PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT

NFU Mutual

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1. Introduction

1.1 Background

We are required by the *regulator* to make available a document containing our Principles and Practices of Financial Management (PPFM). The PPFM aims to explain how a company manages their *With-Profits business*.

This document contains the Principles and Practices of Financial Management as at 1st September 2011 for all of the *with-profits business* written by the National Farmers Union Mutual Insurance Society Limited (the Society). All of this business, together with the Society's *non-profit business*, forms part of the Society's long-term business fund. We have issued both *traditional with-profits business* and *unitised with-profits business* in the fund.

References to "We" within the document refer to The National Farmers Union Mutual Insurance Society Limited, a company limited by guarantee and owned by its members ("the Society"). Membership of the Society is conferred by the issue of a policy (including with-profits, non-profit and general insurance). All but an immaterial part of its long-term business relates to business transacted within the United Kingdom.

We must also produce a consumer-friendly version of our PPFM. This is available on our website.

A glossary of certain terms used in the PPFM is provided in section 9. The terms included in the glossary are highlighted in italics throughout this document.

1.2 Principles

The With-Profits Principles are high level statements describing how we manage our *With-Profits business*. They are enduring statements of the overarching standards which we adopt in managing the long-term business 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.

The Principles are highlighted by yellow shading throughout this document.

1.3 Practices

The With-Profit practices give more detail about the specific practices we follow when managing our *With-Profits business*. They describe our approach to managing the long-term business fund and to responding to changes in the business and economic environment in the shorter term. They may change more frequently than the Principles. The practices 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 Governance

The Board is responsible for the management of our *With-Profits business* and ensuring we comply with our Principles and Practices. The *Actuary* gives advice to the Board on managing the *With-Profits business*. Any changes to the PPFM are approved by the Board.

The Board has a subordinate committee called the *With-Profits Committee*, which monitors the ongoing compliance with the PPFM.

The Board will produce a report each year for our With-Profits customers stating how we have complied with our PPFM. This includes a report to confirm whether the *Actuary* believes we have complied with the PPFM.

1.5 Changes to the PPFM

We may change the contents of the PPFM in the future for a variety of reasons including in response to new product launches, changes in the economic or business environment, regulatory changes or changes to the way we manage our *With-Profits business*.

If we change any of the Principles or Practices we will ensure we comply with the rules in place at that time.

Currently, unless we have permission of the *regulator* to change the Principles without the required notice, we must give our With-Profits policyholders written notice of any change to the Principles at least three months before the change is introduced.

We must also inform all With-Profit policyholders of any changes to the Practices within a reasonable time of the change being introduced.

2. The Amount Payable Under a With-Profits Policy

2.1 The Amounts Payable To Our With-Profits Policyholders

2.1.1 Principles

The aim of the Society when determining the amounts payable to with-profits policyholders is to ensure that policyholders are paid a fair return. That is, a return which reflects the smoothed experience of the assets backing their policy as well as the expense, demographic and taxation experience of the long-term business fund, over the term of their policy. Amounts payable are generally subject to certain contractual guaranteed amounts and also have regard to the Society's *own charge illustration* basis.

The Society's assets are divided between a long-term business fund and other assets whose primary function is to support the Society's general insurance business. The Society's intention, if at all possible, is to meet its aim of paying policyholders a fair return using only the assets of the long-term business fund. The long-term business fund supports the liabilities of the Society's *non-profit business* as well as those related to its *with-profits business*.

For *traditional with-profits business*, certain approximations are accepted by the Society in the application of the methods used to meet the aim to ensure a fair return is paid.

These approximations relate to practical constraints and the more important of them are:

- The adoption of a common *bonus series* for altered and unaltered policies.
- The assumption that the investment return earned in any one year is earned uniformly over that year.
- Inevitable timing delays in implementing changes to bonus rates.
- The need to avoid incurring undue administration costs by making frequent changes to surrender bases.

The Society will control changes to the methods used to meet the aim to pay policyholders a fair return by:

- Requesting and considering the advice of the *Actuary* and the *With-Profits Committee*.
- Following legal or regulatory requirements to obtain independent expert input where necessary.

In order to treat customers fairly, the Society will not change historical parameters underlying the calculations relevant to the methods used to meet the aim to pay policyholders a fair return unless, in the opinion of the Board:

- An error has been found which should be corrected, or
- A different approach is deemed to be more equitable, or
- Previous approximations can be replaced by more accurate information, or
- There has been a change in legislation (including tax legislation) which makes a retrospective adjustment appropriate, or
- In the case of credits for *miscellaneous items of surplus* if this is necessary to meet the long-term business fund's *capital resource requirement*

2.1.2 Practices

Policy Benefits – All policy types other than Capital Access Bond (CAB)

Our with-profits policyholders benefit from annual bonuses. The bonuses are payable only with the basic benefit, at the same time as the basic benefit and in the same form as the basic benefit. Once an *annual bonus* has been added to a policy, it is guaranteed in the same way as the basic benefit under the policy is guaranteed and it cannot subsequently be taken away provided that the policy continues in full force. With the exception of with-profit annuities, when the benefit under the policy becomes payable, a terminal bonus may also be added.

The traditional with-profits pensions we sold between 1st January 1983 and 30th June 1988 have an annuity guarantee. This means that the rate at which the accumulated fund, including all basic benefit, *annual bonus* and *terminal bonus* is converted to a pension has a guaranteed minimum value at each age. These guaranteed annuity factors are listed in the policy document. When a policyholder decides to take his/her pension benefits, we offer to convert the accumulated fund to a pension. The rate we use will be either the guaranteed factor applicable or our current market rate if this results in a higher pension. Policyholders do not need to ask us to apply the guarantee; it will be applied automatically if it results in a higher pension.

The guaranteed factors listed in the policy document only apply to the type of pensions described but the beneficial terms offered by the guarantee will apply irrespective of the form in which the pension is taken.

If a policyholder opts to take part of their fund as a tax-free lump sum, then we currently apply the beneficial terms offered by the guarantee to the tax-free lump sum. For example, if the guaranteed terms were 10% better than our current rates for a single life pension without escalation benefits we would enhance the tax free lump sum that would apply under our standard rates by 10%. We would also apply the beneficial terms to the reduced pension.

The minimum cost endowment policies sold from 1st January 1998 onwards provide a guarantee that proceeds of their policy will be at least equal to the amount of the guaranteed minimum death benefit.

The minimum cost endowment policies sold prior to 1st January 1998 do not include a guarantee that proceeds of their policy will be at least equal to the amount of the guaranteed minimum death benefit. We have applied a statement of intent to these policies that it is our intention that we will pay at least the guaranteed minimum death benefit upon maturity of the policy, for as long as circumstances permit. A small proportion of these policies were individually tailored so that the guaranteed minimum death benefit is greater than would ordinarily have been provided. These policies do not carry this commitment.

In order to ensure that policyholders are paid a fair return on their policy, *terminal bonuses* are set so that the maturity value of the policy reflects the profits earned by the policy over its term. We calculate these profits by reference to *asset shares*. The *asset share* for a policy is the theoretical amount that represents the sum which is built up by accumulating premiums in the fund at the achieved rate of investment return, after allowing for the effects of mortality, expenses, taxation and any charges for guarantees.

