



Abbey Life Assurance Company Limited

Participating Business Fund

Principles and Practices of Financial Management (PPFM)

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1 GENERAL

1.1 Introduction

This document records the Principles and Practices of Financial Management (PPFM) according to which Abbey Life Assurance Company Limited ('the *Company*') currently manages policies in its Participating Business Fund ('the *Fund*'). When preparing it, we have endeavoured to ensure that it accurately reflects how we manage the *Fund*.

Terms in italics are defined in the Glossary which is found in Annex 1 of this document.

The Financial Services Authority ('FSA') requires this documentation of PPFM, in accordance with its rules. Much of the document's form and content reflects these rules.

This is a technical document that has been prepared to enable a knowledgeable observer to understand the material risks and rewards from maintaining a *With-Profits Policy* with the *Company*.

Where we use terms such as "appropriate", "fair", "significant", "similar" and "material", then, unless otherwise required by the context, we are referring to judgements or assessments made by the *Company* or the *Board* of the relevant factors or circumstances.

1.2 The *With-Profits Policies*

The *Fund* is a separate sub-fund of the *Long Term Fund*. It contains mainly unit-linked policies with a small with-profits element, written by the *Company* between 1965 and 1972. There is one main type of unit-linked policy remaining, *PIE*. For this type of plan, premiums (after charges) buy distribution units either in unit trusts or OEICs.

There are also a very few *Conventional* whole life and endowment with-profits policies and relatively few unit-linked pension policies (*IAC*) with a small *Conventional* with-profits benefit (the unit-linked portion being wholly non-profit).

The *Fund* has been closed to new business since 1973.

2 STRUCTURE OF THESE PPFM

2.1 Principles and Practices

The Principles in this document are high-level statements, which we do not expect to change often, of how we manage *With-Profits Policies*.

The Practices are statements of specific practices that we currently follow in managing *With-Profits Policies* but which we may change more frequently.

The Principles and Practices are shown separately in boxes. The rest of the document consists of explanatory commentary.

2.2 Layout

Section 3 contains a number of Overriding Principles of very wide-ranging importance.

The *With-Profits Policies* contain guarantees, which apply in different circumstances for different types of *Policy*. When we pay out in circumstances where these guarantees apply, the amounts that we pay are determined by those guarantees and any bonuses that we add. Section 4.1 deals with those bonuses.

When we pay out in circumstances where the guarantees do not apply, for instance when a *Policy* is surrendered, we determine the amounts differently. Section 4.3 covers these payments.

There is no smoothing of unit-linked benefits, including *terminal bonus*.

We do not hold, and do not intend to hold, an ‘inherited estate’. Section 8 covers this and describes what we mean by this term.

Section 9 deals with the apportionment of surplus between the *Fund* and the shareholder.

3 OVERRIDING PRINCIPLES

The following Overriding Principles take precedence over the other Principles.

Overriding Principles

We will follow all contractual obligations and other legal and regulatory requirements. Those requirements will apply if there is any inconsistency between them and any other part of these PPFM.

We aim to manage the business in line with the reasonable expectations of policyholders. When deciding what policyholders might reasonably expect, the factors other than contractual entitlements that we take into account include our past practice, industry practice, and representations we have made to policyholders.

Subject to the above, we aim to achieve fairness of treatment between different types and groups of *With-Profits Policies*, and between them and the shareholder.

The *Board* can change any of the Principles or Practices. When we change any of the Principles or Practices we will tell relevant policyholders in accordance with the FSA’s requirements at the time.

4 THE AMOUNT PAYABLE UNDER WITH-PROFITS POLICIES

This section covers our approach to payouts under *With-Profits Policies*. The policy benefits for *PIE* policies are a combination of unit-linked benefits (which are not discretionary) and bonuses of different types (which are). The PPFM only describes the determination of discretionary bonuses.

We guarantee a minimum amount to pay out to policyholders under a *With-Profits Policy*. However, such guarantees apply only in specific circumstances, set out in the provisions of the relevant *Policy* and summarised below. Where they apply, the amounts that we pay out are determined by those guarantees and by any bonuses that we add.

On *Conventional life Policies*, the guarantees apply at maturity or on death. On *IAC Policies* the guarantees apply at the selected retirement date.

PIE policies

Guarantees apply on death and at the maturity date for almost all *PIEs*.

