PRUDENTIAL

# Principles & Practices of Financial Management

Applicable to the With-Profits business issued by the Prudential Group to UK policyholders

This version of the PPFM was published in August 2019. The contents of the PPFM may be amended in the future. The latest version can be found at **pru.co.uk/ppfm**

# Contents

# Introduction

## A Purpose of the PPFM

All firms that carry out with-profits business in the UK are required to define, and make publicly available, the Principles and Practices of Financial Management (PPFM) that are applied in the management of their with-profits funds. Prudential is committed to providing open and honest communications and we believe that the PPFM will help with that aim.

In managing with-profits business, firms rely on their ability to use discretion, particularly in relation to the investment strategy adopted, and the smoothing and bonus policies used. The purpose of Prudential's PPFM is therefore to:

- explain the nature and extent of the discretion available;
- show how competing or conflicting interests or expectations of
  - different groups and generations of policyholders, and
  - policyholders and shareholders, are managed so that policyholders and shareholders are treated fairly; and
- give a knowledgeable observer (e.g. a Financial Adviser) an understanding of the material risks and rewards from starting and continuing an investment in a with-profits policy with Prudential.

The PPFM covers all with-profits policies issued in the UK by:

- companies in the Prudential Group (i.e. by The Prudential Assurance Company Limited (PAC), Scottish Amicable Life plc (SAL) which were transferred to PAC with effect from 31 December 2002, Prudential (AN) Limited (PANL) which were transferred to PAC with effect from 31 October 2010, and Prudential International Assurance plc (PIA)), and
- Scottish Amicable Life Assurance Society which were transferred to PAC with effect from 30 September 1997.

The PPFM also covers the with-profits annuity business that was transferred from The Equitable Life Assurance Society (ELAS) to PAC with effect from 31 December 2007. For this purpose, the definition of business transferred includes any business which was excluded from the transfer, but which was reinsured from ELAS to PAC on the basis that it would be dealt with as if it had been transferred. Although the business originally written by ELAS in Germany and Ireland was transferred from PAC to PIA on 1 January 2019, this remains covered by the PPFM, as immediately following the transfer it was reinsured back to PAC.

In general, the Principles and Practices set out in the PPFM do not apply to the overseas business written prior to 1 January 2019 in PAC's branches in Poland, France and Malta which on 1 January 2019 were transferred to PIA and reinsured into PAC, nor the PIA Poland business written from 1 January 2019 which is reinsured into PAC. They do, however, apply to off-shore business reinsured into PAC by PIA and Canada Life Assurance Europe Limited (CLE).

To fully understand the risks and rewards of effecting or holding a Prudential with-profits policy, the reader should read the whole PPFM and not just selected sections. In particular, Principles should be read with their associated Practices (see section B below). However, the PPFM is not a comprehensive explanation either of the management of the with-profits business of the Prudential Group or of every matter which may affect that business.

Statements within the PPFM are by their nature forward-looking statements that are subject to a variety of uncertainties; this document should be read in that context. In addition, no part of the document should be read as a recommendation to policyholders or potential policyholders or their advisers in relation to effecting or maintaining a with-profits policy. Accordingly, any person considering whether to effect or maintain a with-profits policy with any member of the Prudential Group should seek financial advice.

None of the contents of this document forms part of, or varies, the terms or conditions of any policy issued by any member of the Prudential Group. In the event of any inconsistency between the contents of this document and any policy, the terms and conditions of the policy prevail.

## B Principles and Practices

In the PPFM we define the Principles and Practices used in managing the UK with-profits business of PAC, which includes off-shore business acquired by or reinsured into the company (see section C below) by PIA and CLE.

- The Principles define the overarching standards adopted in managing PAC's with-profits business to maintain the long-term solvency of the fund for current and future policyholders and describe the approach used:
  – in meeting our duty to with-profits policyholders, and
  – in responding to longer-term changes in the business and economic environment.
- The Practices describe the approach used:
  – in managing PAC's with-profits business, and
  – in responding to changes in the business and economic environment in the shorter-term.

The contents of the PPFM are normally reviewed on a half-yearly basis. The contents of the PPFM may be amended following such a review, either as the circumstances of the Prudential Group change or business or economic environments alter, or to reflect new product launches, or to reflect changes in the management of the with-profits business. Any proposed changes are reviewed by PAC's With-Profits Committee (WPC) (details of which are given in section G below) and are subject to approval by the PAC Board.

