Principles and Practices of Financial Management

mgmadvantage

1. Introduction

1.1 Overview
The basis for this document was specified by the Financial Services Authority (FSA) in Policy Statement 167 and in rules and guidance set out in the relevant sections of the Conduct of Business Sourcebook. The document aims to explain how the Society manages the financial aspects of its With Profits business.

The Society's With Profits business is written in the Society's long-term business fund which is referred to as the 'Fund' in this document.

The remainder of Section 1 explains the governance arrangements for the Principles and Practices of Financial Management (PPFM).

Section 2 describes the products covered by the PPFM.

Section 3 sets out the overarching principles used by the Society to manage its With Profits business.

Sections 4 to 13 provide a description of the detailed Principles and Practices, as required by the FSA's Conduct of Business rules.

This document was first published on 30 April 2004.

1.2 Principles of Financial Management - Overview
The With Profits Principles are enduring statements of the standards the Society adopts in managing the Fund.

They describe the business model used by the Society in meeting its duties to With Profits policyholders and in responding to longer term changes in the business and economic environment.

1.3 Practices of Financial Management - Overview
The With Profits Practices describe the Society's current approach to managing the Fund and to responding to changes in the business and economic environment in the shorter term. The Practices will normally be reviewed annually, but could be reviewed at any time in exceptional circumstances. A review may not result in any changes to the Practices.

These Practices are intended to contain sufficient detail to enable a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a With Profits policy with the Society.

1.4 Arrangements for changes
For any change to the Principles, the Society will send its With Profits policyholders written notice, setting out any proposed changes to the With Profits Principles of the Society, at least three months in advance of the effective date of the proposed changes.

The Society's Practices are expected to change as the Society's circumstances and the business environment change.

The Society will send its With Profits policyholders written notice setting out any changes to the With Profits Practices of the Society. This notice may be in arrears, but will be within a reasonable time period of the effective date of the change. The Society will make every effort to ensure that the costs of notification are kept to a minimum.

1.5 Corporate structures and governance
The Society is a mutual organisation, and therefore has no shareholders.

The Society has been party to one business transfer scheme that moved the business written through its' subsidiary, MGM International Assurance, directly into the Society. This PPFM reflects the requirements of that business transfer.

In the past the Society has had several wholly owned subsidiaries whose profits or losses accrue entirely to the Society. From time to time, subsidiaries may be opened, closed or sold.

Oversight of the Society's With Profits business ultimately rests with the Board. The Board has established a With Profits Committee to oversee more detailed aspects of the Society's With Profits business and to make recommendations to the Board concerning the management of the Fund.

Each year a report will be prepared by the Society stating whether it believes it has complied with the PPFM, together with reasons for that belief. The Society has appointed a With Profits Actuary, as required by the FSA, whose main duty is to provide advice to the Society on the exercise of discretion. The With Profits Actuary also provides a report to accompany the Society's report, commenting on the Society's compliance with the PPFM. The With Profits Actuary is not, and will not be, a member of the Society's Board.

2. Fund and product structures

The Society currently writes With Profits and non-profits business. Non-profits business comprises unit linked business, where the policyholders' benefits are linked to the value of units in internal segregated funds, and non unit linked business such as term assurance, income protection and annuities.

All of the Society's business is held within the Fund. The assets of the Fund are notionally allocated between different classes of business into internally segregated funds. These notional funds reflect the appropriateness of different asset mixes for different classes of business. A description of the different types of With Profits business is set out below.

Conventional With Profits (CWP) - Life
An initial guaranteed sum assured is granted; this is the minimum amount that will be paid on maturity or earlier death.

Annual bonuses are added to the policy each year following the Board's bonus declaration. Annual bonuses are only paid on maturity or death. They are guaranteed once declared. A non guaranteed interim bonus is also added, reflecting the time elapsed since the effective date of the last declaration.

A simple annual bonus system is used, i.e. each year's bonus is expressed as a percentage of the sum assured.

At maturity or on death, a final bonus may be paid in addition. The final bonus varies with date of commencement and is expressed as a percentage of the sum assured plus a percentage of annual bonuses already declared.

On surrender there are, for most policy types, no guarantees which apply to the amount paid or the methods used to determine the surrender value.

The exception is for "Selecta" and "SelectaPlan" policies, where a table of reduced guaranteed sum assured amounts applies depending on number of years in force. The amount payable is that applicable to policies with this reduced guaranteed sum assured maturing at the date of surrender.

Conventional With Profits (CWP) - Pensions
An initial guaranteed annual annuity is granted; this is the minimum amount that will be paid on maturity. There are guaranteed cash option rates at which annuities may be converted into cash at any age between 60 and 75.

Annual bonuses are added to the initial guaranteed annuity each year following the Board's bonus declaration. Annual bonuses are only paid on maturity. They are guaranteed once declared. A non guaranteed interim bonus is also added reflecting the time elapsed since the effective date of the last declaration. A compound annual bonus system is used, ie each year's bonus is expressed as a percentage of the annuity plus attaching annual bonuses.