The benefit under a *PIE* when guarantees apply is the higher of:

- the guaranteed sum assured plus *reversionary bonuses*, and
- the sum of:
 - a) the value of units bought by premiums paid,
 - b) the total *reversionary bonus* declared, and
 - c) *the terminal bonus(if any)*less a charge for *capital gains tax*.

Principles

We aim to maintain or increase bonus levels, if possible, so that we pay out the whole of the *Fund* (after allowing for outgoings such as taxation, charges and the shareholders' share of distributed surplus described below) to the policyholders of the *Fund*.

Common bonus rates and surrender bases are used for appropriate groupings of *Policies*, reflecting an element of cross-subsidy and pooling of risks. A single group may contain, for instance, *Policies* with different starting dates, different sizes, different ages of lives assured, and different types of premium.

Practices

The main methods, parameters and assumptions that we use are summarised in *Board* papers. These papers are supported by appropriate documentation of the more detailed methods, parameters and assumptions in files in the *Company's* actuarial department.

The parameters and assumptions are derived from analysis of the experience of the *Company* and, where relevant, that of the insurance industry generally.

Changes to methods, parameters and assumptions are documented and are subject to formal approval as part of the bonus-setting process or on reviewing the surrender (including transfers out) and early retirement bases.

Smoothing is limited in that it applies only to the extent that scales of bonus are reviewed only periodically and that single scales of bonus apply across groups of policies.

There are no limits applied to the change in benefits payable from one period to another.

4.1 Bonuses

The two main classes of bonus that we may add are

- *Reversionary Bonus*, which we may add from time to time as permanent increases in the amount of benefit guaranteed, and
- *Terminal Bonus* which we may add to increase the total payout.

Principle

Because of their importance to policyholders, changes in bonus rates are approved by the *Board*.

4.1.1 *Reversionary Bonus*

Reversionary Bonuses are permanent increases in the amounts of benefit guaranteed.

They are declared annually as a percentage of the originally guaranteed sum assured (as a percentage of the originally guaranteed annuity in the case of *IAC*). These bonuses are paid at maturity.

Principles

Reversionary bonuses vary by duration and/or original term. Different scales apply to each of *PIE*, *IAC* and the *Conventional* whole life and endowment *policies*. Rates of bonus do not depend on the age of the life assured.

In some years there may be no *Reversionary Bonuses* added to some or all *With-Profits Policies*.

Practices

Current *reversionary bonus* scales are based on those either originally illustrated to policyholders or modified at an early stage (pre 1980). When *reversionary bonuses* for *PIE* policies have been increased in the past a constant uplift factor has been applied to the whole scale and this practice is expected to continue.

Reversionary bonuses on *PIE* policies will be increased only if the expected value of dividend or rental income received from the assets matching linked liabilities is greater overall than the cost of future *reversionary bonuses*. We do not expect to reduce *reversionary bonuses* except in circumstances where *Terminal Bonuses* are also reduced.

Reversionary bonuses on *Conventional* benefits are expected to remain at current levels without change.

The *Company* does not expect to change *reversionary bonus* scales for *PIE* policies frequently.

Reversionary bonus scales are reviewed at least annually. There is no constraint on the amount by which *reversionary bonus* scales would alter if the *Company* were to change *reversionary bonus* scales.

4.1.2 Interim Bonus

‘Interim bonus’ may be added alongside any *Terminal Bonus* when we pay out under a *Policy*. Although it is a form of *Terminal Bonus* it is covered separately here.

Practices

We decide rates of interim bonus at least as often as rates of *reversionary bonus*. The rates of interim bonus are also expressed as a percentage of the originally guaranteed sum assured (or originally guaranteed annuity in the case of *IAC*).

We normally set rates of interim bonuses for claims in the coming year at the same levels as the rates of *reversionary bonuses* declared at the previous year-end.

4.1.3 Terminal Bonus

This section covers *terminal bonuses*, which may be payable when a policy becomes a claim.

Terminal bonuses are declared from time to time as a percentage of the base units under the policy (i.e. excluding units bought with bonuses) for *PIE*. As such, the amounts of *terminal bonus* on this product will fluctuate in line with unit values. A uniform *terminal bonus* scale is used for all *policies* of the same type.

Principles

Terminal bonuses are declared as a percentage of the bid value of units for *PIE*.

Terminal bonuses are used to distribute that part of the *Fund* which is not required to maintain *reversionary bonuses* at their current rates in most reasonably foreseeable circumstances.

Practices

Conventional benefits

For *IAC*, the *terminal bonus* paid in the event of a claim is calculated as a percentage of the guaranteed annuity in-force. This percentage is proportional to the number of complete years from the date of issue to the date of claim.

