

The Shepherds Friendly Society Limited

Principles and Practices of Financial Management

21st September 2010

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1 Introduction

- 1.1 This document (known as the PPFM) sets out the Principles and Practices of Financial Management by which the Society conducts its with-profits business. It has been approved by the Society's Board of Management (hereinafter referred to as "the Board") and was adopted at their meeting on 21st September 2010.
- 1.2 The purpose of the PPFM is to enable a better understanding of the way the Society conducts its with-profits business and, in particular, the principles and practices adopted by the Board in the application of its discretion. This improved understanding is intended to protect the interests of and promote confidence among with-profits policyholders.
- 1.3 Principles describe the enduring statements of the standards the Society adopts when managing the with-profits fund and are not expected to change often. Practices, on the other hand, describe the Society's current approach and will be subject to more frequent change but still within the principles. The format of this PPFM considers each key area where discretion is applied and sets out firstly the relevant principles, followed by the practices.
- 1.4 In the event that the Society determines that changes are required to any of the principles, the Society will provide with-profits policyholders with at least three months prior notice. Changes to practices must be similarly communicated but do not require prior notice.
- 1.5 The Society is required to have and has in place governance arrangements to ensure that the conduct of its with-profits business complies with this PPFM and these include an independent review and annual report to with-profits policyholders from the Board.
- 1.6 The Society has four key financial objectives that affect with-profits policies and that can be regarded as overriding the principles and practices contained elsewhere if they come into conflict. These are:
 - (a) To meet the contractual obligations to policyholders.
 - (b) To treat policyholders fairly and meet the reasonable expectations of with-profits policyholders.
 - (c) To meet the required tests of solvency and capital adequacy as needed by regulatory bodies.
 - (d) Subject to (a), (b) and (c), to maximise the financial returns to with-profits policyholders.
- 1.7 The Society is a friendly society, a mutual organisation, and there are no shareholders' interests to be considered. As a mutual, the with-profits policyholders share the business risk in full.

- 1.8 The Society does have Holloway insurance liabilities that represent a significant proportion of the with-profits fund but the current Financial Services Authority guidance is that this type of insurance business need not be managed by the terms of PPFM documents. Therefore we do not do so and believe savings can accrue to operational expenses as a result of this. It is however necessary at times to refer to this business in the PPFM document to the extent that it impacts on the remaining with-profits liabilities.
- 1.9 The remaining sections of this PPFM describe the Principles and Practices of Financial Management of the non-Holloway with-profits business.
- 1.10 Certain terms used in this report are defined in the Glossary in section 8.

2 The amount payable under a with-profits policy, annual bonuses, final bonus and smoothing

Principles – amounts payable under a with-profits policy

- 2.1 In assessing the amounts payable under a with-profits policy, the aims of the methods used are to meet the financial objectives as set out in 1.6. Importantly, they aim to provide policyholders with a fair return on their policy that reasonably reflects the experience of the fund whilst the policy has been in-force subject to any smoothing.
- 2.2 A number of approximations are used in the application of the methods and are in line with the overall aim of sharing experience of the with-profits fund between policyholders. This also reflects the relatively small size of the portfolio, its diversity in terms of policy type and duration, and the historic approach to bonus distribution.
- 2.3 Appropriate control mechanisms are in place should the Society wish to change in any way the methods it adopts in determining the amount payable under a with-profits policy. Such changes can be modifications to current methods or the adoption of entirely new methods. The Board or the Actuary can initiate changes. In either case the Actuary will undertake a report for the Board setting out the implications of the change and the Board will then decide whether to implement the change. All methods used, including amendments, will be appropriately documented.
- 2.4 In applying the methods to determine the amounts payable under with-profits policies there is a need to consider historical experience and, where appropriate, make assumptions about the past. In the light of new information, different methods or new techniques, the Society may change any assumptions used regarding the historical experience.
- 2.5 Surplus is generally distributed by means of annual (also known as reversionary) bonus and final (also known as terminal) bonus. The amount payable under a with-profits policy is determined by reference to a guaranteed basic benefit, the attaching annual bonuses and the final bonus applicable at the date of claim.