At maturity a final bonus may be paid in addition. The final bonus varies with date of commencement and is expressed as a percentage of the annuity plus annual bonuses already declared.

On transfer or early retirement for some policies, in some circumstances, guarantees apply as follows:

- For scheme AVC contracts a guarantee has been given that provided premiums continue to be payable to the date of transfer or early retirement, the amount payable will be the same as would have applied had this date been chosen at outset as the maturity date.

- For some Self Employed Retirement Plans, guaranteed early retirement factors apply for transfer or retirement between the ages of 60 and 75.

Unitised With Profits (UWP) - Life and Pensions
The following description applies to business written up to the date of this PPFM.

Policies issued directly by the Society
For policies originally issued directly by the Society contracts may be either single or regular premium. Each premium buys units in the Bonus Growth Life or Pension Fund as appropriate.

The price of units in the Bonus Growth Fund increases daily in line with the declared annual bonus rate. Units are cancelled to cover some or all of the following charges: initial and/or administration charge, policy fee, cost of risk benefits.

Final bonuses may be added or Market Value Reductions (MVRs) deducted from partial or complete policy surrenders, except at the maturity date of regular premium contracts, and regular withdrawals from single premium contracts of not more than 7.5% pa of the premium, where there is a guarantee that no MVR will be applied.

The amount payable on death is as follows:

- For regular premium contracts, the higher of the guaranteed sum assured (if any) and the value of units including any final bonus.

- For most single premium life assurances, 101% of the value of units including any final bonus.

- For single premium pensions contracts, 100% of the value of units including any final bonus.

Policies issued by a subsidiary
For policies originally issued by the Society's subsidiary MGM International Assurance (hereinafter referred to as "former MGMI policies") all contracts are single premium contracts.

The price of units increases daily in line with the declared annual bonus rate (referred to as regular bonuses in policy documentation). Units are cancelled to cover the administration charges.

Final bonuses (referred to as terminal bonuses in policy documentation) may be added or Market Value Reductions (MVRs – referred to as Market Value Adjustments in policy documentation) deducted from partial or complete policy surrenders. For regular withdrawals from single premium contracts there is a guarantee that no MVA will be applied.

The amount payable on death is 101% of the value of units including any terminal bonus.

Flexible Income Annuity (FIA)
Contracts are single premium pensions business. Premiums are invested in units in internal segregated funds as selected by the policyholder. A regular annuity (pension) is paid to the policyholder funded by cancelling units.

The annuity amount payable is determined initially, and reviewed periodically thereafter, as the lifetime annuity supportable by the assets allocated to the policy. The level of the supportable lifetime annuity takes into account the benefits selected by the policyholder and is based on assumptions regarding future life expectancy and investment returns. The investment return assumption is chosen by the policyholder, within a range set by the Society.

The annuity amount is subject to a guaranteed minimum level and a charge will be taken to meet the cost of this guarantee. The level of the assets allocated to the policy will change over time, reflecting investment returns earned on those assets, and reduced by annuity amounts paid. A monthly policy fee will be deducted and other charges may be made against the funds. Annual bonuses are added to the policy each year following the Board's bonus declaration. Annual bonuses are applied as a percentage increase to increase the unit holdings allocated to the policy. Once added to a policy the bonus unit additions are guaranteed.

No final bonus is payable for a FIA policy.

The value of the assets allocated to the policy, including annual bonuses declared, will be available for transfer, subject to a deduction to reflect the health of the policyholder, and an exit charge in the first years of the policy in order to protect the interests of remaining FIA policyholders.

The policy is automatically converted to a fixed income annuity at age 90, or earlier if the policyholder so chooses. On conversion, the annuity amount is reassessed and the revised amount then applies for the lifetime of the policyholder. The assets allocated to the policy are released into the main Fund. Annual bonuses may be added to the annuity amount each year following the Board's bonus declaration, and are guaranteed once declared.

3. Overarching principles

The Society applies a number of overarching principles to the management of the With Profits business. They are set out below in the order in which they would normally apply.

The Society aims to:

- meet all contractual obligations to policyholders, in particular relating to the timely payment of guaranteed benefits,
- meet all relevant tests of solvency and capital adequacy as specified by the UK regulator,
- treat all policyholders fairly, taking into account the conflicting interests between them.

In the event of conflict arising as a result of the application of any one or more of the Principles set out in Section 4.1, these overarching principles will take precedence. Areas where a particular need to make reference to these overarching principles may be likely are highlighted in Section 4.1.

4. The amount payable under a With Profits policy

4.1 Principles

The aim of the methods used to determine the amount payable to With Profits policyholders is to provide a fair return that broadly reflects the experience of the Fund as it applies to each type of contract, subject in adverse circumstances to the application of the overarching principles.

The return on the Fund can be viewed as having four components

- Investment returns on the Fund assets
- Mortality profits/losses
- Other profits/losses arising from the experience of With Profits business
- Profits/losses from non profits business and other business risks taken on by the Fund

Investment returns earned on assets deemed to be backing CWP and UWP policies will be allocated to those policies. For FIA policies investment returns will reflect the returns on the segregated funds supporting each policy.

