

# Principles and Practices of Financial Management

as at June 2020

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## 1 Introduction

The Financial Conduct Authority (FCA) requires insurance companies like National Friendly to set out both the Principles and Practices through which the Board exercises its discretion on behalf of the with-profits policyholders in order to treat them fairly.

### 1.1 Principles

The principles sections of this document outline the over-arching principles that are not intended to be changed, although the Board can change them after informing the with-profits policyholders affected by any change. The practices sections of the document outline the current practices of the Board and can be changed at the discretion of the Board without prior notice to the with-profits policyholders affected by any change (who will subsequently be notified).

As both the principles and practices can be changed, nothing in this document should be taken to be part of the contract terms between policyholders and the Society, which are set out in the Society's Rules and in the terms and conditions of the policies issued to policyholders.

The Society is a mutual friendly society and therefore has no shareholders.

The Society maintains a single long term business fund and the rights of Members to participate in surplus relate to all funds of the Society.

### 1.2 Practices

Only those policyholders whose policies are described as being "with-profits" have a reasonable expectation of participating in regular distributions of surplus.

Some deposit based contracts have the right to participate in distributions of surplus through mechanisms such as an increase in benefits, a loyalty bonus or a change in own share contribution. Therefore, such distributions might be made from time to time where the Board, having received advice from the With-Profits Actuary, considers it equitable to do so and where such distributions do not adversely affect the reasonable expectations of the with-profits policyholders.

There is not a single definitive approach to the distribution of any surplus to deposit based contracts so the Board retains full discretion over the nature and extent of any distributions.

Other policies (including unit linked contracts) are written on non-profit terms and would not normally participate in distributions of surplus. However, such distributions might be made from time to time where the Board, having received advice from the With-Profits Actuary, considers it equitable to do so and where such distributions do not adversely affect the reasonable expectations of the with-profits policyholders.

In order to independently monitor and bring some independent judgement of the extent to which procedures, systems and controls are adequate and effective to ensure that the Society complies with the requirements contained within the FCA Handbook over the management and governance of with-profits business, the Board has established a With-Profits Advisory Arrangement as a sub committee of the Board and reporting to the Board. One of the roles of the With-Profits Advisory Arrangement is to review the advice of the With-Profits Actuary. The Board, in considering the advice of the With-Profits Actuary, will also consider the recommendations of the With-Profits Advisory Arrangement.

Certain terms are defined in a Glossary, which is included at the end of this document. This Glossary is included for reference purposes, but does not form part of the Principles and Practices of Financial Management.

## 2 Business Risks

### 2.1 Principles

Business risk is controlled by the Board, and is under constant review. While the inherited estate remains sufficient, any profits or losses arising from business risks will normally be borne by the inherited estate. However, if the inherited estate falls below its minimum target level, then the impact of business risks will be reflected in the bonuses granted to with-profits policyholders.

### 2.2 Practices

The key business risks include those associated with:

- Investment strategy, which is considered in Section 3
- Charges and Expenses, which are considered in Section 4
- New Business, which is considered in Section 5

The long term business fund bears the risks associated with guarantees provided on with-profits policies. The inherited estate will normally bear the costs of meeting these guarantees. However, if the level of the inherited estate falls below its minimum target level, any excess of the costs of meeting guarantees over the charges already deducted from asset shares may be deducted from the surplus available to provide with-profits policyholders' benefits.

The fund may be exposed to risk from acquiring and maintaining deposit based contracts and non-profit policies. The Board will only do so after considering the balance of risk and potential rewards against those of the investment portfolio. In considering this issue the Board will take into account the potential positive contribution to overhead expenses from increasing the volume of business written. Any profits or losses arising from these risks will be credited or debited to the inherited estate.

It is anticipated that should the level of the inherited estate fall below the minimum target level then the costs would be spread over all with-profits policies irrespective of the nature of the business risk that created the fall in the inherited estate. However, the circumstances of any specific case will be considered by the Board on the advice of the With-Profits Actuary.

Where the Board, after seeking the advice of the With-Profits Actuary, considers that the business risk associated with the potential impact of an unfavourable claims experience for a product or products could not be borne within the normal variations of the inherited estate without possibly unduly adversely affecting the interests of the with-profits policyholders then such policies would, where appropriate terms can be secured, be reinsured with an external reinsurance company. If appropriate reinsurance terms cannot be obtained then the scope of new business may be limited by the Board.

