2010 Report to With-Profits Policyholders on the Society's Compliance with its Principles and Practices of Financial Management

NFU Mutual

Summary

The Board of the National Farmers Union Mutual Insurance Society Limited (the Society) has reviewed the management of the Society's with-profits business for the 2010 financial year (1 January 2010 – 31 December 2010) and is satisfied that it has met its obligations as set out in the Principles and Practices of Financial Management (PPFM).

In reaching this conclusion due regard has been paid to the advice received from the Society's With-Profits Actuary.

Sir Don Curry
Chairman

L N Sinclair
Group Chief Executive

Introduction

It is a legal requirement for directors of insurance companies that write with-profits business to provide policyholders with an annual statement that explains how the business was managed during the year.

The overarching guidelines that describe how we manage the Society's Long Term Business Fund are fully documented in the Principles and Practices of Financial Management (PPFM). This report (covering the period 1 January 2010 to 31 December 2010) sets out how we have complied with the PPFM and also provides a summary of the key decisions (e.g. bonus declarations) that have impacted with-profits policyholders during the year.

When reading this report you may find it helpful to refer to the Society's PPFM and, in particular, the section containing the glossary of terms. The PPFM is available on our website www.nfumutual.co.uk.

Governance of With-Profits Business

The Society has two key roles to provide reassurance that our with-profits business is being managed in accordance with the Society's PPFM – the With-Profits Committee and the With-Profits Actuary.

The With-Profits Committee is a sub group of the Society's Board that is responsible for monitoring on-going compliance with our PPFM. During 2010 it comprised three of the Board's non-executive directors and two executive directors. The Committee met four times during the year and the Committee chairman reported formally to the Board on its proceedings after each meeting.

From 1 January 2010 Mr Christopher Ide (BSc, ARCS, FIA) replaced Mr Alan Frost (DL, BSc, FIA) as one of the non-executive directors of the With-Profits Committee.

The With-Profits Actuary is responsible for providing the Board with advice on all areas of discretion as they relate to the fair treatment of with-profits policyholders. This includes making recommendations regarding bonus rates, reviewing communications to policyholders and ensuring the interests of with-profits policyholders are taken into account in a fair and balanced way.

The With-Profits Actuary is also required to comment on the Board's actions with regard to with-profits business and his annual statement can be found in the Appendix to this report.

Compliance With the PPFM During 2010

Payouts and Bonus Rates

Asset share values, on which payouts are based, were calculated during 2010 using the methods described in the PPFM.

Annual bonus rates were declared for 2009 in April 2010. For both traditional and unitised with-profits contracts, the declared rates were equal to the interim rates in force during 2009.

At the same time new interim bonus rates were set to take effect from 1 April 2010. For traditional with-profits contracts the new interim rates were set at the same level as the declared rates for 2009. For unitised with-profits contracts the interim rates were set at the same level as the declared rates for February to December 2009.

The annual bonus rates payable on With-Profits Annuities were decreased.

We were able to maintain reversionary bonus rate levels as a result of our strong solvency position and the recovery in the investment markets during 2009. However, we believed it was not appropriate to increase bonus rates mainly due to lower expected future investment growth (due to low risk-free yields). The bonus rates set complied with the PPFM. The rates are included in our PPFM appendix which is available on our website www.nfumutual.co.uk.

Market interest rates have a direct impact on the returns we are able to achieve on the assets we hold to back our Capital Access Bond (CAB) policies. We therefore review CAB bonus rates each month and set CAB interim bonus rates accordingly. This practice is consistent with the PPFM. The interim rates in force throughout 2009 for CAB were confirmed as the declared rates.

Terminal, or final, bonuses were declared on 1 January 2010 and 1 July 2010. This is consistent with the PPFM, which states that we set terminal bonus rates twice a year or more often if necessary.

All bonus declarations were reviewed and approved by the With-Profits Committee, having taken advice from the With-Profits Actuary, and subsequently ratified by the Board. In our opinion, the payouts made to with-profits policyholders during 2010 reflected fair value and we are satisfied that bonus rates were calculated using the methods described in the PPFM.