Mortality profit/losses on FIA policies will be pooled and shared out across those policies alone.

Other mortality profits and all other profits and losses will be shared out between all With Profits business or retained within the estate (see section 11) in ways that take account the source of those profits, the contribution of the With Profits business to the financial strength of the Fund and any other factors that the Board of Directors consider relevant to the fair treatment of all policies.

The methods used involve a degree of approximation, for example in determining historical assumptions for which there are no detailed records. Further approximations which may be made include averaging groups of policies by policy type, size of premium and year of issue.

Because of these approximations, historical assumptions or parameters may be changed in the light of further information, if the Board considers it fair and reasonable to do so. Any changes will be approved by the Board, having received advice from the With Profits Actuary and the With Profits Committee as appropriate.

The type of change that would be made is to more accurately determine the amount payable, or more efficiently determine the amount without significant loss of accuracy.

4.2 General Practices

The Society currently uses asset shares as the starting point for determining the amount payable under a With Profits policy. The historic assumptions used in the calculation of asset shares are based on the Society's experience in previous years in respect of investment returns and (for CWP) expenses, and on industry experience in respect of mortality.

Asset shares are calculated as premiums paid accumulated by investment returns less charges for expenses, risk benefits and tax.

The other profits and losses arising from the Society's insurance business will be reviewed at least annually by the With Profits committee and will either be:

- Added to asset shares for all With Profits business,
- Added to claim values for policies falling due in the following year, or
- retained in the Estate, or a combination of these.

In determining the application of these profits or losses, the committee will have regard to the source and sustainability of these profits, and the adequacy of the current level of the estate to support the Society's business plans and meet regulatory solvency requirements. Note that former MGMI policies will not usually share in such normal profits and losses but could share in any exceptional distributions.

Where profits or losses are added to claim values, this will be achieved by adjusting the asset shares on which bonus declarations are based, as described later in this section.

These values are then smoothed as described in Section 7.2 before the amount payable is determined, and is not lower than any guaranteed benefit.

Classes of CWP contract which benefit from the additional guarantees described in Section 2 have different premium rates to classes without such guarantees.

These differences (other than to the extent that they reflect different commission scales applying at point of sale) are deemed to represent charges for the guarantees.

The investment returns allocated to asset shares are equal to the returns on the assets backing different types of policy. Separate asset allocations apply to CWP and UWP business (and within UWP business to former MGMI policies separately from other UWP policies) on a notional basis, as described in Section 8.2.

Tax deducted from asset shares reflects best estimates at the time of calculation of that part of the Society's tax liability attributable to With Profits business. This includes allowance for the expected deferment of the tax due on unrealised capital gains and of tax recoveries on realised and unrealised capital losses.

For this purpose asset portfolios backing With Profits asset shares are considered on a stand-alone basis – that is, unrealised losses are carried forward and credit given only when offset against future gains in the same portfolio rather than immediately offset against gains already existing elsewhere in the Society's assets.

The Society has documented the historical assumptions used in asset share calculations and the basis on which the assumptions have been applied.

The methodology described above sets out the Society's current approach. Calculations may have been done differently or more approximately in the past. Changes in the methods to be used are approved by the Board, having received advice from the With Profits Actuary and the With Profits Committee as appropriate.

Conventional With Profits
For CWP maturities the rates of final bonus are determined by:

- asset share values determined as described above,
- the target payout percentage of asset share, and
- explicit smoothing adjustments, as described in Section 7.2.

Maturity payouts will reflect the level of guaranteed benefits and the final bonus declared at the date of maturity.

For this purpose, asset shares are calculated for specimen policies, chosen to reflect those maturing in the period to which the final bonuses are to apply. These asset shares are normally calculated as at a date midway through the period for which the final bonus rates are expected to apply, assuming future investment returns at the Society's middle growth rate for future benefit projections for the final period.

One specimen policy is chosen to represent each year of commencement, separately for Life and Pensions. Policies that have been made paid-up (where premiums have ceased prematurely and benefits reduced correspondingly) and other categories of altered policies are represented by premium-paying specimen policies, with due adjustment for level of benefit. This reflects the Society's established practice as regards annual and final bonus rates. Payouts on older policies (commencing before 1975) are not based on asset shares as this methodology is not appropriate to these policies.

For maturities the target payout percentage will be in the range between 80% and 120% of asset share, and the Society would expect at least 90% of actual payouts on maturities to be in this range.

The target payout percentage for each policy applies to the appropriate specimen asset share, adjusted for differences in the level of benefit.

For CWP life death claims and for CWP early terminations with guarantees, as described in Section 2, the same final bonus rates apply as for maturities.

For other CWP early terminations a formulaic basis applies, which is regularly reviewed to ensure that payouts fall within a target range of percentages of asset share.

For this purpose specimen asset shares are calculated on the same basis as for maturity values, but extending the range of specimen policies to include all future maturity years, and for pension business to include paid-up as well as premium-paying policies.