No *terminal bonuses* are payable on the whole life and endowment products.

PIE policies

Terminal bonuses will be increased if the value of assets exceeds the realistic value of liabilities, including future *reversionary* and *terminal* bonuses, in most reasonably foreseeable circumstances.

If the value of assets falls below this value of liabilities, *terminal bonuses* would be reduced to a level where the value of assets is expected to exceed the value of liabilities in most reasonably foreseeable circumstances.

Terminal bonus levels are, or may be, different for different policy types. The same rate is used for all policies of the same type.

The same rates of *terminal bonuses* are payable on surrender, death and maturity claims.

4.2 Method used to determine bonus rates

Practices

An investigation of the future rates of bonus that could be supported by the assets of the *Fund* is undertaken each year. The method of investigation consists of a projection of the expected income and outgo of the portfolio. The different policy types are investigated separately with each policy being projected individually.

Calculations are performed for all future years to compute the expected amount of income and outgo each year. Income items include premiums and dividends/rental income. Outgo items include amounts paid on death, surrender and maturity, charges made to the *Fund*, tax, disability benefits and waiver of premium benefits. Income less outgo in each future year is discounted at a market rate of interest, net of tax for life business, for the appropriate period to obtain the present value for each policy type at the investigation date. Surplus for each policy type is the difference between a notional allocation of the assets of the *Fund* to that policy type and these present values.

The calculations allow for current *reversionary* and *terminal bonuses*. The balance, if any, of surplus is available to increase the level of bonus rates, an increase in the rate of terminal bonus being generally considered before an increase in reversionary bonus rates. The extent of any increases is limited in order to leave a level of surplus to carry forward to provide a margin for adverse deviation.

The main assumptions that determine the result of the investigation are the expected dividend yields (rental income in the case of property). These are determined having regard to actual experience in the year prior to the date of the investigation and to published data, if any.

A formal report is presented to the *Board* each year. The report includes a summary of the results of the investigation, the assumptions adopted and the sensitivity of the results to changes in the more important assumptions.

The *Company* does not intend to change this approach to determining bonus rates. The assumptions adopted are reviewed for each investigation and updated as necessary to reflect circumstances then current.

There is no smoothing of investment returns.

4.3 Payouts where guarantees do not apply

This section covers circumstances when we pay out from the *Fund* when guarantees do not apply. Such circumstances include surrenders (including transfers out), or partial surrenders, and early retirements.

Principle

The surrender value payable under a *Unit-linked Policy* is a function of the value of units allocated to the policy and includes a value for the *reversionary bonuses* allocated. A deduction is made to provide for initial expenses that will not be recovered as a result of the surrender.

Practices

The surrender value for *PIE* is calculated in accordance with past practice and is equal to the sum of:

- The bid value of units allocated, plus the current terminal bonus; and
- The value of *reversionary bonuses* for *PIE*, multiplied by a discount factor, which reflects yields on UK government fixed interest securities (net of tax);

less a deduction for capital gains tax.

The surrender value for the *conventional* policies is the sum of the guaranteed sum assured plus *reversionary bonuses* allocated, multiplied by a discount factor which is based on the age of the policyholder and the outstanding term of the policy and reflects yields on UK government securities (net of tax). For premium paying policies a deduction is made to allow for the premiums that will not be received.

The transfer value for *IAC* is the bid value of units allocated plus the cash equivalent of the sum of the guaranteed annuity in-force (adjusted for unpaid premiums), *reversionary bonuses* allocated and *terminal bonus*. The cash equivalent is determined using an annuity value that reflects yields on UK government securities (gross of tax).

Surrender scales will usually be updated at the same time that bonus rates are changed, but may be updated more frequently if required to maintain fairness between policyholders.

5 INVESTMENT STRATEGY

Principles

The investment strategy is decided at least annually by the *Board* taking into account the advice of the *Appointed Actuary*.

The assets, including proportionate components of certain internal linked funds, representing the *Fund* have been segregated from the remainder of the long term business assets since 31 December 1979. Investment income and gains apportioned to the *Fund* are those actually earned on these segregated assets.

Assets are invested in the first instance to match policyholder liabilities including past declared bonuses. Index linked gilts are held to provide for future expenses. Other assets are invested as determined by the *Board* on the advice of the *Appointed Actuary*.

We do not intend the *Fund* to hold on its own account derivatives or other instruments that may alter the economic out-turn from assets.

We do not intend the *Fund* to hold any assets that would not normally be traded.