## 3 Investment Strategy

### 3.1 Principles

All assets of the Society are included within a single long term business fund. The investment strategy of the long term business fund is to maximise the returns to with-profits policyholders whilst maintaining adequate solvency and providing adequate liquidity to meet the Society's day to day needs.

In determining the mix of assets between different asset classes, the investment strategy will take account of the financial strength of the fund, its ability to meet its regulatory capital requirements, and the long term expected returns and volatility in each asset category.

### 3.2 Practices

The investment strategy of the long term business fund, including the mix of assets between different classes of asset, will be reviewed by the Investment Committee, a sub-committee of the Board, at least once a year or more frequently if circumstances require. The Investment Committee will also monitor compliance with the current investment strategy on a quarterly basis. The Investment Committee will not invest in any new or novel classes of investments without seeking the advice of the With-Profits Actuary.

The liabilities in respect of deposit based contracts (other than members' accounts) and non-profit policies (other than unit linked liabilities) will be backed primarily by fixed interest assets of an appropriate term and credit quality. Similarly, expense and other contingency reserves will be backed primarily by fixed interest (or index linked) assets. In each case the target range for investment in fixed interest assets (or index linked) is 60% to 100% of such liabilities. However, while the Society retains a level of inherited estate above the minimum target level the Board may allow the Investment Committee and/or the investment manager to have some freedom to manage these assets to try to enhance returns.

With-profits liabilities will be backed primarily by investment in properties and equities provided that the inherited estate remains above the minimum target level for the inherited estate or such higher amount determined from time to time by the Board having had regard to the advice of the With-Profits Actuary. In this case, the target range for investment in properties and equities is 40% to 90% of such liabilities, except for with-profit pensions where the target range is 0% to 50%. Under adverse market conditions the Society may consider, having had regard to the advice of the With-Profits Actuary, declaring lower future bonuses by retrospectively allocating these assets more towards the asset class(es) affected. The rationale for this action would be to protect the solvency of the with-profits fund and all policies within it.

It may become necessary for the guaranteed benefits attached to with-profits policies to become more fully backed by fixed interest assets if the level of the inherited estate reduces as a proportion of the with-profits liabilities (particularly if the level of the inherited estate fell to below the minimum target level for the inherited estate).

The Board allows the Investment Committee and/or the investment manager to have some freedom to manage the assets to enhance investment returns and this could result in an increase in the proportion of fixed interest assets in some market conditions. The Investment Committee will review the position at least annually having regard to the advice of the With-Profits Actuary.

The assets backing the inherited estate will be managed to enhance overall investment returns and there are no constraints on the investment strategy, provided that the inherited estate remains above the minimum target level. If the inherited estate falls below the minimum target level for the inherited estate, the amount of investments in fixed interest securities may have to be increased. The Board will review the position at least annually having regard to the advice of the With-Profits Actuary.

Specific limits on the exposure to any one counterparty are included in the agreement with the investment manager. The Board will review the counterparty limits at least annually.

The fund may include assets that are not normally traded in order to support the operation of the business, provided that the fund also holds sufficient liquid assets to meet its requirements. Such assets may include the investment in subsidiaries of the Society, properties used by the Society for the operation of its business and loans previously made to staff as part of their employment package.

The fund may invest in its subsidiary companies provided that the expected return on those investments over the longer term is no worse than the return that would be expected on an investment in similar quoted companies.

The Investment Committee will review at least once every three years the use (if any) made of investment in offices for the administration of the Society and consider whether the investments remain appropriate having regard to the advice of the With-Profits Actuary.

## **4 Charges and Expenses**

### **4.1 Principles**

The charges applied to with-profits policies will be the charges deemed by the Board to be fair and appropriate. The Board will take into account the charges included within the premium rates, the charges deemed appropriate for similar contracts and the level of charges disclosed in product literature.

Any difference between those deemed charges and the actual expenses incurred in administering the business will be charged to the inherited estate.

The charges applied to with-profits policies may be reduced (or increased) if the Board, having had regard to the advice of the With-Profits Actuary, consider a change appropriate.

The factors most likely to trigger a change to the charges would be either a change in the level of the inherited estate to a point outside (or close to being outside) the specified target range, and/or a sustained level of actual expenses different to those previously deemed appropriate for the purpose of calculating asset shares.