We maintain equity in maturity payments between different classes and generations of with-profits policies by calculating separate *asset shares* for each of them. We aim to ensure that, on average and over the longer term, the amount paid out on maturity, surrender and retirement 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*. As described below (in section 2.4.2) we would expect this to be broadly neutral over a ten-year period.

The amount paid on death under traditional with-profits endowment and whole of life policies is determined by a *terminal bonus* scale identical to that used on maturity.

All bonuses reflect the surpluses earned in relation to the long-term business fund. All future bonuses from long-term business funds depend on future profits and there can be no guarantee that they will be of any particular amount or, indeed, of any amount at all.

Our Actuarial department document the methods, assumptions and parameters used in determining the amount payable to with-profits policyholders.

Changes to the experience assumptions influencing *asset shares* will be made over time as a matter of course, as the experience of the long-term business fund and the Society changes.

The Board must approve any change to the current methods. If a change is made to the current assumptions or parameters used to determine the amount payable to with-profits policyholders, the change is approved by the *With-Profits Committee* and the Board, after considering advice from the *Actuary*. Our internal documentation will also be amended to reflect the change.

Systems are in place to ensure that the correct experience assumptions are used, with information being received from all relevant departments and available to the *With-Profits Committee*.

Policy Benefits – CAB

The benefit payable under a *CAB* is increased by a daily addition of contingent or notional amounts described as interim bonus. Each year the Board reviews these interim bonuses and a final bonus is added to the bond to replace them. The final bonus will usually be of the same amount as the total of the interim bonuses, but if conditions dictate the final bonus may be different e.g. if there is a default on an asset or if the long-term business fund's ability to meet its *capital resource requirement* is threatened even after receipt of a contingent loan. Once a final bonus has been added, it cannot subsequently be taken away. No further bonuses are added to a *CAB*.

The amount available for distribution to *Capital Access Bond* holders by way of final bonus reflects the actual investment returns on the assets backing the contract. After making an

allowance for tax and expenses, this return is passed on to the bondholders.

Methods and assumptions used to calculate asset shares

The methods we use to calculate asset shares are fully documented and are reviewed by our external auditors.

Investment Return

Undoubtedly, the main factor influencing the amount payable to with-profits policyholders is the size of investment returns. The rate of investment return credited to a with-profits policy will be the investment return on the long-term business fund assets backing that *Bonus Series*.

Investment Return – Non CAB

The investment strategy in relation to *asset shares* is to seek to maximise the total investment returns through a combination of income and capital gains from a wide spread of investments including equity shares, gilts and other fixed interest stocks and property, both within the UK and internationally, subject to being able to meet our *capital resource requirement*. It is the investment return on this portion of the long-term business fund that is credited directly to *asset shares.*

We may need to distinguish amongst different *Bonus Series* when selecting the appropriate assets to back *asset shares* having regard to the levels of guarantees provided.

Investment Return – CAB

The investment strategy in relation to that part of the long-term business fund attributable to *Capital Access Bond* holders is to invest the assets mainly in floating rate notes and cash. Bonuses allocated to *Capital Access Bonds* will then follow the investment performance of this mix of assets. If we chose to invest in other assets, the bonuses allocated to *Capital Access Bonds* would still continue to reflect investment returns on the matching assets.

Expenses

All long-term business funds incur operating expenses, in selling, underwriting, setting up new policies and in servicing existing policies. Expenses also include costs arising from the Financial Services and Markets Act and other consumer protection measures.

We split these expenses amongst all policies that form part of the long-term business fund and the level of expenses allocated to different policies is reviewed by our external auditors.

Expenses incurred due to activities that are not expected to recur year after year (e.g. large systems development projects) are excluded from the above and instead either charged to the long-term business fund's *inherited estate*, or amortised into expenses over a period determined by the Board, having received advice from the *Actuary*.

The expense assumptions or parameters in the asset share calculations for unitised with-profit policies are the charges set out in the policy conditions.

Tax

The part of the long-term business fund that is attributable to life assurance business is subject to tax on its investment income (including market value movements on bonds) and realised capital gains less relevant expenses. The investment return attributable to with-profits life assurance business policies is therefore reduced by the effect of this taxation. To preserve equity amongst policyholders an allowance for deferred tax on unrealised capital gains on equity shares and property is also provided in the *asset share* calculation.

However, we can offset nearly all of the expenses attributable to life assurance business against taxable income. This reduces the tax bill significantly and effectively reduces the expenses that are:

- Charged directly to *asset share for traditional with-profits business,* or
- Used when setting the explicit or implicit charges for business where *asset shares* are charged in this way.

Some approximation of the actual tax payable is necessary to determine *asset shares* and we use a best estimate of the tax for that purpose. For example, approximations apply to the allowance for unrealised capital gains (in particular the allowance made for indexation relief) and translating company level taxation to a product level. Any difference between the aggregate allowance for tax in the *asset share* calculations and the actual tax payable by the long-term business fund accrues to / is charged to the *inherited estate*.

Other Items

We currently apply no charge to *asset shares* for the use of capital, but reserve the right to do so prospectively for both in force and new business, if the Board decides, with the advice of the *Actuary*, that the growth in new business requires this. The form of any charge would be an overall reduction from the annual returns credited in the calculation of the *asset share*

We charge with-profits annuities and the NFU Mutual Vintage Bond for the cost of guarantees. We currently apply no similar charge for other business, however we reserve the right to charge, prospectively, for the cost of these guarantees, provided we have received advice from the *Actuary* that this is appropriate. The form of any charge would be an overall reduction from the annual returns credited in the calculation of the *asset share*. This method is used for with-profits annuities and the NFU Mutual Vintage Bond. Affected policyholders would be notified of the introduction of any charge for guarantees as a change in the practice of the PPFM.

Where a benefit is payable on death during the term of a traditional with-profits policy, in the early years of the policy this will normally be significantly more than the policy's *asset share*. A charge is made to the *asset share* of all policies with this benefit feature to cover the cost of providing this benefit.

As a mutual company we have no shareholders. As a result, any profits made can be paid out to with-profits policyholders, subject to sufficient assets being maintained to ensure that the long-term business fund remains financially strong. However, if the long-term business fund were to make any significant losses, we may have to reduce the return to with-profits policyholders.

The sources where profits or losses may arise include:

- *Non-profit business*.
- Investment profit and losses on assets attributable to the *inherited estate*.
- The release of reserves held in respect of the cost of guarantees offered on with-profits contracts.
- Profits and losses on non-profit and CAB business arising from mismatching assets and liabilities.

The annual return credited to *asset shares* may be enhanced or reduced to reflect the above.

2.2 Setting *Annual Bonus* Rates

2.2.1 Principles

All contract types other than CAB and With-Profit Annuities

The general aim in setting regular bonus rates for contracts other than with-profits annuities, is to establish an underpin to the policy's value on a claim arising which, in normal circumstances, will leave scope for the addition of a *terminal bonus*.