Principles – annual bonuses

- 2.6 The general aim in setting annual bonus rates is to provide with-profits policyholders with additional guarantees above the guaranteed basic benefits that increase over time. Rates should be no higher than those which may be supported on new business which takes into account current and expected future economic and demographic experience over the lifetime of the policy, the investment policy and with an appropriate margin for final bonus. The latter is important to permit greater investment freedom.

- 2.7 The Society also aims to set annual bonus rates that do not fluctuate widely on a year to year basis, and to give policyholders a reasonable expectation that similar bonuses can be declared in future years. Bonuses can only be declared if there is a surplus in the fund and the overriding requirement to remain solvent can mean, in the event of adverse experience, the Society may decide to declare a bonus rate that is significantly different to that in previous years. The decision may be taken to declare no bonus at all.
- 2.8 Where business has previously been pooled for the purposes of determining a bonus rate, the Society will generally continue to operate the same pool for annual bonus. Rates and amounts of any final bonus may be adjusted to bring total payouts into line with the underlying value of the policy as described in 2.10. Should it become apparent that certain contracts within the pool would thereby be materially disadvantaged by other contracts, the Board may, on the advice of the Actuary, agree to revise the basis of the pooling arrangements.
- 2.9 Where circumstances change to such an extent that it would be unfair to existing or new business policyholders to share the same rates of bonus, the Board may, on the advice of the Actuary, decide to declare an alternative bonus series, amend the basis of the contract or withdraw the type of policy altogether.

Principles – final bonus

- 2.10 In determining the total payout on a policy becoming a claim, the Society may add a final bonus. The aim of any final bonus would be to increase the benefits guaranteed under a policy to the underlying value of that policy as assessed by the experience throughout its lifetime within the fund. The principles covering amounts payable (as opposed to the final bonus element) are set out in 2.1 to 2.5 previously.

Principles – smoothing

- 2.11 The Society seeks to smooth contractual (maturity and death) claim payouts on policies of a similar type, size and term becoming claims in different periods of time. It is intended that smoothing will have a neutral effect on the fund over time.
- 2.12 Non-contractual claim payouts may be subject to less smoothing by virtue of the surrender bases adopted or any market value reduction (MVR) applicable. Whilst changes are primarily made to reflect changes in underlying asset values, the Board reserve the right to take other

economic and demographic experience factors into account in determining appropriate bases and MVR's.

- 2.13 The total cost (and hence scale) of smoothing must inevitably be subject to the availability of adequate resources and cannot be allowed to grow too large in relation to the size of the with-profits fund. The key financial objectives as set out in 1.6 are relevant in this respect.

Practices – amounts payable under a with-profits policy

- 2.14 Section 2.5 explains how the amount payable under a with-profits policy is determined by reference to a guaranteed basic benefit, the attaching annual bonuses and the final bonus applicable at the date of claim. The methods used to determine the amounts payable will follow the methods used to determine annual and final bonus rates.
- 2.15 The main approach used is to consider, initially, the application of bonus rates that do not involve a significant departure from bonus rates declared in recent years (the split between annual and final bonus apart) and the financial impact on the Society in terms of its projected free asset position. In effect, projections are undertaken to test whether such bonuses, under reasonably foreseeable economic circumstances, are expected to be supportable in the future.
- 2.16 Bonus rates have, prior to 2004, been set without detailed consideration of the asset share of individual policies and accurate data relating to investment returns and expenses from the point of sale onwards is not available. In 2005, however, the Society determined a 'fair value' on each of its with-profits policies as at 31st December 2004. This 'fair value' was, except for with-profits bonds and unitised with-profits pensions business, based on a realistic estimate of the benefits each policy could provide on maturity or earlier death having regard to prospective future investment returns, premiums, expenses (as set out in policies' key features) and claims. The 'fair value' of with-profits bonds or unitised with-profits pensions business was determined based on an accumulation of past premiums in line with the Society's actual investment experience (or best estimate asset allocations and index returns where no better data is available) allowing for expenses set out in disclosed key features documents.
- 2.17 Subsequent years' asset shares are then determined in accordance with the following formula:

Asset value (of 'fair value') at the start of the year
+ Office Premium

- + Investment Growth
- Expense
- Tax (if applicable)
- Mortality costs
- = Asset share at the end of the year

- 2.18 Further adjustments may also be made to allow for the costs of capital support, cost of guarantees and miscellaneous sources of surplus or loss (eg expenses, surrenders etc) although the current practice is not to make any such adjustments.
- 2.19 The Society aims to ensure that at least 90% of all maturity and surrender payouts are within 70-130% of their asset shares.
- 2.20 In applying the approach outlined previously, the Society needs to make allowance for (and therefore assumptions covering) a number of economic and demographic parameters. The former might include past and assumed future investment returns, interest and inflation rates. The latter might include expenses, mortality and sickness, withdrawal rates etc. The determination of the relevant assumptions is undertaken by performing appropriate investigations and analyses of the Society's past experience and consideration of expectations for future experience.
- 2.21 The investment return is calculated as one overall rate which incorporates all classes of business (with-profits, non-profit and Holloway).
- 2.22 The Society's expense taken into account are currently based on those disclosed within key features documents issued at point of sale. Any difference between the current expense allowances and actual expenses is charged or credited to the inherited estate.
- 2.23 When considering the allowance for tax, parameters and assumptions are used which, when applied to the fund, results in a charge similar to that applying in practice. Bonus rates and payouts reflect the tax status of the relevant products.
- 2.24 Where the inherited estate exceeds its target range (see section 6.8), some enhancement to asset shares may be made at the discretion of the Board. Typically these enhancements may emerge either in the form of additions to annual or final bonuses or some combination of the two. Such awards can only be made where the circumstances permit and should not be regarded as repeatable.
- 2.25 In line with the principle at 2.2, a number of approximations are used in the application of the methods and which carries over to the parameters

and assumptions used. Generally these are shared across generations of with-profits policyholders and across different types of with-profits policies

2.26 The Actuary documents the methods, parameters and assumptions used to determine the amount payable to policyholders and key aspects are contained in reports presented to the Board.

Practices – annual bonuses

2.27 Annual bonus rates are declared in arrears and represent additional guarantees above the guaranteed basic benefits under a policy. These guarantees apply to the policy at death or maturity but are not guaranteed in nominal terms on earlier termination.

2.28 The starting point for the approach used (as referred to in 2.6) is to consider the sustainability of bonus rates that do not depart significantly from those declared in recent years, taking into account the financial impact on the Society in terms of its projected free asset position. This reflects the expectation on the policyholders' part that, in normal circumstances, rates will change relatively infrequently. A long-term view is taken and consideration given to the rates that could apply under reasonably foreseeable economic and demographic experience.

2.29 The Society will also conduct investigations and projections to establish the appropriate proportion of bonus and payout to be paid in final (non-guaranteed) form. The proportion is assessed and takes into account the targeted free asset position (at 6.8) and investment policy mix (at 3.13).

2.30 The approach to setting annual bonuses (as stated) is based on a long-term view and in the normal course of events shorter term variances (to the extent that they need to be taken into account) can be allowed for in setting final bonus rates. However, more significant short-term variances, which can limit the surplus expected to be available for distribution, may be reflected in annual bonus setting. To the extent that recent experience is indicative of long term change, this is allowed for.

2.31 Annual bonus rates are declared at the discretion of the Board. In the normal course of events the Society would not expect to re-set annual bonus between declarations. However, in the event of a significant change in economic circumstances that could adversely affect the surplus expected to be available for distribution, the Board can use its discretion to alter annual bonus rates at any time.

2.32 As described in 2.7, the Society's aim is to set annual bonus rates that will not change often and will try to avoid wild fluctuations. The Society does not have any maximum amount by which annual bonus rates would alter.

In a situation where solvency was under threat, or there is not expected to be sufficient surplus in the fund, the Society may act to reduce annual bonus rates significantly. In adverse financial circumstances, it may decide not to declare a bonus at all.