### **4.2 Practices**

Certain charges are assumed in the asset share method for with-profits policies to verify the appropriateness of claim values. These assumed charges are normally those included within the premium rates and disclosed in product literature. The charges are intended to reflect the actual expenses of the long term business fund.

However, in order that policyholders do not bear any immediate risk from the difference between the expenses of managing the long term business fund and the applicable charges, the inherited estate will normally bear any difference between these charges and the actual expenses of the fund. However, the benefits on with-profits policies may ultimately be affected by the actual expenses of running the fund, if the inherited estate is (or becomes) insufficient to absorb any excess of actual expenses over these charges.

The types of charge assumed reflect the need to cover both acquisition expenses (including commission) and maintenance expenses (including investment management costs) and may include one or more of the following:

- initial charge of a fixed amount
- initial charge as a percentage of premium
- renewal charge as a percentage of premium
- renewal charge as a percentage of fund
- per policy fee of a fixed amount
- investment management fee as a reduction in rate of return
- administration charge on claim event as a percentage of claim value or a fixed amount.

If the level of the inherited estate falls below its minimum target level, a charge for the expected cost of meeting guarantees may be deducted from the asset shares following the advice of the With Profits Actuary.

Most of the costs incurred by the Society are under the direct control of the Society and reviewed annually by the Board.

A number of services are outsourced which, in most cases, can be terminated at less than one month's notice. Outsourced services will be reviewed at intervals of not more than three years.

## 5 New Business

### 5.1 Principles

The volume of new business accepted into the long term business fund will be such that it aims to improve the reasonable benefit expectations of the existing policyholders in the opinion of the Board, having received advice from the With-Profits Actuary.

In the event of closure to new business, it is anticipated that there would be no significant changes in the management of the inherited estate as a prudential margin is likely to be required for a significant period to meet the costs of smoothing and guarantees when required. In the longer term the inherited estate would be distributed to the remaining policyholders when no longer required.

### 5.2 Practices

There is currently no specified limit on the maximum volume of new business (including non-profit policies and deposit based contracts) that is written each year provided that the solvency of the Society is not jeopardised and, in particular, the minimum target level of the inherited estate is not breached.

The Board periodically reviews the demand for and viability of different classes of business. The Board only effects new business where it considers that it is in the best interests of policyholders. Typically, the Board considers that the volume of new business required to justify the Society staying open to new business is that required to ensure that the inherited estate should not have to meet the cost of acquiring and administering new business (although the inherited estate may finance the new business strain).

A specific target for the proportion of new business required to be on a with-profits basis has not been set. The position will be reviewed annually by the Board having regard to the advice of the With-Profits Actuary.

If the Board determines that the Society should close to new business, then the investment strategy and level of expenses would be reviewed. Further actions may be taken depending on the circumstances leading leading to the decision to close.

## 6 Inherited Estates

### 6.1 Principles

The inherited estate is the excess of the assets of the long term business fund over the value of asset shares and the provisions for guarantees (for with-profits policies) and the value of the liabilities for non-profit policies and deposit based contracts. The inherited estate provides the working capital for the fund. Its primary uses include:-

- the capital needed to cover statutory solvency and other working capital requirements
- the cost of meeting the excess of any expenses over the charges applied
- the cost of smoothing of benefits paid to with-profits policyholders
- the cost of providing capital support to cover the costs of meeting guarantees and compensation claims

### 6.2 Practices

With effect from 1 January 2018 the inherited estate and its target range are measured by reference to items disclosed in regulatory reporting to the Prudential Regulation Authority (PRA). The inherited estate is currently defined as the Society's "own funds" determined in accordance with the PRA Rulebook. Own funds will include the effect of any transitional measures as approved by the PRA, where applicable. The target range for the inherited estate is currently defined as between 200% and 300% of the Society's "solvency capital requirement" determined in accordance with the PRA Rulebook.

If the inherited estate falls below the minimum target level, then the Board may apply tighter restrictions on the investment strategy, the smoothing of benefits to existing policyholders, the amount of any subsidy of actual expenses borne by the inherited estate and the level of new business being written in the fund. The Board will determine such increased restrictions having regard to the causes of the fall in the level of the inherited estate and the anticipated impact on the level of solvency and the inherited estate of applying such restrictions and will consider the advice of the With-Profits Actuary before deciding the extent to which such tighter restrictions should be applied.