The Board may allocate to policy classes a different bonus rate to reflect differences in the tax treatment, the expenses, the explicit charges, the investment return on the assets backing the relevant *asset shares* and the nature and cost of guarantees. When assessing the nature and cost of guarantees regard will be had to any historical bonus rates added and the implication this has for projected future *terminal bonus* levels.

A new *Bonus Series* may be introduced into an existing product if the contract charges or contract design is amended in any way, or if, for any other reason the *annual bonus* rate falls materially below the level which is deemed appropriate for new business.

Bonuses will be restricted when the long-term business fund was reliant on a *contingent loan* to support its *capital resource requirement.*

With-Profits Annuities

For with-profits annuities, the aim in setting regular bonus rates is to target increases in the annuity payments in line with changes in the retail price index subject to the caveat described below in 2.2.2.

Bonuses would be restricted when the long-term business fund was reliant on a *contingent loan* to support its *capital resource requirement*.

CAB

The aim in setting regular bonus rates is to increase policy values in line with the total net of tax return earned on the assets deemed to be backing the contract (as described above) less a margin to cover the charges for expenses and any guarantees at a level considered sustainable in the long-term.

Different bonus rates may be applied to policies of different sizes to reflect differences in the underlying expenses.

A new *Bonus Series* may be introduced if the contract charges or contract design is amended in any way.

Bonuses will be restricted if the Board is satisfied that the long-term business fund's ability to meet its *capital resource requirement* is threatened even after receipt of a *contingent loan*.

2.2.2 Practices

Annual bonus rates are recommended by the *Actuary* and require formal approval by the Board. Our current *annual bonus* rates can be found on our website at www.nfumutual.co.uk in our PPFM Appendix.

All contract types excluding CAB and With-Profit Annuities

Our approach for *traditional with-profits business* is to set regular bonus rates once a year. Unitised with-profits bonus rates may be set more frequently.

We aim to target *annual bonus* rates before smoothing (smoothing is described in section 2.4) at a rate based on the following rules:

- For *traditional with-profits business*, *annual bonuses* are set so that when the declaration is considered across all of the portfolio of policies receiving the same bonus rate, the guaranteed return implicit in the sum assured plus the regular bonus broadly equals the total net of tax investment income on the underlying assets. However, consideration is given to the scope left for adding *terminal bonus* on policies becoming claims in the future by declaring this rate. If, by declaring this rate the scope left for *terminal bonus* is deemed insufficient or excessive (having regard to foreseeable adverse investment scenarios) then the above rate may be changed.

- For *unitised with-profits business*, *annual bonuses* are set broadly to equal the total net of tax investment income earned on the underlying assets plus an allowance for net of tax capital gains less the annual management charge less any charge for guarantees. The allowance made for capital gains will reflect the Board's opinion of the likelihood and amount of future capital gains and also whether, by declaring these rates, the scope left for *terminal bonus* on policies becoming claims in the future is deemed insufficient or excessive (having regard to foreseeable adverse investment scenarios).

In addition, the following rules apply for the product types described below:

- For Flexibond, NFU Mutual Vintage Bond and Shrewd Savings Plan ISA contracts the regular bonus rates declared are before any allowance for an annual management charge or any charge for guarantees. An explicit annual management charge and, for the NFU Mutual Vintage Bond, an annual charge for the guarantees is then deducted. This reduces the effective rate of regular bonus applied to the policy.

- Series 1 Personal Pension business has a guaranteed accumulation rate of 4% that underpins the rate declared for those policies.

- Series 1 Capital Investment Bond business has a guaranteed accumulation rate of 3% that underpins the rate declared for those policies.

- The NFU Mutual Vintage Bond has a guarantee that the *annual bonus*, after deduction of the annual management charge and annual charge for guarantee, will not be less than zero.

There is no guarantee on the level of *annual bonus* for other products that are not mentioned in the bullet points above, except that the *annual bonus* before the deduction of any charges can not be less than zero.

When a claim is made, an interim bonus may be payable. The interim bonus is the allowance for regular bonus from the time the last bonus was allocated to the time of claim. Interim bonus rates are set as a best estimate of the regular bonus rate that will subsequently be set at the next declaration. Interim bonuses are set once a year, but may be reviewed more frequently.

In normal circumstances, for *traditional with-profits business* we will not change *annual bonus* rates by more than 1% compound from the previous year's value. For unitised with-profits these limits are 1.5% for pensions and Shrewd Savings Plan ISA and 1.25% for Capital Investment Bond, Flexibond and NFU Mutual Vintage Bond. However, in circumstances where the long-term business fund is reliant on a *contingent loan* to meet its *capital resource requirement*, *annual bonus* rates may be cut more significantly.

With-Profits Annuities

Our approach for with-profits annuities is to set regular bonus rates once a year.

The aim in setting bonus rates, as set out in 2.2.1, is to target increases in the annuity payments in line with changes in the retail price index. However, the total accumulated *asset shares* for this class of contract is compared with the present value of expected future annuity payments. After considering the difference between these two values we may set an *annual bonus* rate that is higher or lower than this target.

A different *annual bonus* can be declared for each year's new business, with a year running for each 12 months following 1st April. The structure of these products is such that no interim bonus rate is declared.

CAB

Policyholders benefit from a daily addition of interim bonus to their bond. Our approach is to review interim bonus rates every month, although actual changes are generally made less frequently. Rates are set to reflect the current net yield on the underlying assets less a margin for expenses. This margin for expenses varies with the size of policy.

Rates can change sharply if the net yield on the underlying assets changes sharply. There is no upper ceiling on the change that can be implemented.

The declared *annual bonus* will usually be of the same amount as the total of the interim bonuses, but may be less in circumstances described in 2.1.2 under the section Policy Benefits – CAB.

2.3 Setting *Terminal Bonus* Rates

2.3.1 Principles

All contract types other than CAB

For with-profits annuities no *terminal bonus* is payable.

For contracts other than with-profits annuities, the scales of *terminal bonus* will be set so that benefits payable on maturity or surrender reflect fairly and proportionately a share in the profits (and losses) which have been generated within the long-term business fund from the policy whilst it has been in force, but not reflecting day-to-day fluctuations in the market value of the assets within the long-term business fund.

Separate *terminal bonus* scales may be applied to different *bonus series* to reflect the different aspects of the products in each *bonus series*, including their tax treatment, forms of benefits, guarantees and history of the addition of regular bonus rates, and the investments deemed to be backing each *bonus series*. No allowance is made, however, for the presence or absence of guaranteed annuity options. For most *bonus series terminal bonus* scales also differentiate between different dates of issue and different periods in force.

CAB

No *terminal bonus* is payable.

2.3.2 Practices

All contract types other than CAB and With-Profit Annuities

Our current approach is to set *terminal bonuses* twice a year. We will review *terminal bonuses* more regularly if the difference between payouts and asset shares becomes excessive due to market movements. *Terminal bonus* rates are recommended by the *Actuary* and are approved by the Board.