- 2.33 It is the practice of the Society to set interim annual bonus rates at levels that, in the normal course of events, will not exceed the likely annual bonus rates at the next declaration. However, rates will generally be set so as not to exceed the last declared annual bonus rates.

Practices – final bonus

- 2.34 Final bonus rates are declared at the discretion of the Board on the advice of the Actuary. The levels of final bonus rates are reviewed at regular intervals, not less frequently than annually, but more frequently when significant changes in investment market dictate.
- 2.35 A final bonus may be paid on claims by death, surrender or maturity that is sufficient to bring the payout into the range set out in 2.19.
- 2.36 The practices governing the approach to setting the amounts payable under a with-profits policy are set out in 2.14 to 2.26. In simple terms, the approach to setting final bonus is merely to determine the amount required to uplift the basic benefit plus attaching annual bonuses to the fair amount payable under the particular policy at the date of claim. The scale is based on a percentage of the basic benefit and declared annual bonuses per year of duration. For unitised with-profits pensions business and with-profits bonds the scale is based on a percentage of the fund (or attaching annual bonus) per year of duration.
- 2.37 A market value reduction (MVR) may apply to certain claims under unitised with-profits pensions business and with-profits bonds subject to contractual MVR free events. Current practice is to set MVRs independently of any final bonus and so both may apply in the case of some with-profits bond claims.
- 2.38 The MVR is intended to protect the interests of policyholders remaining in the fund from the losses which might be incurred where funds are withdrawn following a significant shortfall in the value of underlying assets. It is applied to policies which would otherwise give rise to a gain significantly above that justified by the investment performance over their currency, particularly if that is relatively short and the volume of withdrawals is large.

Practices – smoothing

- 2.39 The Society does not operate a formal smoothing algorithm that would determine how quickly amounts payable might change and the cost of or surplus from smoothing. Current practice is to consider the extent to which the amounts payable under a with-profits policy and those expected in the near future require material support from the inherited estate. In economic and demographic circumstances that adversely affect the fund or the solvency of the Society, the Board could adjust payments very rapidly.
- 2.40 The current smoothing methodology does not differentiate between generations and types of with-profits policies.
- 2.41 The Society's current approach to smoothing is to limit the change in amounts payable under a with-profits policy to 10% from one declaration to the next in normal circumstances. However, the Board can, on the advice of the Actuary, depart from this 10% limit. .
- 2.42 MVRs are set primarily with fairness and simplicity in mind having regard to the asset share calculations and the size of any fall in the value of underlying assets. There is no deliberate smoothing applied other than that implicit in the simplified form and frequency of change. To date a fairly simple flat or stepped scale percentage by duration has been applied (subject to certain conditions). This does not, however, preclude the Board, on the advice of the Actuary, from adopting a more sophisticated and dynamic approach in future.
- 2.43 Some with-profits bonds contain a 5% MVR free income withdrawal option facility. Any eventual total value of such policies is unaffected by the MVR free nature of this facility.

3

Investment Strategy

Principles

- 3.1 The Society's investment strategy supports the key financial objectives set out in 1.6. It is based on the view that over the longer term investing a significant proportion of the investment portfolio in equities and property will produce a better investment return than can be achieved by investing in cash and bonds.
- 3.2 The strategy, is to invest in a broad spread of assets with the aim of maximising the investment return available to with-profits policyholders subject to an acceptable degree of risk. This broad spread applies by both asset class and individual holding, within the admissibility limits set by FSA.
- 3.3 The asset classes that the Society will consider are UK and overseas equities, fixed interest investments (such as gilts and other bonds), index linked investments, property, cash and other investments.
- 3.4 In setting investment strategy, the Society has regard to the nature and term of its long-term business liabilities, the extent of any guarantees applying and the need to demonstrate solvency. In theory, guaranteed benefits should be backed by fixed interest assets of the appropriate term and security. However, investment strategy can vary from this theoretical position to the extent that the Society's free assets can support the corresponding resilience reserve. Regard is also paid to the expectations of policyholders who may expect returns to exceed those available on fixed interest assets. These factors result in the majority of contributions being invested in property and equities.
- 3.5 In determining the investment strategy and extent of deviation away from the theoretical matched position, the Society can rely upon any long-term business assets and no distinction is drawn between with-profits, Holloway and non-profit liabilities.
- 3.6 The Society will consider the use of derivative instruments in its investment strategy. Such assets will generally be used to implement changes in investment policy through efficient portfolio management or as a means to hedge the degree of investment risk.
- 3.7 There are no constraints that apply with respect to parts of the fund either on account of separate policy classes or generations of business.
- 3.8 The Society imposes limits on counterparty exposure consistent with those set by regulatory authorities.
- 3.9 The Society's holdings of assets that would not normally be traded is limited to its premises, part of which are occupied for its own purposes. The office would normally be retained to avoid disruption to the day-to-day