If the inherited estate exceeds the maximum level, then the Board will consider a number of options including pursuing a less restrictive investment policy, writing greater volumes of new business and the distribution of excess surplus to policyholders. The overall aim will be to improve policy values for a greater number of policyholders.

There is no division of the inherited estate between any classes of business within the fund. Any distribution of surplus will appropriately consider the risk borne and contribution to surplus by different groups of policyholders.

In addition to the use of the inherited estate to provide the capital needed to cover statutory solvency and other working capital requirements and to cover the cost of smoothing benefits paid to with-profits policyholders, the current uses of the inherited estate include the cost of meeting the guaranteed terms contained in certain contracts and in covering the cost of any excess of expenses over the charges applied to policies. If such costs increase relative to the size of the inherited estate then the level of the inherited estate could fall to below its minimum target level, thus resulting in the need to take action as noted above.

Further to the points noted above, the inherited estate may be used to finance strategic investments that support the development of the Society and are of overall benefit to its policyholders.



## 7 Smoothing Policy

### 7.1 Principles

The smoothing policy for with-profits policies will aim to operate so that under and overpayments to the underlying asset share will be balanced out over time. The aim over the longer term is to share out all the investment performance (net of charges) earned on the asset shares. If the size of the inherited estate is sufficient then payments in excess of asset shares for a period may not necessarily be followed by a period of underpayments relative to asset shares.

The extent of smoothing will be constrained so that the expected cost of any under or overpayments when compared with projected asset shares can be supported by the inherited estate.

Market value reductions may be applied to claims other than on maturity or death to maintain fairness between policyholders exiting the fund and those remaining in it.

### 7.2 Practices

The Board has not set a predetermined period over which smoothing is expected to be neutral. The cost of smoothing will be considered relative to the impact on the inherited estate. If the cost of smoothing becomes significant relative to the inherited estate such that the inherited estate could fall to its minimum target level within a three year period if the smoothing policy remains unchanged then smoothing costs will be reduced (by making more significant adjustments to bonus rates than implied by the following targets).

For maturities and surrenders of all with-profits policies, the current practice is that the claim value should be within 20% of the asset share.

For classes of policies of a broadly similar nature (such as tax exempt endowments, retirement annuities and personal pensions), the current practice is that claim values for policies paying the same premiums over the same term should not differ by more than 10%. This comparison only applies for policies with a broadly similar charging structure.

For policies of the same class paying the same premiums over the same term maturing in successive years, the current practice is that claim values should not change by more than 10% from one year to the next.

For surrenders of with-profits bonds, market value reductions may be applied. A single market value reduction would apply to a range of bonds based on the date of issue. Market value reductions would apply to partial claims on a proportionate basis.

For surrenders of with-profits ISAs, investment performance adjustments (which could be negative) may be applied. A single investment performance adjustment would apply to a range of ISAs based on the date of issue.

Investment performance adjustments would apply to partial claims on a proportionate basis.

Market value reductions on surrender of other policies will normally only be applied due to the effects of movements in the value of assets held by the long term business fund and the level of the reduction will be set so that payouts will be close to the asset share of the policy. However, major costs arising for other reasons may also need to be reflected in market value reductions if they are considered to be too large to be absorbed by the inherited estate.

The current practice is to apply the same approach to smoothing for all policy types on claims of all sizes and terms, irrespective of the date on which they joined the long term business fund.

In certain circumstances, it may not be possible to remain within the parameters set by the current smoothing policy. In such circumstances, the Board will set bonus rates with the additional aim of being within the smoothing parameters within three years.

## **8 Claim Value Methods**

### **8.1 Principles**

Claim values for with-profits policies are calculated in relation to a guaranteed basic benefit using a formulaic method to add annual and final bonuses. The formulae used are directly affected by the Society's policy on setting annual and final bonuses.

For all types of with-profits policy, the Society uses an "asset share" method (subject to certain limitations) to verify the appropriateness of the claim value calculated using the formulaic method. The asset share method is applied at a broad level by analysing a range of sample policies. A wide enough range of sample policies is analysed to ensure that claim values will be reasonably consistent for all with-profits policies.

The general aim of the Society is to give assurance that on average over the longer term the amount paid out on maturity and surrender claims is 100% of the asset share, subject to a minimum of the guaranteed benefits. This average is taken over all policies becoming claims over a number of years, so that in any one year the amounts paid out on claims may be more or less than 100% of asset shares.