Terminal bonus scales are set to target payouts, in aggregate and over the longer term, of 100% of *asset shares* on maturity subject to the limits on maximum changes in payouts from one year to the next set out in 2.4.2.

On surrender, it is our aim to ensure that payouts are consistent with maturity values where possible. To achieve this aim we target surrender payouts close to 100% of *asset shares*, subject to a smooth blend of surrender values into guaranteed maturity values. We review our methods for determining surrender payouts regularly to ensure the methods are consistent with this aim.

It is current practice that policies that have been made paid up or altered in some way are awarded the same *terminal bonus* rates as those that continue in full force. For these policies, payouts may diverge from *asset shares*.

The amount paid on death under traditional endowment assurances and whole life policies is determined by a *terminal bonus* scale identical to that used on maturity. For traditional whole life policies, the surrender values are calculated to a formula that has regard to the death benefit payable and hence payouts can diverge from *asset share*.

It is current practice to declare separate *terminal bonus* scales for major classes of business. Within those classes, we set different rates for each term for *traditional with-profits business* and for each entry year for *unitised with-profits business*. We also set different terminal bonus rates for each bonus series and premium frequency.

Other types of policies will receive the most appropriate *terminal bonus* for their policy class. In particular, whole of life policies will be awarded the same terminal bonus rate as endowment assurances where there exists an appropriate set of endowment assurance *terminal bonus* rates. Where no appropriate set of endowment assurance terminal bonus rates exist separate *terminal bonus* rates will be calculated for whole of life policies.

For *unitised with-profits business* our practice is to ensure that *terminal bonus* does not result in a payout above 111% of the underlying *asset share* calculated for each single contribution, or series of regular contributions. If this were to occur, *terminal bonus* would be reduced to a level such that the payout equals 111% of the *asset share,* subject to the *terminal bonus* being a minimum rate of nil. We call this *terminal bonus* capping. Conversely we ensure that payouts are not below 85% of the *asset share,* for each single contribution, or series of regular contributions, by increasing *terminal bonus* if such a situation were to arise. We call this a terminal bonus rate floor. These adjustments can happen at any claim event.

For *unitised with-profits business* a *market value reduction* (MVR) may be applied if the economic circumstances justify this. *Market value reductions* may be applied on any type of claim except for the following:

- On retirement on the *Selected Retirement Date* or on death under a unitised with-profits Personal Pension Plan or with-profits Pension Plan.
- On the surrender on the tenth anniversary, switching between funds on the tenth anniversary, on regular withdrawals up to a maximum of 10% per annum of premiums paid in or on death under a unitised with-profits Capital Investment Bond.
- On regular withdrawals up to a maximum of 10% pa of premiums paid in or on death under a unitised with-profits Flexibond.
- On death under a Shrewd Savings Plan ISA.
- On the 5th anniversary of commencement and any subsequent 5th anniversary whilst the guarantee charge is still being paid and also on death at any time for a NFU Mutual Vintage Bond.

The rules for calculation of whether a *market value reduction* applies and its relative size are, except in the circumstances described below, as follows:

- If the *asset share* underlying the contract falls below a figure, currently 85% of the value of units including declared and interim *annual bonuses*, then the amount payable will be adjusted downwards to the *asset share*.
- If the *asset share* is between 85% and 90% of the value of units including declared and interim *annual bonuses*, then the amount payable will be interpolated such that it is the value of units including declared and interim *annual bonuses* at 90% and the *asset share* at 85%. In other words, if the *asset share* is 87.5% of the value of units including declared and interim *annual bonuses*, then the amount payable will be 50% of the value of units plus 50% of the *asset share*.
- In the case of a retirement, switch or transfer out within three years of the *selected retirement date* for a unitised with-profits Personal Pension Plan or with-profits Pension Plan, the amount of any MVR applied will be reduced so that the MVR is smoothed in over the 3 years prior to the *selected retirement date*. The proportion of the standard MVR which is applied reduces linearly from 100% 3 years before *selected retirement date* to 0% on the *selected retirement date*.

The rules covering *market value reductions* described in the three bullet points above would not apply:

- Where the long-term business fund was reliant on a *contingent loan* to support its *capital resource requirement*.
- If, in the opinion of the Board acting with the advice of the *Actuary*, there was an exceptional increase in discontinuance rates.

In either of these circumstances a *market value reduction* would apply more generally than as described above, but not to reduce payouts below *asset share*.

Market value reductions are calculated for each single contribution, or series of regular contributions, separately. It is possible that, for example, a *market value reduction* will be applied to one contribution whilst a *terminal bonus* is applied to another contribution. However, a *terminal bonus* and a *market value reduction* cannot apply at the same time on the same single contribution or series of regular contributions.

CAB and With-Profit Annuities

No *terminal bonus* is payable and no *market value reduction* can be applied.

2.4 Smoothing The Value Of Policies

2.4.1 Principles

All contract types other than CAB

The smoothing policy will aim to operate so that under and overpayments relative to the basic target pay-out level before smoothing will be balanced out over time.

The extent of smoothing will be constrained where the long-term business fund is unable to meet its *capital resource requirement* without the benefit of a *contingent loan*.

For *traditional with-profits business* the extent of smoothing applied on claim values, other than on death or maturity, will generally be less than that applied on death or maturity. This is to maintain fairness between policyholders voluntarily exiting the fund, and those remaining in it.

For *unitised with-profits business*, as described in 2.3.2 *market value reductions* may be applied to certain claims to maintain fairness between policyholders exiting the fund and those remaining in it. *Market value reductions* will only reflect the effects of movements in the value of assets backing the relevant contracts.

For with-profits annuities there is no *terminal bonus* and hence smoothing is much broader than for other classes of business.

CAB

No significant smoothing of bonuses takes place.

2.4.2 Practices

Smoothing applies in two ways:

Implicitly:

- Policies are grouped by entry year or term in force for the purposes of setting *terminal bonus* rates
- Appropriate specimen policies are used to represent each group of actual policies when *terminal bonus* rates are calculated
- *Terminal bonus* rates remain unchanged between declaration dates
- Minor classes of business are allocated the same bonus rates as for a similar major class

Explicitly:

- *Terminal bonus* rates are intentionally set to target payouts greater or less than 100% of *asset share*, in order to reduce the volatility of payouts

The smoothing practice differs to some degree for with-profits annuities, other *traditional with-profits business* and *unitised with-profits business*.

For with-profits annuities *annual bonus* is targeted to reflect changes in the retail price index, which may be volatile.

Our practice for smoothing other *traditional with-profits business* is that for policies of the same original term maturing in successive years:

- If the *asset share* and the previous year's payout differ by less than 10%, then changing payouts to equal the *asset share* would be considered acceptable (subject to acceptable smoothing of payouts of policies of different original terms discussed below).
- If the *asset share* and the previous year's payout differ by more than 10% then under normal circumstances changing payouts to equal the *asset share* would not be considered acceptable and a lesser percentage change would be enacted.
- Only in the circumstances described as constraining the extent of smoothing described above would payouts be changed by more than 25% from one year to the next.