management of the Society. The Board considers regular investment reviews, which include this asset, so as to ensure it remains a worthwhile and useful investment of the fund. No formal limits are set on the scale of investment in such assets which are (and are intended) not to be significant in terms of the impact on amounts payable under with-profits policies and on credit or liquidity requirements.

Practices

- 3.10 For the purposes of the approach to investment, the with-profits fund can currently be considered as a single entity incorporating all the assets and liabilities of the Society.
- 3.11 A formal investment review is currently carried out at least annually. The Society outsources its investment management to several firms as considered appropriate. The respective investment management agreements include objectives, guidelines and constraints. Monthly and quarterly reports are also provided for review purpose.
- 3.12 Investment matching is assessed from the viewpoint of the level of resilience reserve required and the current financial position of the fund using results of a statutory solvency valuation. Regard is also paid as to the likely future development of the financial position under a range of scenarios using results of dynamic solvency testing as contained in the Financial Condition Report. Where the solvency position is threatened, robust monitoring and risk management procedures are in place to establish if and the extent to which equities need to be sold to protect solvency. Implicit in the assessment is the requirement to meet any short to medium term policy payments with suitably matched assets.
- 3.13 Current investment guidelines are based on target investment asset mixes within the following ranges applying in normal circumstances:

Asset Class	Range
Equities	30% - 60%
Property	10% - 20%
Gilts & Fixed Interest	15% - 50%
Cash	1% - 20%

That is not to say that the current mix of investments by class must necessarily fall precisely within the ranges quoted provided the reasons for and circumstances are understood and agreed by the Board and having regard as appropriate to any advice from the Actuary. Guidelines are intended to support the yield requirements both from the viewpoint of statutory valuation bases and longer term target returns.

- 3.14 Current practice is to limit credit risk by restricting investment in non Government fixed interest stocks to 50% of the market value of the total investment in fixed interest stocks and of the unapproved fixed interest stocks at least 50% must have Investment Grade rating. Any proposal to invest in a new or novel investment instrument would require approval by the Board on advice from the Actuary.

4 Business Risk

Principles

- 4.1 As a mutual insurer undertaking long term insurance business, all activities of the Society potentially impact the amounts payable to with-profits policyholders (including Holloway). Routinely, business risks for the with-profits fund will include the acquisition and maintenance of with-profits and non-profit business. New business arrangements are covered in Section 7. The Society currently has one wholly owned subsidiary and may decide to invest in further subsidiaries in the future. The risks associated by investing in the subsidiary are considered minimal as the subsidiary is undertaking activities which were previously undertaken by the Society itself. Any such investment in the future will be subject to a full risk assessment referred to in 4.2.
- 4.2 Any new venture involving significant resource or risk will be subject to a full cost benefit justification and risk assessment. The aim is to ensure that the projected benefits from the perspective of with-profits policyholders generally are competitive (as against alternative investment opportunities) having proper regard for their appetite for risk. Entering into any new and significant area of business risk requires the approval of the Board who will also consider the advice of the Actuary in the matter.
- 4.3 There are no general limits on the size of business risk that is taken on by the with-profits fund. However, the risk assessment and management procedures in place (covering both existing and new risks) are designed to ensure that the Society is able to meet its key financial objectives as set out in 1.6 on an ongoing basis. By virtue of its constitution, any compensation costs from a business risk can only be borne by with-profits customers (including Holloway).

