PRINCIPLES AND PRACTICES OF FINANCIAL MANAGEMENT (PPFM)

NFU Mutual

INSURANCE | PENSIONS | INVESTMENTS

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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 16th March 2020 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.

A glossary of certain terms used in the PPFM is provided in section 9. The terms included in the glossary are highlighted in bold 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 **With-Profits 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 **With-Profits 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 send our with-profits policyholders who are affected by the change written notice setting out any changes to the

Principles at least three months before the change is introduced.

We must also send our With-Profits policyholders who are affected by any change to the PPFM written notice setting out 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 **With-Profits 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-profits annuities, when the benefit under the policy becomes payable, a **terminal bonus** may also be added. For **unitised with-profits business,** a **market value reduction** may also be applied.

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 NFU Mutual's current 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.

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.

The Capital Investment Bond benefited from a guarantee that no **market value reduction** would apply on the tenth anniversary of the commencement date. From 1st June 2005 we adopted an approach whereby a policyholder benefited from the guarantee irrespective of whether they switched out of the with-profits fund or surrendered their policy on the tenth anniversary. If the value of the **shadow fund** units was less than the value of with-profits units on the tenth anniversary, the **shadow fund** units were enhanced to equal the value of the with-profits units. The enhanced **shadow fund** value is used when calculating **terminal bonus** rates for Capital Investment Bonds and when calculating whether a **market value reduction** should apply after the tenth anniversary.

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.

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 the longer term (ten years or more).

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 way we calculate 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 **With-Profits 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 **terminal 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

One of the main factors 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** 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**.

We may also 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, certificates of deposit 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

The **long-term business fund** incurs operating expenses in providing advice to customers, selling, 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** 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 **With-Profits 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 (excluding new **life assurance protection business** from 2013) 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 (excluding new **life assurance protection business** from 2013) 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 may do so prospectively for both in force and new business, if the Board decides, with the advice of the **With-Profits 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 via a guarantee charge. The form of the charge is an overall reduction from the annual returns credited in the calculation of the **asset share**. For some Flexibond policies, we apply a higher annual management charge for the with-profits fund option and use part of this charge towards the cost of guarantees. We currently apply no similar charge for

other business, however we may charge, prospectively, for the cost of these guarantees, provided we have received advice from the **With-Profits Actuary** that this is appropriate. The form of any charge would either be an overall reduction from the annual returns credited in the calculation of the **asset share** or an increase in the annual management charge. Affected policyholders would be notified of the introduction of any charge for guarantees as a change in the Practices 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-Profits 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 above or below the level which is deemed appropriate for new business.

Bonuses will be restricted when the **long-term business fund** is 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** is 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 **With- Profits Actuary** and require formal approval by the Board. Our current **annual bonus** rates can be found on our website at **nfumutual.co.uk** in our PPFM Appendix.

All contract types excluding CAB and With-Profits 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 a proportion of 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. However, consideration is given to the scope left for adding **terminal bonus** on policies becoming claims in the future by declaring these rates. If, 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) then the above rates may be changed.

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

- 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.
- 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 cannot 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. Annuity payments will not decrease, even if the change in the retail price index is negative. 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-Profits Annuities

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**.

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.

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.

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 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.

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

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.

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 death for all products.
- On retirement on the **Selected Retirement Date** under a unitised with-profits Personal Pension Plan, with-profits Pension Plan and Personal Pension Account.
- On switches out of the with-profits fund as part of lifestyle switching under the Personal Pension Account.
- On regular withdrawals up to a maximum of 10% per annum of premiums paid in under a unitised with-profits Capital Investment Bond or Flexibond.
- On the 5th anniversary of commencement and any subsequent 5th anniversary whilst the guarantee charge is still being paid for an NFU Mutual Vintage Bond.
- On any cancellation of units to pay for ongoing product charges.

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**.
- 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, with-profits Pension Plan or Personal Pension Account, 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 **With-Profits 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**.

CAB and With-Profits 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 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**.

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. However, it is 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 (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**.

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 effects 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 the longer term (ten years or more).

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 **inherited estate** was at a level that was deemed to be unnecessarily high or low, or
- 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%

The ranges are set to be wide enough to allow the Society the investment freedom to choose the mix of assets that we believe will maximise returns for policyholders, whilst continuing to apply smoothing in line with the PPFM rules and customer expectations in periods of market volatility.

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. **Stock lending** 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. The **long-term business fund's** investment in these non-quoted equity investments are 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 Mandate 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 Mandate sets:

- Permissible investment assets
- Limits on the concentration of investment in any one company across different asset classes
- Rules on the minimum spread of investments within funds across different asset classes
- Limits on unhedged overseas asset exposure
- Limits on underwriting commitments on new issues
- Counterparty approval
- Limits on **derivatives** use
- Investment grade guidelines for bond purchases
- **Stock lending** limits
- Property transaction size limits
- Any other limits deemed appropriate by the Board

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

- Review the movements in the relevant securities markets
- Review the liquidity 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 the domestic and global economic background
- Set an investment policy and asset profile appropriate to the risk appetite.