These numerical limits on movements apply to the generality of policies; it is, however, possible that an individual policy has a change in policy value beyond this limit due to circumstances unusual to that policy. For

example, the payout on an altered policy may change by more than an unaltered policy when the same *terminal bonus* rate change is applied to both policies.

As well as smoothing payouts from one year to the next, for traditional with-profits policies we also aim to smooth payouts between policies of different terms. This is achieved by ensuring that the yields to the policyholder on policies of similar terms are not too divergent. This means that in order to smooth out yields for policies of certain terms, we may target payouts of greater than 100% of *asset shares* whilst for policies of other terms payouts may be targeted at less than 100%.

The surrender and transfer bases for *traditional with-profits business* are smoothed to some extent. Surrender and transfer value bases are reviewed at the same time as *terminal bonus* rate changes on maturity values to ensure consistency between maturity and surrender payments.

However, the degree of smoothing applied may be less than on claims that occur due to death or maturity. We aim to smooth surrender and transfer values into maturity values so that policies with a short remaining term to maturity will have surrender or transfer values that reflect, to some degree, the smoothing currently being operated on maturity values.

Our practice for smoothing unitised with-profits policies of the same term maturing or being surrendered in successive years is to a large degree the same as for *traditional with-profits business*. The key difference is that whilst smoothing rules are applied when assessing bonus rates, the interaction of *terminal bonus* caps and floors or *market value reductions* can lead to changes outside of these parameters for individual policies.

When *market value reductions* are applied on *unitised with-profits business*, as described in 2.3.2, in general no smoothing is applied and the policy receives its *asset share*. The exceptions to this are:

1. Where the *asset share* is between 85% and 90% of the value of units including declared and interim *annual bonuses*.

2. For unitised with-profits Personal Pension Plans or with-profits Pension Plans within three year of the Selected Retirement Date.

The details of how the smoothing is applied are described fully under section 2.3.2.

Unitised with-profits Flexibond policyholders are contractually entitled to withdraw up to 10% pa of the premiums invested without incurring a *market value reduction*. Similarly it is current practice, although not a contractual guarantee, that CIB policyholders are allowed to do the same. When a policyholder affects a withdrawal in a situation where a *market value reduction* would otherwise have applied, the same proportion that the withdrawn amount bears to the total policy value is cancelled from the underlying *asset share*. In other words, in a situation where a *market value reduction* would otherwise have applied, the amount cancelled from the *asset share* is less than the withdrawn amount.

We do not operate an overall limit on the accumulated cost of or excess from smoothing, but would expect smoothing to be broadly neutral over a ten year period.

The smoothing practice is not affected by the accumulated cost or excess from prior smoothing. However the extent of smoothing would be constrained if:

- The long-term business fund was reliant on a *contingent loan* to meet the solvency requirements of the *regulator*, or

- The Board believed that the *estate* was at a level that was deemed to be unnecessarily high or low.

- The Board was not satisfied that the overwhelming majority of maturity and surrender payments (excluding those where the guaranteed benefits already exceed *asset share*) would fall within the following target ranges, expressed as a percentage of unsmoothed *asset share*:

Traditional with-profits business: 75% to 125%

Unitised with-profits business: 80% to 120%

3. INVESTMENT STRATEGY

3.1 Principles

Non CAB

The investment strategy of the long-term business fund is to seek to maximise the total investment returns through a combination of income and capital gains from a wide spread of investments. This, however, is subject to any constraints reflecting the level of guarantees granted and the ability of the long-term business fund to meet its *capital resource requirement* together with any other capital requirements of the *regulator* which the Board has not agreed can be met by the Society's "other than long-term assets". Different *bonus series* may have different asset backing reflecting differing levels of guarantees.

Where the Board has agreed, the Society may rely on the appropriation of assets from the "other than long-term assets" to support the solvency position of the long-term business fund. The agreement will lay down the circumstances in which the assets would be transferred to, and subsequently withdrawn from, the long-term business fund by way of *contingent loan* and the extent to which the transferred assets could be taken into account when setting investment strategy.

Derivatives and other instruments may be used within limits set by the Board to match particular liabilities for example liabilities under guaranteed annuity rates or to protect the fund against sudden or sharp movements in asset values. They may also be used to change exposure to asset classes in a tax or cost efficient manner. Investments in *derivatives* are not made for speculative purposes. Stocklending within limits set by the Board may take place with the long-term business fund benefiting from any fees earned.

The Board sets aggregate counterparty exposure limits which over-ride other investment considerations.

CAB

The investment strategy for the CAB is to invest mainly in cash on deposit, floating rate notes and certificates of deposit.

Non Traded Assets

The Society invests some of the assets comprising the long-term business fund in certain non-quoted equity investments. These are non-quoted equity shares selected purely for their investment potential and certain subsidiary companies of the group of which the most significant is a 50% holding in NFU Mutual Unit Managers Ltd. Investments are made in the latter in order that those companies can provide the appropriate benefits to the Society's customers, i.e. to enable the Society to write unit trusts, PEP, ISA and open ended investment company business. The long-term business fund's investment in NFU Mutual Unit Managers Ltd is not of a size to have any material impact on the amounts payable to with-profits policyholders.

3.2 Practices

3.2.1 The Board sets the overall investment risk appetite for the long-term business fund and sets the Investment Limits of Authority after considering the overall position of all of the Society's funds under investment and the financial strength of those funds, both individually and in aggregate. The Investment Limits of Authority set:

- Limits on the concentration of investment in any one company
- Rules on the minimum spread of investments within funds
- Limits on exposure to overseas equity markets
- Limits on underwriting commitments on new issues
- Counterparty approval
- Limits on *derivatives* use
- Investment grade guidelines for bond purchases
- Stocklending limits
- Property transaction size limits
- Any other limits deemed appropriate by the Board

The Board delegates responsibility for the investment strategy of the long-term business fund within the agreed risk appetite to the *Market Risk Committee*. At least quarterly, the *Market Risk Committee* will:

- Review the movements in the relevant securities markets
- Review the liquidity and cashflow position of the long term business fund
- Review recent investment activity

- Review the long-term business fund performance against suitable benchmarks and portfolio risk profiles

- Review domestic and global economic background

- Set an investment policy and asset profile appropriate to the risk appetite.

In carrying out these duties, the *Market Risk Committee* will take advice, where appropriate, from the *With-Profits Committee* and the *Actuary* with regard to:

- Appropriate asset allocation limits for *asset shares* for different classes and generations of policyholders

- Policyholder reasonable expectations and compliance with both the PPFM and the regulatory regime for with-profits policyholders.

Information regarding the investment strategy being followed for our with-profits business, in particular the latest operating bands and asset allocation of asset shares, can be found on our website (www.nfumutual.co.uk,) or in our PPFM Appendix.

3.2.2 Our investment management team has discretion to select individual assets with the aim of maximising investment return within the overall investment strategy set by the *Market Risk Committee* and subject to the Investment Limits of Authority approved by the Board. Investing outside the Investment Limits of Authority, including investment in new or novel instruments, would require initial sanction of the *Market Risk Committee* and approval by the Board.