For surrenders the target payout percentage will be in the range between 80% and 120% of asset share, and the Society would expect the average across groups of similar policies of actual payouts on early termination to be in this range.

As with maturity payouts the target payout percentage for each policy applies to the appropriate specimen asset share, adjusted for differences in the level of benefit.

Unitised With Profits
For UWP surrenders and maturities, and for deaths where the guaranteed death sum assured does not apply, the rates of final bonus or MVR and hence total payout are determined by:

- asset share values determined as described above,
- the target payout percentage of asset share, and
- explicit smoothing adjustments, as described in Section 7.2.

For surrenders and maturities the target payout percentage will be in the range between 90% and 110% of asset share, and the Society would expect at least 90% of actual payouts to be in this range.

For this purpose, asset shares are calculated for all policies and the results grouped by month of commencement.

5. Setting annual bonus rates

5.1 Principles

In setting annual bonus rates for CWP and UWP business, the Society is mindful of the objective to maximise the overall return on a policy subject to an acceptable level of risk, which is best achieved by expressing a relatively modest proportion of the total policy proceeds in guaranteed form through annual bonuses. This allows greater investment freedom and the potential to provide higher returns to policyholders. The setting of annual bonus rates is always subject to the overarching principles in Section 3.

For FIA policies, the allocation of investment returns is carried out directly rather than by means of a bonus allocation. All other sources of surplus are allocated by way of annual bonuses (there being no final bonus), and the level of annual bonus rates is set accordingly.

The Society operates different bonus series for each of its Conventional With Profits (CWP) and Unitised With Profits (UWP) life and pensions business, and for Flexible Income Annuities (FIA). Policies based on the same underlying premium rates and which were effected at the same time will normally have the same bonus rate declared, unless this would lead to unfairness in the treatment of different groups of policyholders, in which case different bonus rates may be declared. If a new policy type was introduced with significant differences in investment backing, expenses or the cost of smoothing or guarantees which were not reflected in the explicit charges on the policy, then a new bonus series may be introduced.

5.2 General Practices

Annual bonuses are declared by the Board, having regard to the overarching principles in Section 3.

Annual bonuses are reviewed at least once a year as part of the year end investigations. However, relevant investigations may be carried out throughout the year.

In setting annual bonus rates in normal circumstances for CWP and UWP policies the aim is to reflect the after tax investment yield on the underlying assets. However, significant consideration is given to the scope left for adding final bonus on future claims by declaring a given rate. If this scope is deemed insufficient or excessive (having regard to foreseeable adverse investment scenarios), then this would affect the basis on which the annual bonus rate was declared.

Consideration is also given to the ability to sustain the annual bonus rate in the future under different investment scenarios.

There is no maximum amount by which annual bonus rates may change between successive declarations.

Conventional With Profits
It is not the Society's intention to change the rates of annual bonus frequently in order to reflect short-term movements in investment conditions.

Interim bonuses, which apply proportionately to claims falling due between one declaration date and the next, are added at the same rate as the latest declared annual bonuses. They may change during the year, particularly if investment conditions change significantly.

Annual bonuses are declared for the previous calendar year, currently on the following 1 April. All claims made before 1 April will include an interim bonus at the latest declared rate.

Unitised With Profits
Annual bonus rates are reviewed quarterly, currently on 1 February, 1 May, 1 August and 1 November.

One bonus rate is declared for all life contracts, one rate for all pension contracts and a further rate for all former MGMI policies.

Annual bonuses are declared in advance, so there are no interim bonuses.

Flexible Income Annuity
Annual bonuses are declared for the previous calendar year, currently on 1 April. No interim bonuses are paid.

6. Setting final bonus rates

6.1 Principles
Final bonus rates are determined for CWP and UWP business, with the aim of ensuring that payouts represent a fair return which broadly reflects the experience of the Fund over the duration of a contract. Payouts are subject to smoothing as described in Section 7.2.

Policies based on the same underlying premium rates and which were effected at the same time will have the same final bonus rate declared. The final bonus rates depend on the duration in force as a With Profits policy at the time of a claim. Where different underlying premium rates or product structures are used, the Society may choose to declare a different final bonus.

No guarantees are made about the rate of final bonus or that there will be a final bonus. Although the final bonus will not be negative, for UWP business the Society is able to impose an MVR, other than in the circumstances described in Section 2, in times of adverse market movements in assets, in order to maintain fairness between policyholders voluntarily exiting the Fund and those remaining in it. The Society reserves the right to change final bonuses at any time without advance notice.

Final bonuses are reviewed at least annually. However, particularly in times of significant market movements or if the statutory solvency of the Society is at risk, the level of current final bonuses and MVRs will be considered and revised bonus rate declarations may be made.

No final bonus applies for FIA policies.

6.2 General Practices
Final bonuses in any year are set to bring the total amounts paid out on maturity or (for UWP) early termination, when averaged over all policy types and in force terms, to within the target percentage of asset share as described in section 4. Over a period of years this target is intended to average 100%, but will vary between individual policies and over successive years due to the degree of smoothing as described in section 7.

