SUMMARY OF CHANGES TO THE PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT (PPFM) 1 MAY 2019, 1 JANUARY 2020 & 16 MARCH 2020

NFU Mutual
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SUMMARY OF CHANGES TO THE PPFM

The Principles and Practices of Financial Management (PPFM) is a document that aims to explain how a company manages its **with-profits business**. We introduced a new version of our PPFM on 1 May 2019, 1 January 2020 and 16 March 2020 and this document summarises these changes. The changes were proposed by the **With-Profits Actuary**, approved by the **With-Profits Committee** and then ratified by the Society's Board.

Words highlighted in **bold** in this document are listed in the glossary of the PPFM. A copy of the updated PPFM is located on our website at nfumutual.co.uk.

Summary of Changes to PPFM – 1 May 2019

Previously it was the Society's practice to calculate payouts for with-profits whole of life business using the same **terminal bonus** rates as used for with-profits endowments. We have now revised our approach to setting payouts for with-profits whole of life policies. Payouts for these policies are now set by reference to their own set of terminal bonus rates.

We have also amended the approach to calculating payouts on death for with-profits endowment policies.

The following amendments have been made to the PPFM to reflect these changes.

Section 2.1.2 – The Amounts Payable To Our With-Profits Policyholders

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

The ninth paragraph has been removed due to the changes in the endowment and whole of life payout methodologies. The removed paragraph read:

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

Section 2.3.2 – Practices

All contract types other than CAB and With-Profits Annuities

The fourth, fifth, sixth and seventh paragraphs in this section have been altered to detail the new approach to setting payouts for with-profits whole of life policies, including how we group policies to set the rates and our method for determining the payouts on paid up policies. We have also removed wording that is no longer applicable due to the revised approach. The previous wording was:

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**, premium frequency and for policies with different escalation rates applying to regular premiums.

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.

The new wording for these paragraphs is shown below:

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**. For traditional with-profits whole of life business that has been made paid up our practice is to ensure that **terminal bonus** does not result in a payout above 125% of the underlying **asset share**. If this were to occur, **terminal bonus** would be reduced to a level such that the payout equals 125% of the **asset share**, unless a guarantee was applying. Conversely for these policies we ensure that payouts are not below 75% of the **asset share**, by increasing **terminal bonus**, if such a situation were to arise, to a level that the payout equals 75% of **asset share**.

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 entry year and entry age for whole of life policies, for each term for other **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**, premium frequency, premium term for whole of life policies and for policies with different escalation rates applying to regular premiums.

Other types of policies will receive the most appropriate **terminal bonus** for their policy class.

Section 2.4.2 – Practices

The first bullet point in this section has been amended to include more detail on how whole of life policies are grouped for **terminal bonus** setting. The previous wording was:

- Policies are grouped by entry year or term in force for the purposes of setting **terminal bonus** rates.

The new wording is:

- Policies are grouped by entry year or term in force, and by age at entry for whole of life policies, for the purposes of setting **terminal bonus** rates.

Summary of Changes to PPFM – 1 January 2020

As part of an annual review of our PPFM we have made the following updates.

Section 3.2.3 – Practices

We have added an additional paragraph to clarify that the **long-term business fund** may use an **asset share** shorting strategy.

The additional wording is shown below:

We may use an internal **asset share** shorting strategy to help protect the **long-term business fund** during adverse market conditions. Shorting involves holding fewer risky assets in the **long-term business fund** than required to cover the **asset share** liabilities, with the balance of assets being held in lower risk assets. The achieved rate of investment return credited to **asset shares** is unaffected by this arrangement as it is the remainder of the fund that is taking the risk. In favourable market conditions the shorted assets perform better than the low risk assets, the loss to the **long-term business fund** may be partially offset by the reduced guarantee or smoothing costs. If the shorted assets perform worse than the low risk assets part of the profit to the **long-term business fund** will meet the increased costs of providing guarantees and smoothing in these circumstances. Any profits or losses accrue to the **inherited estate**.

Section 5.2.2 – Practices

We have added an additional sentence to the penultimate paragraph to explain our current practice of applying a cap to the annual increase to the expenses for **traditional with-profits business**.

The new sentence is shown below:

We currently cap the annual increase to the expenses apportioned to **traditional with-profits business** so they move broadly in line with expense inflation. This approach may be changed in the future.

Section 5.2.4 – Practices

The paragraph in this section has been amended to make our position clearer on charges and expenses. The previous wording was:

- 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.

The new wording is:

- Costs derive from internal and external services, including those provided by other companies in the NFU Mutual Group. There are currently no circumstances under which the **long-term business fund** will be charged an amount other than a reasonable allocation of NFU Mutual Insurance Society's costs or at cost for external expenses. We may outsource services if there is a potential benefit to our policyholders. Any out-sourced services are reviewed at least every three years.