3.2.3 We do not operate a strategy of precisely matching with-profits liabilities. The extent to which liabilities are not precisely matched will reflect the risk that the Board concludes the long-term business fund can run whilst still meeting its solvency requirements defined as its capital resource requirement together with any additional capital requirements of the regulator.

We back our non-linked *non-profit business*, including our non-profit annuity business, with appropriate fixed interest and index-linked assets to broadly match the liabilities.

3.2.4 No investments are made in sub-investment grade bond assets. If any investments held are re-rated as sub-investment grade then these will not automatically be sold, but they are subsequently monitored carefully and sold if this is considered to be in the best interests of the with-profits policyholders.

3.2.5 We invest some of the assets of the long-term business fund in assets that would not normally be traded. These assets include physical assets such as our head office buildings and fixed assets. They also include investments in certain non-traded assets as described in section 3.1. The investment return earned on the non-traded assets is included in the *asset share* return or is allocated to the *inherited estate* and therefore contributes to the payouts as described in section 2 of the PPFM. Investing in non-traded assets does not impose any constraints on the firm's investment freedom.

3.2.6 The Board has agreed that £500m of "other than long-term assets" is available both to transfer into the long-term business fund and to back additional capital requirements of the regulator. The *Actuary* may request a transfer of up to this amount in the form of a *contingent loan*, if there is a reasonable likelihood that the long-term business fund will not be able to meet the capital requirements of the *regulator*. The *contingent loan*, with interest, would be repaid if the long-term business fund's solvency had recovered to the extent that there was no reasonable likelihood of being unable to meet the capital requirements of the *regulator* in the following twelve months. The long-term business fund would be managed with the aim of securing, with a high probability, repayment of the loan and hence investment and bonus policy would be modified to achieve this result.

4. BUSINESS RISK

4.1 Principles

All policy types other than CAB

As members of a mutual society, the with-profits policyholders (not CAB policyholders) are entitled to the profits and must meet the losses arising from the business activities of the long-term business fund. These arise mainly from the profits or losses emerging from the writing of non-profit policies, from any under- or over-payment of benefits on with profits contracts, and from any other business activities of the long-term business fund.

The Society seeks to limit mortality risk arising on term assurance, critical illness and impaired life annuity business by means of reinsurance arrangements.

The exposure of the *with-profits business* to business risks arising from the application of charges and the apportionment of expenses in relation to *with-profits business* is described in 5.1. In normal circumstances any excess of the actual expenses over the charges applied to with-profit policyholders will accrue to the *inherited estate*, which will usually bear the excess. However, should the long-term business fund be unable to meet its *capital resource requirement* without the benefit of a *contingent loan* then the excess arising during the period of the *contingent loan* will be reallocated to all with-profits policyholders.

The long-term business fund bears the residual risks associated with the cost of guarantees provided on with-profits policies exceeding any explicit charges made in the *asset share* calculation. These excess guarantee costs will accrue to the *inherited estate*, which will normally bear the costs of meeting them. However, should the long-term business fund be unable to meet its *capital resource requirement* without the benefit of *contingent loan* then the excess costs of guarantees arising during the period of the *contingent loan* will be reallocated to all with-profits policyholders. The limits on accepting new *with-profits business* are addressed below.

The long-term business fund is exposed to the risks of acquiring and maintaining *non-profit business*. The Society will only write such business in the longer term if it is believed that the contribution to expenses from the business meets or exceeds the costs of writing and maintaining the business.

The long-term business fund will only invest in non-quoted group companies providing that the overall expected return on those investments is better than that expected on an investment in similar quoted companies or as described in 3.3 where the group company provides benefits to the Society's customers and the investment is not material in the context of determining benefits payable to with-profits policyholders.

Any costs incurred by the long-term business fund in fines, redress or compensation awards will be borne by the *inherited estate*. However, should the long-term business fund be unable to meet its *capital resource requirement* even with the benefit of a *contingent loan* then these costs will fall to be charged to all with profits policies.

CAB

CAB policyholders do not benefit from profits arising from miscellaneous sources, nor are they liable to losses occurring.

4.2 Practices

4.2.1 The Executive Risk Committee recommends to the Board the Group's strategy and policy/philosophy for risk management, and monitors its adoption throughout the Group. The Executive Risk Committee reviews the processes and procedures for ensuring all business risks are properly identified and appropriate systems of monitoring and control are in place under the categories Market, Insurance, Credit, Liquidity, Operational and Group. This includes reviewing the procedures for identifying business risk and controlling their financial impact.

When considering whether to undertake a business risk we will consider factors including:

- Whether the business risk will provide a suitable return above the risk free rate to our policyholders
- Our current financial strength
- Size of potential impact on the *inherited estate* and our ability to meet our *capital resource requirements*
- Our exposure to existing business risks

We will only undertake a significant business risk after approval by the Board.

4.2.2 The circumstances in which we will limit the acceptance of new business are detailed in section 7.1.

4.2.3 We regularly review the profitability of the existing *non-profit business* in the long-term business fund. This includes assessing

the adequacy of charges for these contracts and considering whether the charges need to be adjusted. Current practice is to broadly match non-linked *non-profit business* with bonds (nominal or index linked as appropriate) and cash to minimise market risk.

4.2.4 Other than in relation to CAB policies, the profits and losses arising from business risks in the long-term business fund are either included in the *asset share* return calculation or are allocated to the *inherited estate*. Where the profits and losses are included in the *asset share* return calculation, they impact directly on the payouts to with-profits customers. Where the profits and losses are allocated to the *inherited estate* they may affect the amount payable to with-profits policies via an increase or decrease to *asset share* returns in some years. This is described in section 2.1.2.

5. CHARGES AND EXPENSES

5.1 Principles

The Society aims to apportion expenses to its *with-profits business* and amongst different classes of *with-profits business*, in a way that is fair and reflects the actual expenses incurred in selling and administering each class of business (having regard to the relative time taken to process transactions) and managing its investment portfolio. For *traditional with-profits business* (other than with-profits annuities), expenses apportioned to the relevant classes of business are then allocated to individual policies when setting bonus rates. The allocation to individual policies has regard to any policy fee payable; the policy fee is deemed to cover those expenses unrelated to the size of the policy.

When setting bonus rates for *unitised with-profits business*, CAB and with-profits annuities the Society will apply any explicit charges specified in the policy documentation (subject to the comment below about changing these charges) and implicit charges on those contracts where explicit charges are not specified. To the extent that charges and expenses differ, then the difference will, initially, be charged to / credited to the *inherited estate*. However, as described in 4.1 in certain circumstances any charge to the *inherited estate* can be recharged to all with-profits policyholders.

If the Board judged that the basis on which expenses are apportioned to classes of business had become inequitable, it may exercise discretion to revise the apportionment. For example, the basis could require amendment on this account if there was a change in the way the Society sells or administers its business, such as a new distribution channel, or use of out-sourced services.

The Board may increase charges applied to *unitised with-profits business*, CAB and with profits annuities if the expenses of administering the relevant business are not met by the allowance for administration expenses within the charges. However, no increase may be made in order to recoup excess acquisition expenses which the Board has agreed should be written off when calculating *own charge illustrations*.