Conventional With Profits
Final bonus rates are normally reviewed annually as part of the year end investigations. However, in times of significant market movements, when there is the likelihood that payouts will fall outside the target range referred to in section 4, they will be reviewed more frequently.

Declarations of new final bonus currently take effect from 1 April each year.

Final bonus is expressed as a percentage of the sum assured (or guaranteed annuity in the case of pensions business) plus annual bonuses already declared. The percentages vary by type of policy and by the commencement date of the policy.

Two tables apply; one to life and one to pensions. Rates currently vary by year of commencement (or conversion to With Profits if later).

For death claims, the same final bonus rates apply as for maturities. For early terminations, a final bonus rate is applied at the same rate as for deaths or maturities of the same period in force.

Unitised With Profits
Final bonus rates and MVRs are reviewed quarterly, currently on 1 February, 1 May, 1 August and 1 November. However, in times of significant market movements, when there is the likelihood that payouts will fall outside the target range referred to in section 4, they will be reviewed more frequently.

Final bonus is paid on policies which surrender or transfer out on the same basis as policies which remain in force to maturity.

Policies may either have a final bonus or MVR applied at any time. Final bonuses and MVRs vary by commencement date of the policy (or date of purchase of UWP units if later) and are expressed as a percentage of the value of units under the policy.

The same table of rates currently applies to life as to pensions policies although this is under review. A separate scale applies to former MGMI policies.

7. Smoothing

7.1 Principles
The smoothing policy will aim to operate to ensure that, for CWP and UWP business, payouts on similar policies do not vary beyond certain limits if those policies terminate within a certain time span of each other, whilst in the long run ensuring that the long-term cost of smoothing is neutral.

There is no significantly different approach adopted depending on the type of claim arising for CWP and UWP business.

For FIA business, the smoothing policy aims to distribute appropriate profits/losses in full each year although extreme amounts in either direction could be spread over more than one year. In the long run the aim is to ensure that the long-term cost of smoothing is neutral.

There is no specific limit to the total smoothing cost over the shorter term that the Society believes should not be exceeded, provided the interests of continuing policyholders are not prejudiced. However, the extent to which smoothing applies will be subject to the overarching principles in Section 3 and in particular would be constrained if the statutory solvency of the Society would otherwise be at risk.

The Society may apply MVRs to UWP policies and change the surrender bases for CWP policies, to reflect changes in underlying asset values.

7.2 General Practices
Smoothing for CWP and UWP policies applies in two ways:

(a) implicitly:

- by grouping policies for the purpose of determining final bonuses by year or month of commencement,
- by holding final bonus rates and MVRs unchanged between declaration dates, and
- by limiting the number of different bonus scales, so that minor product classes share the experience of the major classes.

and

(b) explicitly, by paying more or less than the target percentage of asset share in order to reduce the volatility of payouts.

The cost of implicit smoothing can be expected to be close to zero. The cost of explicit smoothing is intended to be zero over the long-term. However, there is no period over which the Society has decided that smoothing should be neutral, neither is there any overall limit to the accumulated cost or benefit from smoothing that the Society has decided it is prepared to tolerate. However, the extent to which smoothing applies in periods of sustained asset falls may be constrained if statutory solvency is at risk.

In determining the level of explicit smoothing to be applied to policy payments the Society takes into account:

- The relationship between the asset share for each year of commencement with the corresponding figure at the previous declaration,
- The level of smoothing applied for each year of commencement at the previous declaration,
- The aggregate cost or benefit of the proposed smoothing,
- The resources available to support this smoothing cost.

Except where guarantees are directly affecting payouts, the change in payouts for policies with similar characteristics expressed as a percentage of asset share would not on average be more than 5% from one year to the next, subject to the overarching principles in Section 3.

The Board would, in some cases, invoke the overarching policyholder fairness principle and breach this limit. Circumstances where this is likely are when the value of the underlying investments change significantly in a short period of time, e.g. more than 7.5% in a month. The 5% limit would, in these cases, be used as a longer term constraint.

Smoothing accounts are maintained, separately for CWP and UWP (and within UWP business separately for former MGMI policies and other UWP business), to keep track of the costs and benefits of smoothing, both explicit and implicit. These accounts may, from time to time, be negative, implying that temporary support is being given by the inherited estate to the smoothing process.

Conventional With Profits
For CWP policies, smoothing operates by assuming that policies entering into With Profits in each calendar year enter and leave the Fund halfway through the relevant calendar years when determining specimen asset shares and final bonuses, as described in Section 4.2

Unitised With Profits
For UWP policies, smoothing operates by treating policies' investments in each calendar month as entering and leaving the Fund halfway through the relevant calendar month when determining asset shares, final bonuses and MVRs. Smoothing currently operates to favour payouts to single premium policies whose investment returns have been negative.

The cost of guarantees, for example partial surrender payments under UWP policies to which no MVR applies, is not charged to the smoothing account.