Practices

- 4.4 The Society does not operate formal limits on the taking on of business risk. However, the Society has established robust procedures, systems and controls covering the mitigation and management of business risk. These encompass both the existing and the taking on of any new business risks and involve consideration of both the probabilities of occurrence and impact. The Board reviews these on a regular basis and, in any event, no less frequently than annually.
- 4.5 The principles and practices set out in Section 2 deal with all aspects affecting payouts under with-profits policies. No special practices are in place to cover the distribution of the rewards and losses in respect of existing and new business risks associated with current operations

beyond those described therein. Should a risk crystallise with significant financial impact then, to the extent that new practices are required, these will be developed to deal appropriately with the particular situation and will be subject to the approval of the Board and having regard to the advice of the Actuary.

- 4.6 For the purposes of the sharing of business risk, the fund can be considered as a single entity incorporating all the assets and liabilities of the Society. Any surpluses arising on non-profit business are available for distribution to with-profits policyholders (including Holloway). The volume of such business is relatively small.

5 Charges and Expenses

Principles

- 5.1 The aim of the Society's approach to apportioning expenses to with-profits policies (including Holloway) is that it should be fair and appropriate.
- 5.2 The basis upon which expenses are apportioned seeks to reflect the drivers and the activities that give rise to such expenses. A basis change might be introduced to reflect changes to these drivers or activities (e.g. new outsourcing arrangements). It might also be introduced to accommodate new business methods and practices (e.g. new distribution). It may simply be introduced to improve the current apportionment basis in the light of new information.

Practices

- 5.3 The Society's expenses are almost wholly attributable to the management of the long-term business operations; membership activities are peripheral to these and costs are not material. Expenses cover the acquisition of business (including commission) and the maintenance of business that includes administration and investment management as well as other structure costs. Some costs may be directly attributable to particular classes of business whereas others will need to be apportioned according to appropriate bases. Apportionment bases may also be required to split acquisition from maintenance costs.
- 5.4 As referred to above, the basis on which expenses are apportioned reflects the drivers and the activities that give rise to such expenses. Bases used include those based on time analysis, numbers of policies, percentage of premium, mean fund size or, indeed, a factoring up of direct costs. The apportionment bases used from time to time have regard to ease of application and consistency as well as fairness.
- 5.5 Any expenses included and apportionment bases adopted must be appropriate for the purpose and compliant with any relevant rules and guidance. In general all costs will be included and apportioned but circumstances can arise where adjustments may be appropriate, for example, in determining the amounts payable under with-profits policies. By way of example, adjustments may be made to allow for the amortisation of significant development costs, non-recurrent expenditure and (providing it is of sufficient size) subsidy by the inherited estate.
- 5.6 A separate expense analysis is performed for Holloway and other with-profits business at regular intervals (at least annually). This will include a review of any apportionment methods and bases adopted to ensure they remain appropriate over time.

- 5.7 There are no current circumstances under which the Society will charge expenses at an amount other than cost except to the extent of any adjustments referred to in 5.5. These adjustments, of course, do not ultimately affect the costs attributable to with-profits policyholders (including Holloway) as a class.
- 5.8 The main outsourced services are those covering investment management, referred to in Section 3, the provision of actuarial services by OAC plc, ANS and A1 for the provision of IT infrastructure support and the management of the portfolio of pensions business by a wholly owned subsidiary of Reliance Mutual Insurance Society Limited. None of these outsourcers are connected parties. It is our policy to review services on a three yearly basis, but with an option to do so sooner if it is considered appropriate in terms of price or service.
- 5.9 For the purposes of apportioning expenses, the with-profits fund can be considered as a single entity and there are, therefore, no issues associated with apportionment between with-profits funds. As the Society is a mutual, there are no issues associated with the existence of any shareholder interest.