### **8.2 Practices**

Claim values are calculated using a formulaic method. Any changes to the methods used to determine claim values will be approved by the Board, having received advice from the With-Profits Actuary. In order to treat customers fairly, the Society will not make any significant changes to the historical assumptions and methods previously applied, unless it can be clearly demonstrated that a significant class of policyholders has been materially disadvantaged. However, the methods of determining asset shares used are approximate and can be expected to be developed and refined over time.

In particular, the collection of relevant data on the performance of different classes of assets has been expanded over time. Therefore, over time the nature of the investment performance credited to with-profits policies may more closely reflect the assets notionally allocated to with-profits policies.

A brief description of the formula used for each major class of policy is set out below.

#### **Whole Life and Endowment Assurances**

The benefit payable on maturity or death is calculated as the guaranteed sum assured plus annual and final bonuses. Annual bonuses are calculated as a percentage of the sum assured (and, for certain policies, accrued annual bonuses) and, once declared, become part of the guaranteed benefits). The final bonus is calculated as a percentage of the total annual bonuses, based on the term of assurance completed at the date of claim. For the purpose of setting final bonus rates for whole of life policies, the relevant generation of endowment policies is used or, for whole of life policies that have been in force for more than 40 years, extrapolated where necessary.

For policies issued before 1985, special bonus rates were declared to distribute additional surplus at the time to long term contracts in order to ensure that the benefits remain consistent with asset shares. These special bonuses are expected to continue for as long as is consistent with asset shares.

Surrender values are calculated by reference to the term of premiums paid with due allowance for expenses and an appropriate share of bonuses accrued to date.

### **Personal Pensions**

The benefit payable on maturity (or open market value) is calculated as the guaranteed fund value plus annual and final bonuses. Annual bonuses are calculated as a percentage of the fund value and accrued annual bonuses and, once declared, become part of the guaranteed benefits. The final bonus is calculated as a percentage of the total annual bonuses, based on the term of assurance completed at the date of claim.

Paid up policies have reduced benefits based on the term of premiums actually paid. Benefits are recalculated on early or late maturity as if the actual maturity date had been selected at outset.

Benefits payable on death, transfer or encashment are calculated as a percentage of premiums paid, subject to a minimum of the open market value that would have applied at the claim date (if applicable). An administration charge may be applied on transfer or encashment.

### **Retirement Annuities**

The annuity payable on maturity is calculated as the guaranteed annuity plus annual and final bonuses. Annual bonuses are calculated as a percentage of the annuity and accrued annual bonuses and, once declared, become part of the guaranteed benefits. The final bonus is calculated as a percentage of the total annual bonuses, based on the term of assurance completed at the date of claim.

The open market value at maturity will be increased in certain market conditions to allow for the guaranteed annuity rate included in the policy terms.

Paid up policies have reduced benefits based on the term of premiums actually paid. Benefits are recalculated on early or late maturity as if the actual maturity date had been selected at outset.

Benefits payable on transfer or encashment are calculated as a percentage of premiums paid, subject to a minimum of the open market value that would have applied at the claim date (if applicable). An administration charge may be applied on transfer or encashment.

The benefit payable on death is a refund of premiums plus 3% accumulated interest in accordance with the policy terms.

### **With-Profits Bonds**

The benefit payable on death is calculated as the single premium investment, less any partial withdrawals, plus annual and final bonuses. Annual bonuses are calculated as a percentage of the single premium investment (and, for certain bonds, accrued annual bonuses). The final bonus is calculated as a percentage of the single premium investment and annual bonuses, based on the date of issue. The death benefit is subject to a minimum of 101% of the single premium investment.

The benefit payable on surrender is calculated as for a death claim, but a market value reduction may be applied, based on the date of issue. An explicit surrender penalty is also applied if a bond is surrendered during the first five years. Partial withdrawals are treated in a consistent manner to full surrenders.

### **With-Profits ISAs**

The benefit payable on death or surrender is calculated as the regular monthly and/or single premium investments (net of premium charges), less any partial withdrawals, plus annual and final bonuses. Annual bonuses (net of fund charges) are credited monthly and are calculated as a percentage of the premiums and existing annual bonuses. The final bonus (which is referred to as an investment performance adjustment) is calculated as a percentage of the premiums and annual bonuses, based on the date of issue. Partial withdrawals are treated in a consistent manner to full surrenders.