Glossary

We have added the definition of assets backing/underlying asset shares to the glossary for reference.

ASSETS BACKING/UNDERLYING ASSET SHARES

The assets backing (or underlying) asset shares are the theoretical assets in which asset shares are invested. This is set by the investment managers to fall within the asset share bands set by the With-Profits Committee and the split of assets between different asset categories is detailed in the PPFM appendix. The asset split of asset shares and resulting investment return credited to asset shares is unaffected by any internal asset share shorting arrangement. Shorting involves holding fewer risky assets in the long-term business fund than required to cover the asset share liabilities, with the balance of assets being held in lower risk assets.

Summary of Changes to PPFM – 16 March 2020

Due to the launch of the With-Profits Trustee Investment Plan in March 2020 we made the following amendments to the PPFM.

Section 2.1.2 - Practices

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

An additional sentence has been added to the end of the first paragraph to clarify that a **market value reduction** may apply to **unitised with-profits business**. The additional wording says:

For **unitised with-profits business** a **market value reduction** may also be applied.

The seventh paragraph has also been updated to include wording relating to **market value reductions**.

The previous wording was:

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 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 new wording is:

In order to ensure that policyholders are paid a fair return on their policy, **terminal bonuses** (and, where applicable, **market value reductions**) are set so that the maturity value of the policy reflects the underlying performance of the **asset share** of the policy over its term. The **asset share** for a policy is 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, charges and expenses, taxation and any charges for guarantees.

Section 2.1.2 – Practices

Investment Return – Non CAB

Additional wording has been added to the first paragraph in this section to clarify the investment strategy in relation to **asset shares**.

The new wording is set out below, with the additional wording highlighted in italics:

The investment strategy in relation to **asset shares** *for each **bonus series** is set by the **With-Profits Committee**. The investment strategy* 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** *and making due allowance for policyholders' reasonable expectations*. It is the investment return on the **asset shares** of the **long-term business fund** that is credited directly to **asset shares**.

Section 2.2 - Setting Annual Bonus Rates

Section 2.2.2 – Practices

All contract types excluding CAB and With-Profits Annuities

The first bullet point in the third paragraph has been updated to include the With-Profits Trustee Investment Plan in the description of how charges are taken account of when setting regular bonus rates.

The updated bullet point reads:

- For Flexibond, NFU Mutual Vintage Bond, Shrewd Savings Plan ISA, With-Profits Trustee Investment Plans and Personal Pension Account contracts, the regular bonus rates declared are before any allowance for an annual management charge, annual product charge or any charge for guarantees. These charges are then deducted to reduce the effective rate of regular bonus applied to the policy.

Section 2.3 - Setting Terminal Bonus Rates

Section 2.3.2 – Practices

All contract types other than CAB and With-Profits Annuities

Wording has been added to the first paragraph to describe how we set **terminal bonuses** on a monthly basis for the new With-Profits Trustee Investment Plan and to clarify the role of the **With-Profits Committee** in relation to setting **terminal bonus rates** for this product.

The revised paragraph is shown below with the new wording highlighted in italics:

Our current approach for *With-Profits Trustee Investment Plans* is to set **terminal bonuses** *monthly, and for all other products* 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 **With-Profits Actuary** and are approved by the ***With-Profits Committee*** *and the* Board. *The Board delegate authority to set* ***terminal bonus*** *rates for the With-Profits Trustee Investment Plans to the* ***With-Profits Committee.***

Wording has been removed from paragraph two because the new With-Profits Trustee Investment Plan will limit changes over a different time period than our current products, which limit the change from one year to the next. Therefore the wording referring to the maximum change from one year to the next has been revised. The revised wording is shown below:

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 set out in 2.4.2.

Paragraph three in this section has been amended slightly to clarify that our aim to smooth surrender values into guaranteed maturity values is for traditional with-profits business. The revised wording is shown below, with the new wording highlighted in italics:

On surrender it is our aim to ensure that payouts are consistent with maturity values where *relevant*. 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 for ***traditional with-profits business***. We review our methods for determining surrender payouts regularly to ensure the methods are consistent with this aim.

Paragraph seven has been updated to refer to the With-Profits Trustee Investment Plans **terminal bonus rates** being set monthly and to specify that the same **terminal bonus rates** apply to all premiums applied in the same month.

The updated wording has been split into two paragraphs and is shown below and the new wording is highlighted in italics:

It is current practice to declare separate **terminal bonus** scales for major classes of business *and for each* ***bonus series***. Within those *categories*, we set different rates for each entry year and entry age for whole of life policies, for each term for other **traditional with-profits business**, *for each entry month for the With-Profits Trustee Investment Plan* and for each entry year for *all other* **unitised with-profits business**.