6

Management of the Inherited Estate

Principles

- 6.1 The term inherited estate (sometimes known as estate or free estate) usually refers to the excess of the realistic value of assets over the realistic value of liabilities. For this purpose, the value of the with-profits liabilities needs to take into account the reasonable bonus expectations of the policyholders.
- 6.2 The Society will manage the inherited estate for the benefit of its with-profits and Holloway policyholders. The purposes for which it will be applied include supporting the Society's solvency and supervisory requirements, its investment and bonus policy (including smoothing) and its capacity to write new business. It may from time to time be used to meet certain expenses or business risks. The management of the inherited estate must, therefore, have the immediate and future requirements in mind insofar as each of these purposes is concerned.
- 6.3 The implications of the preferred scale of the inherited estate for the value of with-profits and Holloway policies will reflect the purposes set out in 6.2. For example, it enables the investment strategy as set out in Section 3 to be pursued with the prospect of higher investment returns. It can enable higher levels of new business to be written which can help contain or reduce unit costs. It can enable greater smoothing in terms of payouts and reduce the immediate impact of financial shocks due to economic change or business risk. To the extent that the scale currently lies outside of the target range, payouts may also be affected by the need to replenish or reduce the level of free assets or inherited estate.
- 6.4 As the Society has no shareholders, there are no issues concerning any attribution of value as between policyholders and shareholders.
- 6.5 There are no constraints on the Society's freedom to deal with the inherited estate as a result of previous dealings.

Practices

- 6.6 The inherited estate is not a separately identifiable part of the fund and therefore is available to meet all costs associated with the long-term business operations. No explicit allowance is made for the inherited estate in determining the amounts payable under with-profits policies although clearly there is an indirect effect for the reasons stated previously.
- 6.7 The investment strategy for the inherited estate is the same as the strategy for the rest of the with-profits funds.

- 6.8 The Board currently aims for the inherited estate to be up to 20% of the total asset value of the with-profits fund.
- 6.9 Where the inherited estate ratio falls outside the range referred to in 6.8, the aim would be to restore the position to within range over a maximum 5 year timeframe provided this did not lead to the material unfair treatment of policyholders. The Society undertakes regular investigations into the projected estate position under a range of scenarios using results of dynamic solvency testing. The results and conclusions from these investigations are used to decide upon appropriate actions to manage the scale of the inherited estate over time.

7 Volumes of new business and arrangements on closing to new business

Principles

- 7.1 The approach to setting the volume of new business (with-profits, Holloway and non-profit) has regard to a number of different aspects. It must first be determined that it is in the interests of with-profits policyholders for the Society to remain open to new business against the alternative of closure and the options available for managing the closed book of business.
- 7.2 The primary consideration in the setting of new business volumes is the level of resource (both in terms of capital and processing capacity) required. A report that contains projections is used to establish any maxima in terms of limitations of the Society's financial capacity to take-on new business where this becomes an issue. It would also take into account the business mix if appropriate.
- 7.3 Consideration would also be given to the nature of the products being sold, their potential suitability for customers, the financial and business risks associated with the products and the methods and terms upon which they are sold as compared with the market.
- 7.4 Should the Society determine that it is not in the interests of with-profits policyholders to remain open to new business, it will develop a closure plan. This will include a strategy for managing the closed book of business and how the inherited estate will be distributed over the expected lifetime of the with-profits policies.

Practices

- 7.5 There are no specific practices regarding the setting of new business volume limits beyond those implied by the principles set out previously. Currently maximum volumes and business mix are not an issue.
- 7.6 The substantial majority of the Society's business is with-profits and Holloway, with the volume of non-profit business being relatively small. In practice, therefore, any decision taken concerning remaining open to new business would cover both classes. The Society has set no minimum scale in terms of new business volumes to justify staying open to new business. However, the position is subject to review from time to time according to the principles set out previously. The likely progression of unit costs and investment freedom under alternative scenarios would be key factors in any decision taken.