There is no reliance on assets outside the *Fund* to maintain the investment strategy of the *Fund*.

There are no constraints on the *Fund's* investment strategy other than the regulatory close matching requirement for unit-linked liabilities.

Practices

Policyholder unit-linked liabilities, including future terminal bonuses on current scales on *PIE*, are matched closely by the appropriate linked assets.

Policyholder non-linked liabilities, including future terminal bonuses on current scales on *IAC*, are broadly matched by fixed interest investments. These include holdings of gilts, investment grade corporate bonds and a holding in an internal linked fund of the *Company*, the Abbey Fixed Interest Fund (which invests in a portfolio of similar assets).

The value of future reversionary bonuses on current scales for *PIE* policies is broadly matched by future dividend income from linked assets (rental income in the case of property) and fixed interest investments.

Future expenses are broadly matched by index-linked gilts.

Surplus assets are invested so as to broadly replicate the asset distribution of a balanced managed Fund.

The *Fund* can use investment instruments that are of a new type, or are of a type not already authorised for use within the *Fund*, only with the approval of the *Board*.

6. EXPENSES AND CHARGES

We make charges from the *Fund* to recover our expenses.

Charges are amounts that we debit from the *Fund* in return for meeting the expenses relating to *with-profits policies*.

In this section we describe the way in which we apply charges and apportion expenses.

6.1 Expenses

The *Company* has two outsourcing arrangements. In 2009 the *Company* outsourced its policy administration functions to Capita, for an initial period of 10 years, but with an option within the first 5 years to convert to a perpetual arrangement. After 3 years, the contract may be terminated by the *Company* subject to 6 months' notice or at any time for a material breach. It also has a contract with Scottish Widows Investment Partnership (SWIP) to manage its investments.

Principles

We deduct charges from the *Fund* to cover the expenses incurred in maintaining the policies in the *Fund*, including investment dealing expenses and a share of overhead expenses.

We may change the levels of charges if in our opinion this would achieve a more appropriate balance between policyholders and the shareholder.

We aim for each with-profits policy to bear a share of the total charges levied on the *Fund*.

Practices

The amounts charged to the *Fund* comprise a per policy amount to cover administration costs and amounts in respect of investment management and renewal commission.

The charge for administration costs is based on a fixed amount per policy per year. This charge is intended to be no more than the costs of administering the policies plus an appropriate recovery of overheads, allowing for the additional complexity of with-profits business. The level of the charge is reviewed annually, with any increase being limited to our assessment of cost inflation. The charges are based on the fees payable under our outsourcing arrangements.

The investment returns credited to the *Fund* are net of the actual investment dealing costs.

The amount charged to the *Fund* in respect of investment management expenses in a year is no more than the amount payable to the investment managers.

Renewal commission paid on with-profits policies is charged to the *Fund*.

The *Company* monitors its outsourcing arrangements on an ongoing basis.

6.2 Charges

Management Charges on unit trusts, OEICs, and internal linked funds

This section describes the treatment of initial and renewal management charges where the *Fund* has holdings of units in unit trusts, OEICs, or internal linked funds. The initial management charge is 5% of the amount allocated to units from premiums on *unit-linked policies*.

Principles

Initial management charges are deducted from the *Fund* when units are allocated to *PIE* and *IAC* as a result of premium payments.

Renewal management charges are deducted from the *Fund* only on units allocated to policies.

Practices

Renewal management charges on the internal-linked funds of the *Company* are $\frac{3}{8}\%$ per annum of the unit-linked reserves held in respect of policyholders' accrued benefits ($\frac{1}{4}\%$ in the case of certain *IAC* contracts).

No renewal management charges are deducted by the *Company* in respect of holdings of the Legal & General Capital Trust, the SW UK Growth Class C OEIC and internal-linked funds of the *Company* in excess of units allocated to policies.

Tax**Principle**

The *Fund* is treated on a stand-alone basis for tax purposes with the tax charged to the *Fund* being calculated on the normal basis used for life companies, i.e. investment income less

Expenses for the life business and the Case VI profits basis for pensions business. Investment income includes capital gains, both realised and unrealised, except for those gains on units held in respect of policyholders' accrued benefits where the *Company's* liability to capital gains tax is effectively met by a deduction from policy proceeds.

Practice

The prevailing rates of policyholder tax are used. Allowance is made for indexation.