Flexible Income Annuity
For FIA business, the smoothing policy aims to distribute appropriate profits/losses in full each year although extreme levels of profits/losses may be spread over more than one year. In the long run, the aim is to ensure that the long term cost of smoothing is neutral.

8. Investment Strategy

8.1 Principles
The investment strategy of the Fund is ultimately determined by the Board, having taken advice from the Investment Committee and With Profits Committee as appropriate.

The aim of the Society's investment strategy, for CWP and UWP policies, is to maximise the returns to those With Profits policyholders whilst preserving the ability of the Fund to meet the guarantees it has given. In determining the mix of assets between asset classes, the investment strategy will take into account the financial strength of the Fund, its ability to meet regulatory capital requirements, and the long-term expected returns anticipated for each asset category, together with their volatility. Different classes and generations of policy within the Fund may have different investment strategies depending on their liability profile and levels of guarantees. The inherited estate may also have a different investment strategy. In considering the range of assets in which to invest, the Fund may use derivatives and other instruments within limits determined by the Board. Limits may be set as to the maximum exposure to specific assets, asset types, and counter party exposure.

The Fund may invest in assets such as the Society's head office and subsidiary companies which would not normally be traded. The basis of valuation, yield, and the proportion of the Fund invested in such assets is reviewed regularly to ensure they remain appropriate investments of the Fund.

For FIA business the policyholder chooses their own investment strategy via their selection of segregated funds.

8.2 General Practices

The Society's investment strategy is formally reviewed each year.

Non linked, non-profit liabilities are backed by a diversified portfolio of fixed interest assets of suitable outstanding term and cash on deposit.

Unit linked liabilities are matched by units in the relevant unit linked fund as are the investments connected to the FIA policies.

Different asset allocation strategies apply to CWP business, UWP business and the inherited estate. In particular, UWP business has a higher proportion of equities and property than CWP business, reflecting the lower level of guarantees and the desire to maximise returns, subject to an acceptable level of risk. Within UWP business separate strategies apply to former MGMI policies and to other UWP business.

If statutory solvency was at risk, equity assets would be switched to fixed interest to restore solvency to acceptable levels.

Investment guidelines allow an investment mix within the following ranges:

	Equities (including property)		Fixed interest, variable interest, deposits and cash	
	Lower Limit	Upper Limit	Lower Limit	Upper Limit
CWP	0%	60%	40%	100%
UWP	30%	80%	20%	70%
UWP (former MGMI policies)	40%	85%	15%	60%

The following table gives an indication of the current ranges of investment mix:

	Equities (including property)		Fixed interest, variable interest, deposits and cash	
	Lower Limit	Upper Limit	Lower Limit	Upper Limit
CWP	0%	20%	80%	100%
UWP	30%	50%	50%	70%
UWP (former MGMI policies)	50%	75%	25%	50%

In respect of fixed interest investments, up to 5% may be invested in sub-investment grade bonds.

Investment in new or novel investment instruments is subject to approval by the Society's Board. The risks and rewards of such instruments would be analysed in the context of the Fund's investment strategy, the existing assets held and the liability profile of the With Profits policies. The Board would approve new or novel instruments if they believe the benefits associated with such investments outweighed any increase in risk or cost.

The Fund owns properties in Worthing which are occupied by the Society. These properties are treated as an investment asset for accounting purposes and do not place any restraint on investment freedom since their value is small (currently under £5 million) compared to the size of the Fund.

The Society uses its subsidiary companies to increase the range of products, distribution and services available to its members. New subsidiaries will be established only if financial projections indicate that the return to With Profits policyholders compares favourably with investment in other asset classes. The operations of subsidiary companies are reviewed regularly through Board meetings of those companies, their reports and accounts and feedback to the Society's Board.

Conventional With Profits matching

The Society will look to match a proportion of its guaranteed liabilities in the CWP fund with fixed interest and cash. Such matching will have due consideration to both the investment policy outlined above, and the overall impact on both regulatory capital and internal capital assessments.

The duration of the assets is chosen to match, on an approximate basis, the pattern of expected cash outflows of the proportion of claims less premiums being matched, making best estimate assumptions for the early termination of policies and mortality.

Unitised With Profits matching

The Society does not operate a policy of seeking to match precisely the anticipated profile of UWP liabilities with fixed interest assets, although due regard will be paid to guarantees which have been given when determining the level of fixed interest investment.

Investment of Inherited Estate

The investment strategy applying to the inherited estate differs from that applying to assets backing insurance business. The strategy for the inherited estate is intended to complement the investment of the remaining With Profits funds and could be materially affected by any potential liabilities that the Directors expect to attribute to the inherited estate (see note below). At present the strategy for the estate is aimed at reducing risk and preserving the value of the estate rather than maximising the investment return.

The inherited estate may also make investments in derivative assets and other instruments, subject to approval by the Society's Board. The Board would approve such investments if they believe the benefits for the With Profits funds as a whole outweighed any increase in risk or cost. Such investments might also be used, at certain times, in order to protect the solvency of the Fund and the security of policyholders' benefits.