8 Glossary

Actuary	The person who from time to time is the actuary appointed to the Society under the Financial Services Authority (FSA). Note that more than one actuary may be thus appointed. In this case, the context determines which actuary is being referred to.
Algorithm	A procedural model for undertaking calculations.
Annual bonus	A method of distributing surplus. The bonus is declared each year but is not paid until a policy becomes a claim.
Asset share	In relation to a policy, the accumulated value of premiums paid with deductions for expenses, mortality costs and any tax, where the accumulation rate is the rate of return achieved by the assets assumed to back the asset shares in question. Adjustments may be made for the cost of guarantees, capital and miscellaneous profits or losses if deemed appropriate.
Board	The Board of Management from time to time of the Society.
Bonus recommendation	The process by which the Actuary recommends regular and final bonus rates for approval and declaration by the Board.
Bonus series	A group of policies considered separately in the bonus recommendation.
Capital adequacy	The requirement for a firm to hold sufficient capital to ensure its short and long term solvency having regard to the risks it is undertaking.
Conduct of Business sourcebook (COBS)	Produced by the FSA and containing the COBS rules and guidance covering the information to be included in this PPFM.
Counterparty	An individual or company in which the Society has made investments or against which it has rights under a contract.
Demographic experience	The experience factors driving movements in the fund such as mortality, sickness, withdrawals, expenses, tax etc. but excluding economic factors such as those pertaining to investments.

Derivative instruments	Includes options, futures contracts and contracts for differences and includes contracts under which the amount payable by either counterparty is calculated by reference to the value of any other asset.
Final bonus	A method of distributing surplus, whereby the bonus is only declared when a policy becomes a claim.
Financial Services Authority (FSA)	The body responsible for the regulation of long term insurance business carried on in the United Kingdom under the Financial Services and Markets Act 2000.
Friendly Society	A friendly society is a mutual organisation, whose main purpose is to provide various types of insurance and savings services, and to assist members, usually financially, during sickness or unemployment.
Free assets	The surplus assets after meeting the liabilities and solvency margin determined in accordance with the rules of the FSA.
Guaranteed basic benefits	The amount specified under the policy as being payable on death or on survival to the end of the term of a policy.
Holloway policy	A with-profits policy that combines both sickness and savings benefits.
Inherited Estate	The term inherited estate (sometimes known as estate or free estate) usually refers to the excess of the realistic value of assets over the realistic value of liabilities.
Interim bonus	The bonus declared in respect of the period since the last declaration of regular bonus to the date of claim.
Long term business fund	The long term fund of the Society comprising life assurance, pensions, and other similar business within the definition of "long term insurance business" in the Glossary to the Financial Services Authority Handbook.

Market value reduction (MVR)	A downward adjustment that may be made to certain claims under unitised with-profits pensions business and with-profits bonds to help ensure fair treatment and protect the interests of policyholders remaining within the fund. It is sometimes (alternatively) known as a market value adjustment or MVA.
Membership activities	The activities and services the Society provides to members that do not fall within the main long term business activities and services.
Miscellaneous profits or losses	Profits or losses other than arising from investment returns, mortality costs, tax and expenses.
Mortality costs	Excess of benefits on death over asset shares.
Mutual	A firm engaged in long term insurance business whose constitution does not include shareholders. The firm is, therefore, owned by its members.
Non-profit policy	Any policy which does not confer on the holder a right to share in the profits of the Society.
Resilience reserve	The resilience test is required by the FSA to assess the ability of a firm to withstand major falls in asset prices such as equities and fixed interest securities. This may require the firm to make additional provisions (resilience reserves) or to consider adjusting their investment strategy.
Smoothing	The process by which the fluctuations in policy payouts as between types of policy and over time are moderated.
Society	The Shepherds Friendly Society Limited
Solvency	The excess of the value of the assets over the liabilities.
SUP	The Supervision Manual issued by FSA.
Surplus	The excess of the value of assets over the amount of the liabilities determined in accordance with the rules of the FSA.

With-profits policy

Any policy which confers on the holder a right to share in the profits of the Society.

**With-profits
policyholder**

A person who holds a with-profits policy.