Surrender Value Terms
Our traditional pension policies have factors used to calculate retirement values when a policyholder retires at a date other than his/her birthday. In September 2010 the factors were reduced to reflect the fall in reversionary bonus rates over recent years. Our policy documentation makes it clear that the factors can be revised and the change to the factors complied with the PPFM.

Our unitised with-profits policies can have a Market Value Reduction (MVR) applied to the value of the policy in certain conditions. For Flexibond and Shrewd Savings ISA policies the MVR is phased in gradually once the shadow fund falls below 90% of the with-profits value. Up to 1 January 2010, the MVR was applied in full as soon as the 90% level was reached for our older unitised with-profits products, the Capital Investment Bond and Personal Pension Plan.

Although the latter approach was entirely consistent with our PPFM and policyholder documentation, on 1 January 2010 we changed our approach towards Capital Investment Bond and Personal Pension Plan payouts so that the MVR is phased in, in the same way as for Flexibond. This is an improvement in policy terms for both products but has no material impact on the benefits or security of other policyholders.

All our unitised with-profits products have a terminal bonus cap that prevents terminal bonus being paid at a rate that would take the payout to greater than 111% of the underlying shadow fund value, except for guaranteed benefits. Our Flexibond and Shrewd Savings ISA products also have a terminal bonus floor. The terminal bonus floor increases the terminal bonus paid in circumstances where the payout would otherwise be less than 85% of the underlying shadow fund value.

Previously we did not operate a terminal bonus floor for the Capital Investment Bond or Personal Pension. On 1 January 2010 we implemented this benefit across all product types. This is an improvement in policy terms for both products but has no material impact on the benefits or security of other policyholders.

The introduction of a phased MVR and terminal bonus floor for the Capital Investment Bond and Personal Pension Plan was reviewed and approved by the With-Profits Committee, having taken advice from the With-Profits Actuary. The wording in the PPFM and CFPPFMs (Consumer Friendly PPFM) was updated to reflect the change.

Apart from the changes described above, the surrender value bases for our traditional with-profits policies and unitised with-profits policies were not changed during 2010. The bases used were consistent with the PPFM.

Target Ranges
The PPFM includes target ranges for payouts for unitised and traditional with-profits business. The target ranges compare the payout to the underlying value of the policy and our aim is to make 90% of the payouts fall within these target ranges.

We can confirm that during 2010 we complied with the target ranges set out in the PPFM.

Investment Policy During 2010
The With-Profits Committee, after considering advice from the With-Profits Actuary, is responsible for setting asset allocation limits for that part of the Long Term Business Fund that backs asset shares of with-profits policies. Specifically, it sets a maximum and minimum percentage of the asset shares that can be invested in each category of asset.

These operating bands remained unchanged throughout 2010 and were:

- UK Equities 35-55%
- Overseas Equities 10-15%
- Property 15-20%
- Fixed Interest 15-35% (including cash and index-linked)

During 2010 there were no significant changes to the asset mix of the asset shares. The proportion invested in each asset class is shown below:

	01/10/09 - 31/12/09	01/01/10 - 31/03/10	01/04/10 - 30/06/10	01/07/10 - 30/09/10	01/10/10 - 31/12/10
Property	17.5%	18.0%	19.0%	19.0%	19.0%
UK equities	41.5%	40.0%	40.0%	40.0%	40.0%
Overseas equities	12.0%	13.0%	13.0%	14.0%	14.0%
Index-linked bonds	6.5%	8.0%	7.5%	7.5%	7.5%
Fixed interest gilts	5.5%	4.7%	5.7%	5.9%	5.7%
UK corporate bonds	14.8%	14.2%	12.8%	11.9%	12.1%
Overseas bonds	2.2%	2.1%	2.0%	1.7%	1.7%
Cash and other assets	0.0%	0.0%	0.0%	0.0%	0.0%

The proportion of the asset shares invested in each asset category remained within the operating bands throughout 2010.