7. BUSINESS RISKS

In this section we describe the exposure of the *Fund* to various types of business risk, such as:

- Profits and losses arising from our management of *with-profits policies*, including the operation of guarantees
- Compensation costs

No non-profits insurance business, or any profit on non-profits insurance business, is attributed to the *Fund*.

PIE has a guarantee that the amount payable on death or on maturity, in the case of certain policies, will not be less than specified amounts. *IAC* has minimum guaranteed annuity rates that will be applied to the unit proceeds on vesting.

Principles

We aim to maintain a sound and prudent approach to the management of the *Fund* when considering the nature and extent of risks taken.

No charge is made to the *Fund* for the following guarantees:

- The guaranteed minimum sum assured at maturity on *PIE*
- The guaranteed annuity rates applying to the unit-linked benefits on *IAC*

Any cost arising from the excess of the guaranteed amounts over the value of units (including any terminal bonus) is met by the *Company* from assets outside the *Fund*.

Any amount payable by the *Company* in respect of actual or alleged mis-selling will not be charged to the *Fund*.

Practices

Since the *Fund* is closed to new business it is not exposed to any risks in connection with acquiring new business.

8. INHERITED ESTATE

We do not aim to hold an inherited estate. By inherited estate we mean assets held in the *Fund* that we do not intend to distribute to its policyholders.

Principles

We do not aim to hold any significant, long-term excess of assets over and above the amounts required from time to time to meet

- The reasonable expectations of the *Fund's* policyholders
- Any regulatory requirements which can only be met by holding such an excess.

9. APPORTIONMENT OF SURPLUS BETWEEN THE *FUND* AND SHAREHOLDERS

Principles

Policyholders will receive 90% of surplus distributed from the *Fund* whether on maturity, surrender or death; shareholders will receive 10% of the distributed surplus. The division of surplus between policyholders and shareholders will not change.

Practices

The amount of surplus distributed is valued for this purpose as:

- the value of *Reversionary Bonuses* calculated on the basis used for the regulatory valuation of the liabilities of the *Fund*, which allows for the taxation of the *Fund*, but ignoring for this purpose the solvency requirements of the FSA (or its successor) ;
- the value of interim and *terminal bonuses* paid on maturity, death and surrender claims made during the year;
- the value of the shareholder transfer.

If there is any change in the basis used to quantify the value of surplus that is distributed, we do not intend to change the planned division of that surplus between policyholders and shareholders.

Management charges on unit funds are not credited to the policyholders' account for the purpose of determining the surplus in the *Fund*.

Taxation borne by the *Company* on the transfers described in this section is not borne by the *Fund* and is not reflected in payouts under *With-Profits Policies*.

ANNEX 1: GLOSSARY

Appointed Actuary means the holder for the time being of the office of With Profits Actuary of the *Company*, or the holder for the time being of the office of Actuarial Function (with regard to the determination of tax on capital gains referred to in Section 4) or the holder of any successor office.

Board means the Board of Directors of the *Company*.

Company means Abbey Life Assurance Company Limited, company number 710383 and having its registered office at Winchester House, 1 Great Winchester Street, London EC2N 2DB.

Conventional, as applied to a *Policy* or a benefit payable under a *Policy*, means not unit-linked.

Fund means the Participating Business Fund, a separate fund maintained by the *Company* within the *Long Term Fund*.

IAC means the Investment Annuity Contract. This is a retirement annuity contract providing both unit-linked and with-profits benefits. The with-profits benefits are in the form of a guaranteed annuity payable at the chosen vesting date and bonuses are in the form of additional annuity amounts. There are guaranteed annuity options on the unit-linked benefits but no guaranteed cash option on the with-profits annuity.

Long Term Fund means the long term fund maintained by the *Company* pursuant to FSA rules.

PIE means the Planned Investment Endowment. This is a unit-linked policy with benefits linked to OEIC shares. Almost all policies have minimum guaranteed benefits on maturity or on earlier death.

Policy means any contract of insurance within the meaning of section 424(2) of the Financial Services and Markets Act 2000 and SI 2000/2361 (as amended) which forms part of the *Long Term Fund*

Reversionary Bonus means a type of bonus taking the form of a permanent increase in the amount of benefit guaranteed under a *With-Profits Policy*.

Terminal Bonus means an amount that is added when an amount becomes payable under a *With-Profits Policy* and is not guaranteed in advance.

Unit-linked policies means *PIE*.

With-Profits Policy means that part of any contract of insurance which at the relevant time confers on the holder a right to share in the profits of the *Company* or of any specified sub fund of the *Company*, as appropriate.