5.2 Practices

5.2.1 The charges that we apply to unitised with-profit policies are those described in the relevant policy documentation. These charges may include:

- A deduction from premiums invested.
- An annual management charge.
- An annual per policy charge.
- A monthly charge to cover the cost of life cover and waiver of premium benefits.
- Surrender charges when withdrawals are taken in the early years of a policy.
- A charge for guarantees

More details about the charges that apply to different products are included in section 4 of the PPFM appendix that is available on our website (http://www.nfumutual.co.uk/).

The charges for unitised with-profits policies are reviewed regularly by the *Actuary* to ensure that they are appropriate to cover the expenses allocated to the relevant class of business. If the *Actuary* believes that the charges are no longer appropriate for the expenses of any class of business, the *Actuary* will submit a recommendation to the Board that the charges are altered.

Any difference between the charges applied to *unitised with-profits business* and the expenses incurred for those policies is charged or credited to the *inherited estate*. However, as described in 4.1 in certain circumstances any charge to the *inherited estate* can be recharged to all with-profits policyholders.

5.2.2 The following description excludes the *non-recurrent expenses* which, as described in 2.1.2, are charged to the *inherited estate* or amortised into expenses over a period determined by the Board.

As described in section 2.1.2 the long-term business fund incurs operating expenses, in selling, underwriting, setting up new policies and in servicing existing policies. We split these expenses amongst all policies that form part of the long-term business fund. The expenses are split into acquisition and maintenance expenses. Where expenses cannot be directly allocated to a type of product, the expenses are allocated by the most appropriate method for the specific type of expense being considered. Examples of the methods used include splitting expenses in proportion:

- to premium income weighted by sales force remuneration
- to number of new policies sold
- to number of policies in force

- to time taken to process business
- to head count

For *traditional with-profits business*, expenses apportioned to the relevant classes of business described above are then allocated to individual policies by deducting the expenses from the *asset share* of the policy as described in section 2.1.2. The expenses are reviewed by the *Actuary* and our external auditors.

5.2.3 We charge with-profits annuities and our NFU Mutual Vintage Bonds for the cost of guarantees. We currently apply no similar charge for other business, however we reserve the right to charge, prospectively, for the cost of these guarantees, provided we have received advice from the *Actuary* that this is appropriate. The form of any charge would be an overall reduction from the annual returns credited in the calculation of the *asset share*.

5.2.4 There are currently no circumstances under which the long-term business fund will be charged at an amount other than cost. We outsource services if there is a benefit to our policyholders, for example where cost benefit analysis indicate that this would result in an expense saving to the long-term business fund when compared to keeping the service in-house. Any out-sourced services are reviewed regularly.

5.2.5 The Society's overheads are apportioned between the Life and General Insurance business and a number of subsidiary operations. The apportionment will reflect the nature of the overhead – for example the Society's human resource costs are apportioned in proportion to the number of employees in each area of the business.

6. MANAGEMENT OF THE INHERITED ESTATE

6.1 Principles

The *inherited estate* provides the working capital of the long-term business fund. It is managed in such a way that there will be a sufficiency of working capital in the future in foreseeable circumstances. The primary uses of the *inherited estate* include:

- Supporting the smoothing of benefits paid to with-profits policyholders.
- Providing statutory capital to meet reserving requirements and *capital resource requirements* and any additional capital requirements deemed necessary, in addition to the statutory minimum, to reflect risks run by the Society and new business plans.
- Providing working capital to cover any mismatch in timing between the receipt of charges applied to the policies in the long-term business fund and the actual expenses incurred in the acquisition and maintenance of those policies.
- To meet the costs of policy guarantees and guarantees and other statements of intent provided to mortgage endowment policyholders that the proceeds of their policy will be at least equal to the amount of the guaranteed minimum death benefit.
- To meet the expenses of policies which exceed the charges made to those policies and which, in the opinion of the Board, are more appropriately met from the *inherited estate*.
- To meet any exceptional costs in managing the *with-profits business* arising as a result of legislation, taxation or other circumstances which, in the opinion of the Board, should not be charged directly to policyholders.
- To provide capital to support writing *non-profit business*.

The Society does not aim for a particular size or scale of *inherited estate*. The Board satisfies itself that the size is sufficient to support the business plans of the Society having regard to regulatory requirements. Any excess in *inherited estate* on this basis would be distributed to with-profits policyholders.

The Society has only one long-term business fund and hence the *inherited estate* is attributable to that fund. There has been one transfer of business into the long-term business fund, of the subsidiary company Avon Insurance Plc's long-term business fund, which has not given rise to any constraint in the Board's freedom to deal with the *inherited estate*.

6.2 Practices

The *inherited estate* is used to:

- Smooth benefits being paid to with-profits policyholders.
- Provide statutory and working capital including capital support to write *non-profit business*.
- Provide investment freedom. A strong *inherited estate* enables us to invest a higher proportion of the long-term business fund in more risky assets, such as equities and property, which have the potential for higher investment returns.
- Meet the costs of guarantees (and statements of intent to mortgage endowment policyholders) that are unable to be funded from the accumulation of deductions made from policies for that purpose.
- Meet the excess of expenses over charges to with-profits policies.
- Meet any compensation payments.
- Meet any 'one-off' exceptional expenses.
- Provide working capital for operational projects and business risks.

The Board does not aim for a particular size or scale of *inherited estate*. In the event of the *inherited estate* becoming excessive, the Board, after advice from the *Actuary*, would decide on a suitable distribution, including an appropriate period over which the excess would be distributed. The Board would have regard to policyholder reasonable expectations and the nature of the different classes of with-profits policies, including consideration of the level of guarantees already attaching. In the event of the *inherited estate* becoming too small, the Board would take whatever action was deemed appropriate to ensure we continued to meet our regulatory capital requirements. Appropriate actions could include a change in asset allocation, reducing the returns credited to *asset shares* as described in section 2.1.2 or the use of a *contingent loan*.

The investment strategy for the *inherited estate* is regularly reviewed with the aim of maximising investment return subject to policyholder reasonable expectations and the overriding principle of managing the risk of failure to meet the *capital resource requirement* and any additional capital requirements identified by the *regulator* or by internal capital assessments of the Board.

As such, the investment strategy for the *inherited estate* may differ from the strategy for the *asset shares* and for the rest of the long-term business fund. In particular, *derivatives* and/or *contingent loans* may be used to facilitate the stated strategy.

7. Volumes of New Business and Arrangements on Stopping Taking New Business

7.1 Principles

All policy types other than CAB

If the volume of new with-profits business is sufficiently high that the capital strain being placed on the long-term business fund threatens either its solvency or the benefit expectations of with-profits policyholders then the Board may choose to limit the volumes of one or more category of new contract being written. If, on the other hand, the volumes of new business are sufficiently low that the burden of expense makes a contract non profitable or non-viable then the Board may choose to withdraw the contract from sale.

Other changes may occur in, for example, the regulatory environment or in taxation which would make a contract non-viable in which case the Board may choose to withdraw the contract from sale.