The investment policy for asset shares is consistent with the PPFM, product documentation and marketing literature and therefore, in our opinion, satisfies Policyholder Reasonable Expectations (PRE).
Assets backing the Capital Access Bond (CAB) were invested in cash and floating rate notes throughout the year. This is consistent with the PPFM.

Charges and Expenses
Detailed expense investigations are periodically undertaken to ensure that the expenses incurred in the with-profits fund are fairly assigned to the relevant policies. The With-Profits Actuary and With-Profits Committee are satisfied that the current allocation of expenses is fair and equitable. In addition this process has been independently scrutinised by our external auditors.

Any large one-off project costs are borne by the Inherited Estate and therefore do not impact directly on the expenses attributed to policyholders.

In the paragraphs that follow we have outlined the new product lines that we brought to market during 2010. The With-Profits Actuary and With-Profits Committee are satisfied that the charges or premiums for the products mentioned cover sufficient expenses and hence the terms offered were not to the detriment of with-profits policyholders.

From January to May 2010 the Society ran an ISA campaign that offered a nil initial charge for lump sum investments of £1,000 or more. The discounted charges applied to the Shrewd Savings ISA and Stocks and Shares ISA.

In April, June and September 2010 the Society changed its annuity pricing basis to reflect underlying changes in mortality assumptions, investment returns and expenses.

In July 2010 the Society launched two new investment bonds. The NFU Mutual Classic Bond is invested in the cautious managed fund and offers a guarantee at the end of each five year period that the unit price will be no lower than at the beginning of that five year period. The NFU Mutual Vintage Bond is invested in the with-profits fund and offers a guarantee that no market value reduction will be applied at the end of each five year period. Both bonds apply an additional annual charge in return for enjoying the benefit of the guarantee. The policyholder can choose at the end of each five year period to continue paying for the guarantee or opt out of the guarantee.

From July 2010 to September the Society ran a summer campaign that offered enhanced allocation rates or discounts on initial charges for investments into our Flexibond, Portfolio Investment Plan (OEIC), NFU Mutual Vintage Bond and NFU Classic Mutual Bond. Investments of £25,000 and over received a 0.5% enhancement or 0.5% discount to the initial charge and investments of £50,000 or over received an enhancement of 1% or 1% discount to the initial charge. This campaign was limited to £50 million of sales.

During October 2010 the Society ran a campaign for regular investments into the Shrewd Savings ISA, Stocks and Shares ISA or Portfolio Investment Plan (PIP). The campaign offered a cash back reward at the end of the first and second policy years if a policyholder started a regular monthly premium investment or increased an existing monthly premium. Each refund is the amount of the first monthly premium and was limited to a maximum of £300 for each payment.

In October 2010 the Society launched a six year FTSE linked income bond, which was sold for a limited period to December 2010.

During 2009 we changed our unit pricing approach so that we restrict the annual management charge taken from the life and pension deposit funds to prevent the unit prices falling when fund returns are less than the annual management charge. We apply this restriction to all deposit funds, except for capital units in Personal Pensions, which have a higher annual management charge. During 2010 we have continued to apply this restriction.

The cost to the estate was not material in relation to the overall assets held by the Long Term Business Fund and therefore the With-Profits Committee and With-Profits Actuary are satisfied that the restriction did not act to the detriment of with-profits policyholders. We intend to review this practice on an annual basis.

The bonus philosophy for CAB is to set interim bonuses that increase policy values in line with the total net of tax return (less a margin for expenses) earned on the assets backing the contract. During 2009 the net of tax return earned on the assets backing the CAB fell to very low levels and this meant that the total return, less our standard allowance for expenses, was negative for some of the interest rate bands for CAB.

However, the volume of new business for CAB has fallen to negligible levels and therefore it was appropriate to review the standard allowance for expenses to take into account the reduction in initial costs being incurred. The total expense margin therefore was set to be sufficient to cover maintenance costs and this meant that we could continue to offer some bonus on all bands. We continued with this approach throughout 2010.

The With-Profits Actuary and With-Profits Committee are satisfied that the approach taken is fair to CAB policyholders and is consistent with the PPFM. They are satisfied that due to the current low levels of new CAB business that this decision does not materially affect other with-profits policyholders. This decision will be reviewed as investment returns and volumes of new business change.