In carrying out these duties, the **Executive Investment Committee** will take advice, where appropriate, from the **With-Profits Committee** and the **With-Profits 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 (**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 **Executive Investment Committee** and subject to the Investment Mandate approved by the Board. Investing outside the Investment Mandate, including investment in new instruments, would require initial sanction of the **Executive Investment Committee** and approval by the Board.

3.2.3 We do not currently 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 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**.

We back our non-linked **non-profit business**, including our non-profit annuity business, with appropriate fixed interest and index-linked assets and cash to broadly match the liabilities, where there is certainty over the expected liability cashflows.

3.2.4 The Investment Mandate includes a maximum exposure to sub investment grade bonds and non-rated bonds.

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 may include physical assets such as our head office buildings and fixed assets. They also include investments in certain non-traded assets which may include non-quoted equity investments selected purely for their investment potential and certain subsidiary companies of the group. The most significant of these are a 100% holding in NFU Mutual Unit Managers Limited and a 100% holding in NFU Mutual Select Investments Limited. These investments are made in order that those companies can provide appropriate benefits to the Society's customers, i.e. to enable the Society to offer investments into collective investment vehicles.

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 "other than long-term assets" may be available both to transfer into the **long-term business fund** and to back additional capital requirements of the **regulator**, if required to support the solvency position of the **long-term business fund**. These "other than long-term assets" may also be used to support the **long-term business fund's** position against the risk appetite set by the Board.

The **With-Profits Actuary** or the **Chief Actuary (Life)** may request a transfer 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 may 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 3.2.5 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 **Board Risk Committee** recommends to the Board the Group's strategy and policy/philosophy for risk management, and monitors its adoption throughout the Group. The **Board 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, where there is certainty over the expected liability cashflows, 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 for the initial advice charge
- A deduction from premiums invested for other product charges
- 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 (**nfumutual.co.uk**).

The charges for unitised with-profits policies are reviewed regularly by the **With-Profits Actuary** to ensure that they are appropriate to cover the expenses allocated to the relevant class of business. If the **With-Profits Actuary** believes that the charges are no longer appropriate for the expenses of any class of business, the **With-Profits 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 providing advice to customers, selling and 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 expenses incurred when providing advice to customers and those incurred for providing products for our customers and then 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 **With-Profits Actuary** and our external auditors.

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.

Advice is charged for separately on policies commencing on or after 31 December 2012 and therefore the expenses applied to the **asset shares** for these policies do not include any costs arising from providing advice.

5.2.3 We charge with-profits annuities and the NFU Mutual Vintage Bond for the cost of guarantees via a guarantee charge. The form of the charge is an overall reduction from the annual returns credited in the calculation of the **asset share**. For some Flexibond policies, we apply a higher annual management charge for the with-profits fund option and use part of this charge towards the cost of guarantees. We currently apply no similar charge for other business, however we may charge, prospectively, for the cost of these guarantees, provided we have received advice from the **With-Profits Actuary** that this is appropriate. The form of any charge would either be an overall reduction from the annual returns credited in the calculation of the **asset share** or an increase in the annual management charge.

5.2.4 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 outsourced services are reviewed at least every three years.

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 may be 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 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 **With-Profits 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 categories of new contracts 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 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.

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 Principles

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

ANNUAL BONUS (Also known as regular or reversionary 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.

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 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.

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.

BOARD 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.

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 Regulator.

CHIEF ACTUARY (LIFE)
The Society's Chief Actuary function (SIMF20). The Chief Actuary (Life) has responsibility for the actuarial function.

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.

(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.

EXECUTIVE INVESTMENT COMMITTEE
The Committee that is responsible for formulating an appropriate investment risk appetite and strategy for the Society. The Committee is ultimately accountable to the Board.

LIFE ASSURANCE PROTECTION BUSINESS
Temporary assurance business and mortgage temporary assurance business.

LONG-TERM BUSINESS FUND
All of the with-profits business written by the Society, together with the Society's non-profit business. The long-term business fund is classed as a ring fenced fund under current rules. This means that the assets within the fund cannot be used to support business written by the Society outside of the ring fenced fund.

MARKET VALUE REDUCTION
A method that we use for unitised with-profits business to reduce the value of the with-profits units when they are sold. 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 method.

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 Conduct Authority and Prudential Regulation 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. For the Personal Pension Account this is known as the target pension date.

SHADOW FUND
The notional units that represent each policy's share of the with-profits fund. The value of these units goes up and down with the value of the underlying investments in the fund.

STOCK LENDING
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 may be added to a policy when money is taken out of the with-profits fund. This could be on termination of the contract, death, switching into another fund or withdrawing part of the total investment.

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 ACTUARY
The Society's With-Profits Actuary. The With-Profits Actuary acts as an adviser to the With-Profits Committee.

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.

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NFU Mutual

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