An “asset share” method is used to verify the appropriateness of the claim values calculated using the formulaic method. Annual and final bonus rates are set having regard to asset shares. The aim is that claim values will be within an appropriate range covering 100% of asset shares. An acceptable target range for claim values has been set, as specified in the smoothing policy. The asset share method is applied at a broad level only by determining an approximate asset share for a range of sample maturity and surrender claims. The range tested includes different policy types, issue dates, durations and tax status, and is considered wide enough to ensure consistent and equitable treatment for all with-profits policies.

The asset share is calculated as the net premium accumulated at the investment returns (adjusted if necessary) actually achieved by the Society over the relevant period, with an allowance for the cost of mortality and guarantees where appropriate.

The net premium is taken as the gross premium less the charges for expenses included in the premium rates (or subsequently deemed by the Board to be appropriate for the asset share calculation).

For years up to and including 2003 (except for with-profits bonds), investment returns have been based on the returns achieved by the long term business fund as a whole, plus an addition to each year’s return. This adjustment reflects the fact that with profits liabilities would have been covered by a higher proportion of equities and property compared to the long term business fund as a whole, since the non-profit business would have been backed primarily by fixed interest assets. Equities and property have generally over longer terms generated higher returns than fixed interest assets.

For years after 2003 (and all years for with-profits bonds), the investment return is calculated directly from the assets assumed to be allocated to with-profits policies, using a weighted average of the returns achieved by each major asset class.

The investment return may be adjusted to allow for any distribution of surplus from the inherited estate that the Board considers equitable having regard to the advice of the With-Profits Actuary.

For taxable policies, a further adjustment may be made to the investment return to allow for tax payable in respect of this part of the business.

Descriptions of the methods and assumptions used to determine claim values for with-profits policies are included in various reports produced by the With-Profits Actuary and in other relevant documents.

## **9 Annual Bonus Policy**

### **9.1 Principles**

The Board will determine annual (or reversionary) bonuses which they consider to be:-

- affordable
- sustainable having regard to long term expected rates of return on fixed interest securities
- reasonably fair between policyholders

### **9.2 Practices**

The current approach is for the Board to declare regular bonus rates for with-profits policies once a year, or more frequently if circumstances require, having received advice from the With-Profits Actuary. It is expected that this approach will continue for the foreseeable future.

For conventional with-profits policies, the aim in setting annual bonus rates is to achieve a smooth progression of guaranteed bonus additions from year to year to avoid sudden fluctuations. The rates are set having regard to the investment returns recently achieved by the assets notionally backing the policies. However, the rates will also reflect levels that are considered to be sustainable in the long term having regard to yields on fixed interest securities. Returns in excess of a sustainable rate derived from fixed interest yields will normally be credited by means of a final bonus.

For with-profits bonds and with-profits ISAs, the aim in setting regular bonus rates is to increase policy values in line with the average redemption yield on medium to long term fixed interest securities (the rate for ISAs is quoted as a gross rate and is reduced by the applicable fund charge, whereas the rate for bonds is quoted as a net rate that allows for a margin to cover the charges for expenses.) However, the bonus rates are also limited to levels that are considered to be sustainable in the long term and, therefore, may reduce if investment returns have been below yields on fixed interest securities. Returns in excess of a sustainable rate derived from fixed interest yields will normally be credited by means of a final bonus.

However, annual bonuses will only be declared if the Board is satisfied that the solvency of the fund will not be detrimentally affected over the short or long term. The annual bonus may fall to zero in certain circumstances, for example where sustained low investment returns reduce the freedom of the Society to increase benefits and still maintain an appropriate degree of freedom in the investment strategy.

Although there is no maximum amount by which annual bonus rates may change, it is expected that in most circumstances the change will be limited to +/-1% from the current annual bonus rate (or 2% for child endowments) in any one year. However, in extreme circumstances, there may be a greater yearly change.

For with-profits ISAs annual bonus rates are declared in advance and are credited to policies and applied to claims until a further declaration is made. For claims arising before the next declaration of annual bonus rates in respect of all other policies, the normal approach is to use interim bonus rates similar to the latest annual bonus rates in the calculation of the claim value. In addition, the normal approach does not allow for any change in interim bonus rates before the next declaration. However, in some circumstances the Board may deviate from this normal approach having regard to recent or anticipated investment returns over the relevant period.

Different annual bonus rate series are currently used for different types and generations of policy, to reflect the differing levels of guaranteed benefits and tax status. These bonus rate series will continue to be used for all new business in the fund, except where there are significant differences in the guaranteed benefits, tax status or charges applied to the policy, when a new bonus series might be introduced.