In normal circumstances we would expect to give affected policyholders written notice at least 3 months in advance of the effective date of any material change to the Principles. However, there may be circumstances when changes will be made without notice with the agreement of our regulators, the Financial Conduct Authority (FCA) and Prudential Regulatory Authority (PRA), or their successors.

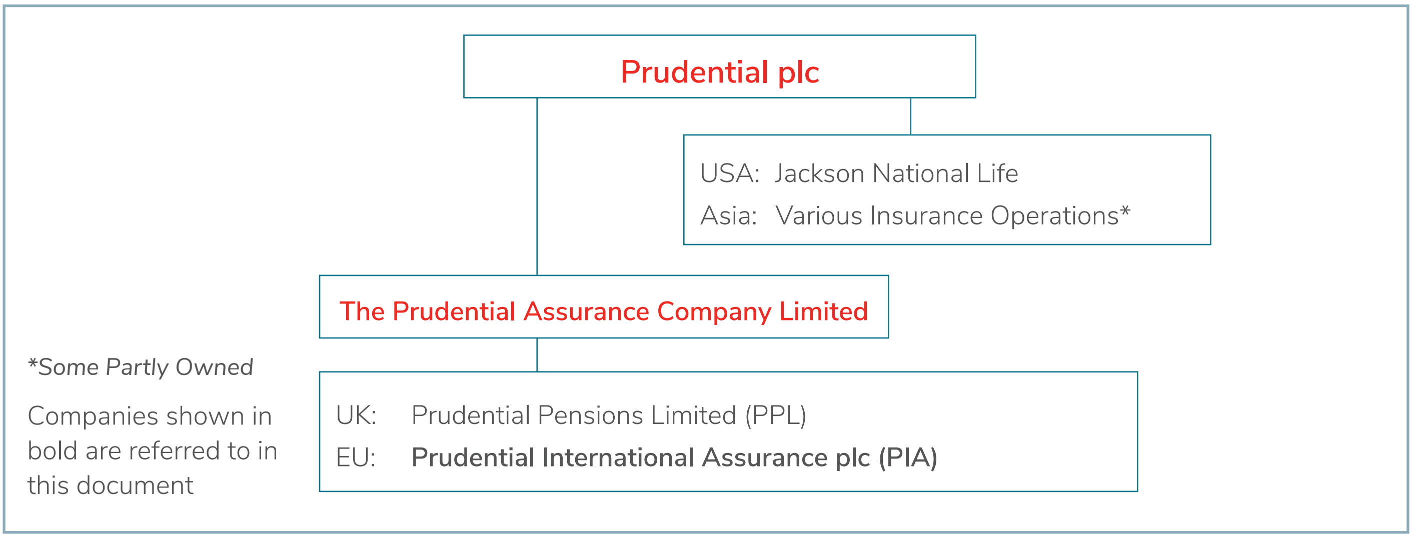
We expect our Practices to be revised from time to time as both circumstances and the business environment change. We will notify affected policyholders in a reasonable period after the effective date of any such change, generally in their next annual statement.

The most important aspects of the PPFM have been summarised in customer friendly form called a Consumer Friendly PPFM (CFPPFM). We have a small number of different versions, each appropriate to particular products. All UK with-profits policyholders who received an annual statement following the February 2006 bonus declaration, and all new UK with-profits policyholders from 1 January 2006, received or will receive a CFPPFM. Policyholders will subsequently be notified of any significant changes in the relevant CFPPFM made as a result of changes to the PPFM.

# C Structure of the Prudential Group

## C1 Company Structure

Prudential plc owns, directly or indirectly, all or part of a number of insurance companies which are shown below, as well as a number of other types of company which are not shown.




Prudential plc also owns, directly or indirectly, various investment management companies including Prudential Portfolio Management Group, M&G, PPM America, M&G Real Estate and Eastspring Investments (Asia). A large part of PAC's assets are managed by these companies.