Any investment in subsidiary companies is also made by the inherited estate and hence the profits or losses from such investments have only an indirect effect on policy payouts.

Assets currently held in the Fund which would not normally be traded due to their importance to the Society are:

- The head office buildings,
- Investments in subsidiary companies.

Note: Where explicit reserves need to be established in respect of liabilities that are to be attributed to the inherited estate these would then form part of the main policyholder reserves. Amounts are transferred out of the estate to cover the establishment of such reserves. The investment strategy for such reserves is then consistent with that adopted for other policy reserves (normally non-profit liability reserves).

9. Business risk

9.1 Principles
As a mutual organisation, the Fund bears the risks and reaps the rewards of business risk accepted by the Society.

The Fund is exposed to the risk from acquiring and maintaining both non and With Profits business and from other investments made by the Society. It will only accept such risks if at the time of the investment the expected rewards are greater than the rewards available from investment in the asset portfolio by a margin that allows for the nature of the risks being undertaken. If it is considered desirable, the Society may offer services to its members even though they may not be fully financially viable. The expenses to be charged against CWP policies in the calculation of asset shares are intended to represent the proportion of the Society's total expenses which are attributed to CWP policies.

9.2 General Practices
As a mutual organisation with all With Profits business written within the Fund, the Society's With Profits policyholders share in the results of all the Society's business risks.

Examples of business risks are:

- Exposure to maintaining and acquiring With Profits policies.
- Exposure to maintaining and acquiring non-profits policies.
- Exposure to risks from other investments: for example, in investment management companies, service companies or overseas subsidiary insurance companies.

Before taking on any significant business risk, it must be approved by the Society's Board, who would consider the costs and benefits of entering into a given venture. The Board's assessment would include reviewing financial projections of the projected benefits. This calculation will use a risk discount rate reflecting returns available on alternative investments plus an additional risk margin.

The profits or losses arising from these business risks will be credited or debited to the inherited estate and will be available for distribution to With Profits policies at the time of claim as described in Section 4.2.

The maximum net investment which the Society would commit to a specific business risk at the time of its investment is 25% of the inherited estate.

For those profits or losses arising from business risks that are allocated to With Profits policyholders, With Profits policyholders share in business risk in proportion to their asset shares. Former MGMI policies will not normally share in such distributions of profits and losses but potentially share in any exceptional profits or losses , for example the profits and losses arising should the Society ever decide to close or demutualise.

10. Charges and expenses

10.1 Principles
The expenses to be charged against CWP policies in the calculation of asset shares are intended to represent the proportion of the Society's total expenses which are attributed to CWP policies.

UWP and FIA policies have defined expense charges as set out in the policy literature. These are the same charges as are applied to asset shares. Any difference between those charges and the actual expenses incurred in administering the business will be charged or credited to the inherited estate. The expense charges made to UWP and FIA policies may be increased (subject to any maximum in the policy terms) if the actual expenses increase above those allowed for in the policies.

The basis for apportioning charges and expenses may be changed prospectively if the Board determines that it has become inequitable. This could apply if there was a change in the way the Society sells or administers its business, if there were significant changes in business volumes, or if investigations into expense apportionment or the cost of smoothing, guarantees and the use of capital demonstrated the need to change the basis.

For FIA policies a guarantee charge is also made. Differences between these charges and actual guarantee costs will be charged or credited to the inherited estate. Guarantee charges reflect expected costs of guarantees over time and can be adjusted if those expectations change.

10.2 General Practices
The expenses to be charged to With Profits policies in the calculation of asset shares are based on the Society's internal expense model.

All expenses incurred on behalf of subsidiary companies by the Society are charged at cost.

The Society uses a number of outsourced services. The contracts for such arrangements typically include a review period and terms under which the Society may terminate the arrangements.

The outsourced contracts of greatest significance are in respect of investment management, where the Society has investment management agreements with several fund managers, and may terminate the agreements at three months' notice in the majority of cases.

The Society has a single With Profits fund and no shareholders. There are, therefore, no judgements to be made about how expenses should be apportioned between shareholders and policyholders. Within the Fund, judgement is used in order to apportion expenses between non-profit policies and different classes of With Profits policies and to determine charges made to subsidiary companies for services provided by the Society.

Expenses attributed to With Profits business are allowed for in the calculation of asset shares as described below.

No charges are currently being made for the cost of smoothing, guarantees and the use of capital.

Conventional With Profits
The expenses charged to asset shares are as follows:

- Initial - acquisition expenses, deducted at outset.

- Renewal - policy maintenance and investment management expenses, expressed as a percentage of asset share.

Unitised With Profits and FIA policies
The charges to be applied to UWP and FIA policies will be those set out in the policy literature. Any difference between those charges and the actual expenses incurred in administering the business will accrue to the inherited estate. The expense charges made to UWP and FIA policies may be increased (subject to any maximum in the policy terms) if the actual expenses increase above those allowed for in the policies.