An asset share (or similar) approach is not appropriate for deposit based contracts and there is no equivalent of the annual bonus augmentation expected for with-profits policies. Any distribution of surplus to deposit based contracts will be at the discretion of the Board in accordance with the principles and practices set out in this document.

## 10 Final Bonus Policy

### 10.1 Principles

The Board will determine final (or terminal) bonuses which they consider to be:-

- affordable
- sustainable having regard to asset shares
- reasonably fair between policyholders

### 10.2 Practices

The current approach is for the Board to declare final bonus rates for with-profits policies once a year, having received advice from the With-Profits Actuary. It is expected that this approach will continue for the foreseeable future.

However, in certain economic circumstances (e.g. significant changes in equity or property values) the Board may increase or decrease the final bonus rates before the next declaration is due. In some market conditions, final bonuses may fall to zero.

The current approach is to set final bonus rates such that payouts are targeted to be 100% of asset shares (subject to the limitations of the asset share method currently in use) though not reflecting fluctuations in asset share due to market volatility. This approach is subject to the current smoothing policy of limiting the change in maturity payouts on policies of the same original term to 10% in any one year. However, in extreme circumstances the Board may deviate from this normal 10% limitation.

The final bonus is intended to reflect sustained capital gains over a period. Therefore, credit for final bonus is intended to build progressively and may not reflect short term gains at early durations.

For with-profits bonds, market value reductions may apply on surrender or partial withdrawal. The final bonus is intended to reflect investment returns in excess of returns credited by means of annual bonus rates, whereas the market value reduction is intended to reflect lower investment returns than credited by means of annual bonus rates. The market value reduction is applied to the full surrender value including any final bonus.

For with-profits ISAs, a final bonus (which is referred to as an investment performance adjustment) may apply on death, surrender or partial withdrawal. The final bonus can either be positive or negative and therefore is intended to reflect actual investment returns that are higher or lower than the returns credited by means of annual bonus rates.

For conventional with-profits policies, surrender values are calculated using a formulaic method. The formulae are based on the term of premiums paid and make allowance for expenses incurred and an appropriate share of annual and final bonuses. A market value reduction may also apply on surrender.

Different final bonus rate series are currently used for different types of with-profits policy, to reflect the differing levels of guaranteed benefits. Further series will be introduced as necessary to ensure that payouts remain close to asset shares.

The concept of final (or terminal) bonuses is not applicable for deposit based contracts and any distribution of surplus to deposit based contracts will be at the discretion of the Board in accordance with the principles and practices set out in this document.

## Glossary

This Glossary is included for reference purposes, but does not form part of the Principles and Practices of Financial Management.

<b>Asset Share</b>	The accumulation of the premiums paid under a with-profits policy at the investment returns (adjusted if necessary) actually achieved by the Society after allowance for expenses and the cost of mortality and guarantees where appropriate, as described in Section 8.
<b>Board</b>	The Board of National Friendly.
<b>Deposit based contract</b>	A long-term insurance policy issued by the Society which does not provide for the policyholder to be eligible for participation in surplus on an asset share basis but which may receive, from time to time, benefit improvements or changes in own share contribution.
<b>Non-profits policy</b>	A long-term insurance policy issued by the Society which does not provide for the policyholder to be eligible for participation in surplus.
<b>Inherited estate</b>	The excess of the assets of the long term business fund over the value of asset shares and the provisions for guarantees (for with-profit policies) and the value of the liabilities for non profit policies and deposit section contracts, as described in Section 6.
<b>With-Profits Actuary</b>	The actuary appointed by the Board to advise them upon the rights and expectations of the with-profits policyholders, including the bonuses to be allocated to such policyholders. The With-Profits Actuary will also advise the Board on the allocation of surplus to fund any benefit improvements for deposit based contracts.
<b>With-profits policy</b>	A long-term insurance policy issued by the Society which provides for the policyholder to be eligible for participation in surplus and is operated on an asset share basis.

**To request a copy in Braille, large print or audio please call us on:  
0333 014 6244**

Calls from UK landlines and mobiles cost no more than a call to an 01 or 02 number and will count towards any inclusive minutes.

**8am-6pm weekdays. Calls are recorded for training and quality purposes.**

**Or email us at:**

**info@nationalfriendly.co.uk**



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