Management of the Inherited Estate
The Inherited Estate provides the working capital to support current and future business written within the Long Term Business Fund.

The With-Profits Actuary and With-Profits Committee are satisfied that during 2010 the Inherited Estate was managed in accordance with the rules of the PPFM.

Volumes of New Business and Arrangements on Stopping Taking New Business
During 2010 levels of new with-profits business were regularly monitored to ensure that the volume of new business was not so high that it threatened solvency nor too low so that any particular product was no longer viable.

In November 2010 the With-Profits Committee agreed to withdraw the with-profits endowment product from sale due to the low volumes of sales over recent years. The withdrawal of the product complied with the rules in the PPFM.

The With-Profits Actuary and With-Profits Committee are satisfied that the volume of business written was within an acceptable range throughout 2010 and no restriction on new business or withdrawals of other contracts was therefore necessary.

Sales of the NFU Mutual Vintage and NFU Mutual Classic Bonds launched in July 2010 were restricted to £50m of premium income. Sales reached this limit in December 2010.

Sales of FTSE linked bonds sold during the campaign launched in October 2010 were restricted to £10m of premium income.

Changes to the PPFM
The Consumer Friendly PPFM (CFPPFM) is a shorter, simpler version of our PPFM. We have four versions of our CFPPFM to cover different types of products.

The PPFM and unitised CFPPFM were amended on 1 January to explain the introduction of phasing of MVRs and terminal bonus rate floors that we described earlier in this report.

On 5 July the PPFM and all four CFPPFMs were amended to take account of the launch of the two new guaranteed bonds, the NFU Mutual Vintage Bond and NFU Mutual Classic Bond.

The new versions of the PPFM and CFPPFMs (effective from 1 January 2010 and 5 July 2010) were added to the NFU Mutual internet site (www.nfumutual.co.uk), giving policyholders access to the revised documents. A copy of the relevant new CFPPFM is sent to with-profits policyholders with their annual statements in the year following the change.

Communication with policyholders
The With-Profits Actuary has responsibility for controlling representations made to policyholders by reviewing and signing off documents for PRE and PPFM compliance. Documents that have been reviewed during 2010 include Key Features Documents, policy documents, marketing material, the Society's Consumer Friendly PPFM, annual statements and illustrations of possible future benefits from policies.

All companies use standard growth rates provided by the FSA for illustrations, unless they believe that using lower rates would be more appropriate for their products. For Capital Access Bonds, lower projection rates of 0.5%, 2.5% and 4.5% have been used in illustrations since 2009, to avoid overstating the growth potential of what is essentially a deposit investment. We review these rates annually and can confirm that we feel that these rates are a fair representation of the likely range of future investment returns achievable on the Capital Access Bond.

Throughout 2010 we used standard FSA projection rates for all other products and the appropriateness of these rates are reviewed regularly. During the review in 2010 it was highlighted that using lower rates would now be more appropriate for our fixed interest (including gilt and corporate bond OEIC), index-linked and deposit funds. Therefore from early 2011 we will use lower rates in illustrations for investors in these funds. For all other funds, including our with-profits funds and products, it remains appropriate to use the standard FSA projection rates.

The With-Profits Actuary and With-Profits Committee are satisfied that the illustrations and documentation that is provided to our policyholders comply with relevant regulations and guidance and do not have the effect of misleading with-profits policyholders as to their expectations.

Appendix

Annual report from the With-Profits Actuary
In my opinion, and based on the information and explanations provided to me by the Society, discretion exercised by the Society over 2010 took the interests of the with-profits policyholders into account in a reasonable and proportionate manner.

I am also satisfied that the Society has complied with its PPFM during 2010 and that the annual report to with-profits policyholders prepared by the Board provides an accurate summary of the key decisions that have impacted with-profits policyholders during the year.

In reaching these opinions I have taken into account the relevant rules and guidance issued by the Financial Services Authority and the Actuarial Profession.

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With-Profits Actuary
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