Many of these charges are fixed or linked to inflation. However, the annual management charge, which is charged as a deduction from the investment return credited to asset shares, is at the Society's discretion. For most UWP business the same percentage is charged as for comparable unit linked funds offered by the Society - currently 1% pa for life and 1.25% for pensions. For former MGMI policies a separate scale of charges is applied but any changes to these scales will be linked to equivalent changes to charges for the rest of the Society's UWP business. For FIA the charge will vary by fund choice, premium size, commission income, age and health to reflect the different costs of these aspects. These levels of charge are implicitly disclosed to policyholders at point of sale through the reduction in yield quoted at that time.

11. Management of the inherited estate

11.1 Principles
The Society's inherited estate is the excess of the assets of the Fund over the amount required to meet the liabilities and expected benefit payments (including future bonuses) for current policyholders.

Its primary uses include:

- Providing statutory capital to meet reserving requirements in excess of policyholder asset shares and provisions for guarantees that have already been given or which may arise as a result of the investment policy of the Fund, and to meet the reserving strains of writing new business.
- Allowing the Society to accept a greater degree of investment freedom and diversification, and acceptance of greater investment risk than would otherwise be possible.
- Providing working capital to cover any mismatch in timing between the receipt of charges on new and existing policies in the Fund and the actual expenses incurred in the acquisition and maintenance of those policies.
- Supporting the smoothing of benefits paid to With Profits policyholders.
- Meeting any exceptional costs in managing both with and non-profits business arising as a result of legislation, taxation or other circumstances which, in the opinion of the Board, should not be charged to policyholder benefits.
- Providing additional security to policyholders in the event of adverse changes in experience.

There is no division of the inherited estate between classes of business in the Fund, and existing policyholders have no right to a distribution.

The preferred size of the inherited estate is the level required to meet the above objectives. To the extent that the inherited estate falls to an unacceptably low proportion of total asset shares, the investment policy may be restricted as may the level of new business to be written in the Fund, and the ability to smooth the payment of benefits to existing policyholders. In such circumstances the intention would be to rebuild the estate by reducing payouts on With Profits policies.

11.2 Practices
The Society's inherited estate is used to assist in running all the Society's business. The primary uses of the inherited estate are described in Section 11.1.

The Society aims to maintain the inherited estate at a size which allows the criteria in Section 11.1 to be met.

To assess the appropriate level of additional security referred to in section 11.1, the Society has regard to its "risk appetite" as determined by the Board from time to time. This is currently expressed as 125% to 150% of the Society's "Individual Capital Guidance" (ICG). The ICG is the amount of capital required to meet certain extreme events, as agreed from time to time with the regulator.

The society aims to maintain an estate that:

(a) meets the society's regulatory capital requirements,

(b) has sufficient additional capital to ensure that its risk appetite is not exceeded and

(c) has in addition sufficient working capital to support its new business plans over the next five years.

Should the estate materially exceed this level, it would be the Society's intention to return this excess to its members. This is not the case at present, however.

The inherited estate is currently meeting the following specific costs, and will continue to do so for the foreseeable future:

- The cost of meeting payments in excess of asset shares on maturing CWP pensions policies resulting from the granting of guaranteed annuity options.

- Expense overruns on the acquisition of new business. It is anticipated that the expense overrun will be eliminated in the future so that this will not be a long-term cost.

- The acquisition or development costs of business ventures.

- The cost of meeting MVR free guarantees on UWP policies.

Reserves have been established in respect of some of these liabilities. As noted in Section 8 these reserves are initially covered by transferring assets out of the inherited estate. Any subsequent release of reserves that is not matched by benefit payments would revert back to the inherited estate.

12. Volumes of new business and closure of the fund

12.1 Principles
The volume of new business, both with and non-profits, to be accepted into the Fund will be such that it does not in the opinion of the Board materially worsen the benefit expectations of the existing policyholders, and does not prejudice the overarching principles in Section 3.

The aim in writing non-profit business is that it should deliver an adequate level of profitability to the Society.

In the event that the Fund was to close to significant amounts of new business, the Society would:

- Review its investment strategy for CWP and UWP business and may switch assets from equities to fixed interest and other less volatile asset classes to more closely match liabilities.

- Review the extent to which payments on CWP and UWP business were being smoothed.

In the event that the Fund were to close permanently to new business, the Society would review the management of the inherited estate to ensure its equitable distribution to the remaining members of the Society, taking into account the need to retain adequate reserves to meet payments to non-profit policyholders.

12.2 Practices
Each year the effect of writing various levels of new business on the financial position of the Society is investigated.

Following the results of recent investigations, the Society does not consider that it is necessary to prescribe a minimum proportion and scale of With Profits new business needed to justify the Fund remaining open to new business.

Projections of future solvency are carried out at least annually in order to ensure that the volume and mix of business does not materially affect the benefit expectations of existing policyholders, in the opinion of the Board.

13. Equity between the With Profits fund and any shareholders

The Fund is a mutual fund and has no shareholders. Therefore, this section is not applicable.

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