rate for the remaining five months was 6.75% p.a. for Life contracts, 8% p.a. for Pension contracts and 7.6% p.a. for Equitable 2000 Personal Pension Plans.
- Policy Values as at 31 December 2000 were reduced by 14% and 16% for UK RSP Life business and RSP Pension business respectively, and those resultant Policy Values as at 31 December 2000 were used as the basis for calculating Policy Values on 16 July 2001 and on subsequent valuation dates. The overall rate for the first six months of 2001 was 0% p.a. The rate for the remaining six months was 3.25% p.a. for Life contracts, 4% p.a. for Pension contracts, and 3.6% p.a. for Equitable 2000 Personal Pension Plans.
- Policy Values as at 31 December 2001 were reduced by 9% and 10% for UK RSP Life business and RSP Pension business respectively, and those resultant Policy Values as at 31 December 2001 were used as the basis for calculating Policy Values on 1 July 2002 and on subsequent valuation dates.
- Policy Values as at 31 December 2007 were reduced by 2.4% and 3.0% for UK RSP Life business and RSP Pension business respectively, and those resultant Policy Values as at 31 December 2007 were used as the basis for calculating Policy Values on 31 December 2008 and subsequently.

Capital Distribution Amount

Since 1 April 2011, the Capital Distribution Amount has been calculated as a percentage of policy values on a specific date.

<i>From</i>	<i>Percentage</i>	<i>Date of Policy Value to calculate Capital Distribution Amount</i>
1 April 2011	12.5%	31 December 2010
1 April 2014	25%	31 December 2013
1 April 2015	35%	31 December 2014