We also set different **terminal bonus** rates for each premium frequency, premium term for whole of life policies and for policies with different escalation rates applying to regular premiums. *For With-Profits Trustee Investment Plans, the same* ***terminal bonus*** *rates apply to all premiums invested in any given month*.

Wording has been added to paragraph nine to detail the payout ranges for the new With-Profits Trustee Investment Plans.

The revised wording has been split into two paragraphs as shown below and the new wording is highlighted in italics:

For With-Profits Trustee Investment Plans our practice is to ensure that ***terminal bonus*** *does not result in a payout above 120% of the underlying asset share calculated for each contribution received*. For *all other* **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 the *relevant percentage (120% or* 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 *80% of the **asset share** for each contribution received for With-Profits Trustee Investment Plans,* or 85% of the **asset share**, for each single contribution, or series of regular contributions *for other **unitised with-profits business.*** **Terminal bonus** *would be increased* if such a situation were to arise. We call this a **terminal bonus** rate floor. These adjustments can happen at any claim event.

Following the bullet points in paragraph ten a new paragraph has also been added and the following paragraph expanded to include reference to how **market value reductions** are calculated and applied to With-Profits Trustee Investment Plans and other **unitised with-profits business**.

The new wording is highlighted in italics:

*For the With-Profits Trustee Investment Plan, **market value reductions** are calculated in the same way as **terminal bonuses,** with market conditions giving negative outcomes rather than positive ones. However, a **market value reduction** will not reduce the amount payable below the **asset share.***

*For all other **unitised with-profits business, market value reductions** are calculated for each single contribution, or series of regular contributions, separately. Therefore 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.* The rules for calculation of whether a **market value reduction** applies and its relative size are as follows:

- If the **asset share** underlying the *single contribution, or series of regular contributions* 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.**

The final paragraph in this section has been removed because the wording is now covered in the previous paragraphs. The paragraph previously said:

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.

Section 2.4 - Smoothing The Value of Policies

Section 2.4.2 – Practices

We have made wording changes to the sections covering the implicit and explicit smoothing to include how smoothing and **market value reductions** are applied for the With-Profits Trustee Investment Plans.

The revised paragraphs are shown below, the additional wording is highlighted in italics:

Smoothing applies in two ways:

Implicitly:

- Policies are grouped by entry *month,* year or term in force, and by age at entry for whole of life policies, for the purposes of setting **terminal bonus** rates *(and **market value reduction** rates for With-Profits Trustee Investment Plans)*
- Appropriate specimen policies are used to represent each group of actual policies when **terminal bonus** rates are calculated
- **Terminal bonus** rates *(and **market value reduction** rates for With-Profits Trustee Investment Plans)* 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 *(and **market value reduction** rates for With-Profits Trustee Investment Plans)* 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,** *With-Profits Trustee Investment Plan business and other* **unitised with-profits business**.

We have revised paragraphs nine and ten and added several paragraphs between these two paragraphs to detail how we smooth **terminal bonus rates** and **market value reduction** rates for the With-Profits Trustee Investment Plan.

The revised wording is shown below, with the new wording highlighted in italics:

Our practice for smoothing unitised with-profits policies *(other than the With-Profits Trustee Investment Plan)* 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.

*Our practice for smoothing With-Profits Trustee Investment Plans **terminal bonus** and **market value reduction** rates is that for specimen policies:*

- *We project the **asset share** forwards for six months at our best estimate for future investment returns. We compare the projected **asset share** to the payout for the specimen policy one month before the declaration date, including any **terminal bonus** or **market value reduction** that would have applied. We set a growth rate that would return the payout to the projected **asset share** value in six months time. We then apply one month of the growth rate to the payout* *for the specimen policy one month before the declaration date to set the **terminal bonus** or **market value reduction** rate. Therefore if the **asset share** has moved significantly since the time the rates were last set the payout will not be moved straight to the revised **asset share.***

- *When the method described in the bullet point above results in a **terminal bonus** rate, we reduce the rate by multiplying the rate by 95%, subject to a maximum reduction in the rate of 5%. When it results in a **market value reduction** rate, we reduce the rate by multiplying the rate by 90%, subject to a maximum reduction in the rate of 5%.*
- *If the resulting payout and the payout for the same specimen policy with the same entry month from 3 months earlier differ by more than 3% then a lesser percentage change would be made.*
- *If the resulting rate is a **market value reduction** of less than 3% then the rate is altered to 0%.*

*The limits and time periods used in the smoothing methods can be changed over time to target payouts in aggregate, over the longer term, of 100% of **asset shares.***

With the exception of With-Profits Trustee Investment Plans, 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 years of the **Selected Retirement Date**.

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PPFM-0320