Should the Board decide that it would be appropriate to withdraw completely from the sale of new business, there would be several consequences:

- The investment policy would be reviewed and it might be considered appropriate to realign investments by, for example, selling equity shares and buying fixed interest investments and derivatives to match closely any guarantees.
- The extent that payments were being smoothed would be reviewed.

The inherited estate would be managed for the continuing benefit of the remaining with-profits policyholders and distributed to them over time subject to retaining sufficient capital within the long-term business fund to meet the capital resource requirement and any additional capital requirements imposed by the regulator. As the outstanding duration of in-force policies is very long, the inherited estate would continue to exist and be applied to policyholder benefits for many years.

CAB

If the Society has chosen to accept an investment mismatch, the Board may choose to limit the risks being taken by other with-profits policyholders by placing a limit on the amount of investment it will accept in CAB policies. If, on the other hand, the volumes of new business are sufficiently low that the burden of expense makes the contracts not profitable or non-viable then the Board may choose to withdraw the contract from sale.

Other changes may occur in, for example, the regulatory environment or in taxation which would make the contract non-viable in which case the Board may choose to withdraw the contract from sale.

7.2 Practices

There are currently no explicit constraints on the volume of new business that may be accepted into the long-term business fund. However, projections of solvency are carried out at least annually, using various modelling techniques, to ensure volumes of new business do not threaten the financial soundness of the long-term business fund.

We may set a maximum volume for sales of a specific product or campaign if the product offers significant guarantees or involves other risks. The Board would set the maximum limit after considering the risk to the solvency of the long-term business fund from selling the product.

We currently have an upper limit in place, which means we would not make any further sales of our NFU Mutual Vintage and NFU Mutual Classic Bonds if the combined value of in force business for both bonds exceeded a certain amount. This is due to the capital intensity of the guarantees the products offer. The limit is regularly reviewed.

There are a number of reasons other than solvency constraints why we may choose to permanently stop selling a particular product. These reasons include:

- Changes in regulation, legislation or taxation rules
- Low volumes of sales
- Product strategy changes

In addition there are reasons why we may choose to temporarily stop or start selling particular products. For example the appropriate charge for guarantees in the NFU Mutual Vintage and NFU Mutual Classic Bonds is sensitive to market conditions. The required level of charge may make the product commercially unviable and as a result we may choose to temporarily stop or start selling this product.

The Society is a company limited by guarantee and is owned by its members. Membership of the Society is conferred by the issue of a policy (including with-profits, non-profit and general insurance). The long-term fund’s inherited estate is available to support the writing of

non-profit business and therefore there is no minimum scale of new business of a with-profits type required to justify the long-term fund remaining open to new business.

8. Shareholders

8.1 Principle

The fund is a mutual fund with no shareholders. All profits or losses arising within the long-term business fund are attributable to with-profits policyholders.

9. Glossary

ACTUARY	The Society's With-Profits Actuary. The Actuary acts as an advisor to the With-Profits Committee.
ANNUAL BONUS (Also known as regular bonus)	A bonus which is added on a regular basis throughout the life of a with-profits policy, providing an addition to the guaranteed benefits payable to the policyholder.
ASSET SHARE	The theoretical amount which represents the sum which is built up by accumulating premiums in the fund at the achieved rate of investment return, after allowing for the effects of mortality, expenses, taxation and any charges for guarantees. The achieved rate of investment return may have been enhanced / debited with the profits / losses on non-profit business for years prior to 2004 and may, from 2004, be enhanced / debited with items related to credits from the estate / debits for the cost of business risks as explained in the PPFM. The enhancements / debits represent the miscellaneous items of surplus.
BONUS SERIES	A group of policies for which the same set of bonus rates is declared.
CAPITAL ACCESS BOND (CAB)	An investment bond designed to mimic the performance of a deposit account.
CAPITAL RESOURCE REQUIREMENT	An amount over and above the actuarial reserves which we are required to hold by the FSA's Prudential Sourcebook for Insurers.
CONTINGENT LOAN	A loan made into the long-term business fund, where repayment is conditional upon a satisfactory solvency position, where this is defined in the loan agreement.
DERIVATIVES	A generic term for financial instruments used in the management of investment and other risks, including futures contracts, forwards, swaps and options.
EXECUTIVE RISK COMMITTEE	The Committee that recommends to the Board the Society's strategy and policy/philosophy for risk management and monitors its adoption throughout the Society.
(INHERITED) ESTATE	The excess of the total assets of the long-term business fund over the amount required to meet future liabilities to non-profit and with-profits policyholders and other obligations of the long-term business fund.
MARKET RISK COMMITTEE	The Committee that is responsible for setting an appropriate investment risk appetite and strategy for the Society. The Committee is ultimately accountable to the Board.
MARKET VALUE REDUCTION	A discretionary mechanism that reduces the surrender or transfer value or payment on retirement at other than the Selected Retirement Date under a unitised with-profits contract below the level of the accumulated fund. The terms of the contract will specify the circumstances when a market value reduction cannot be applied. The expression Market Value Adjuster is often used to describe the same mechanism.

MISCELLANEOUS ITEMS OF SURPLUS	See definition of asset share.
NON-PROFIT BUSINESS	Those policies, written in the long-term business fund, where the policyholder has no right to participate in bonus distributions.
NON-RECURRENT EXPENSES	Expenses incurred due to activities that are not expected to recur year after year, e.g. large systems development projects.
OWN CHARGE ILLUSTRATIONS	The basis used by the Society to provide illustrations of future benefits on prescribed rates of investment return, having regard to the Society's view of future charges, expenses and insurance risk.
REGULATOR	The Financial Services Authority or any successor body.
SELECTED RETIREMENT DATE	The date specified in the policy document of a unitised with-profits policy as the date on which guaranteed benefits become payable.
STOCKLENDING	An arrangement by which legal ownership of an asset is sold to a counterparty, but with a short term agreement for repurchase so that economic exposure to the original asset is retained. The counterparty will supply collateral in respect of the obligation under the repurchase agreement.
TERMINAL BONUS	A bonus that is added to a policy only on termination of the contract.
TRADITIONAL WITH-PROFITS BUSINESS	With-profits business that is not unitised with-profits business or the Capital Access Bond.
UNIT-LINKED BUSINESS	Those policies where the benefits are linked to the value of units in a specifically defined fund. Some policies may contain some unitised with-profits benefits and some unit-linked benefits in which case the relevant parts of the policy form unitised with-profits and unit-linked business respectively.
UNITISED WITH-PROFITS BUSINESS	With-profits business where the benefits are expressed in terms of numbers and price of notional units. Some policies may contain some unitised with-profits benefits and some unit-linked benefits in which case the relevant parts of the policy form unitised with-profits and unit-linked business respectively.
WITH-PROFITS BUSINESS	Those policies where the benefits depend on bonus additions made throughout the term of the policy and possibly a bonus addition at the end of that term.
WITH-PROFITS COMMITTEE	The subordinate committee to the Society's Board that is charged with monitoring ongoing compliance with the Principles and Practices set out in this document.