## C2 Structure of PAC

PAC is a proprietary company, the shares of which are wholly owned by Prudential plc. PAC's principal activities are with-profits and non-profit life and pensions insurance business. For with-profits business, there are three sub-funds, the With-Profits Sub-Fund (WPSF), the Scottish Amicable Insurance Fund (SAIF) & the Defined Charge Participating Sub-Fund (DCPSF) described in paragraphs C2.1 to C2.3, which are collectively referred to as the With-Profits Fund throughout this document. PAC also conducts some general insurance business outside the With-Profits Fund.

| The Prudential Assurance Company Limited (PAC) | | | | | |
|---|---|---|---|---|---|
| With-Profits Fund | | | Non-Profit Sub-Fund (NPSF) "0:100" | General Insurance Fund "0:100" | Other "0:100" |
| With-Profits Sub-Fund (WPSF) "90:10" | Scottish Amicable Insurance Fund (SAIF) "100:0" | Defined Charge Participating Sub-Fund (DCPSF) "100:0" | | | |

This diagram does not indicate relative sizes.

PAC's life and pensions business is transacted mainly in the UK and is predominantly with-profits.

The UK with-profits business consists of business:

- written directly in PAC,
- transferred into PAC from the Scottish Amicable Life Assurance Society (SALAS) on 30 September 1997 and from SAL on 31 December 2002,
- transferred into PAC from ELAS on 31 December 2007, and
- transferred into PAC from PANL on 31 October 2010.

PAC also contains with-profits business written outside the UK, comprising business:

- written by branches of PAC in Poland, France and Malta, prior to 1 January 2019, which on 1 January 2019 was transferred from PAC to PIA and reinsured back to PAC,
- written by PIA Poland from 1 January 2019 and reinsured into PAC,
- reinsured into PAC by
  - other Prudential Group insurance companies, such as PIA, or
  - Canada Life Assurance (Europe) Ltd (see paragraph C3.3 below), and
- written by branches of ELAS and transferred into PAC from ELAS on 31 December 2007 including the business originally written by ELAS in Germany and Ireland which, on 1 January 2019, was transferred from PAC to PIA and reinsured back to PAC.

With-profits business is written in the With-Profits Fund and consists of with-profits policies which share in the divisible profit of PAC as determined each year in accordance with the company's Articles of Association. The constituents of the divisible profit and the proportion attributable to policyholders may vary by product type; the proportion attributable to policyholders in the With-Profits Sub-Fund (see paragraph C2.1 below) may be varied by the company over time. The With-Profits Fund is divided into sub-funds to facilitate the management of the various risk-bearing and profit-sharing arrangements that apply.

The profits (if any) available to policyholders and/or shareholders vary between the sub-funds as described below.

### C2.1 With-Profits Sub-Fund (WPSF)

The With-Profits Sub-Fund (WPSF) consists mainly of with-profits business, which is/was written by:

- PAC, both Ordinary Branch and Industrial Branch,
- SAL, and transferred into PAC, and
- PANL, and transferred into PAC.

The WPSF also contains a significant amount of non-profit business, which consists of:

- non-profit annuity business that has arisen from with-profits pension policies that were originally written in the WPSF,
- non-profit immediate and deferred annuities originally written by Prudential Annuities Limited (PAL) and transferred into the WPSF,
- other non-profit (including unit-linked) business written by PAC that is not allocated by the Directors to the Non-Profit Sub-Fund (see paragraph C2.4 below), and
- certain types of business originally written by SALAS and now contained in the Scottish Amicable Account (SAA), which are:
  - the unitised with-profits life business, other than its investment content which was transferred to the Scottish Amicable Insurance Fund (SAIF) (see paragraph C2.2 below),
  - the non-profit life business, and
  - the unit-linked life business.

Prior to 1 October 2014, the WPSF owned PAL, a subsidiary company writing non-profit annuity business. PAL was established in 1992, but closed to new business in July 2004 as a result of the WPSF reaching its risk limits in relation to the credit and longevity risks associated with non-profit annuity business. The long-term insurance business of PAL was transferred to the WPSF on 1 October 2014.

The WPSF contains the PAC inherited estate. This is the amount of money in the sub-fund in excess of that which the Directors of PAC expect to be paid out to meet obligations to existing policyholders (see sections D and E below). The business written by PAC's Polish and Maltese branches, which on 1 January 2019 was transferred from PAC to PIA and reinsured back to PAC, and the business written by PIA Poland, which is reinsured into PAC, are all treated on equal terms with PAC's UK business in relation to the support it receives from the PAC inherited estate.

Divisible profit arising in the WPSF, including profit that arises on the non-profit business, is divided between with-profits policyholders and shareholders. The Articles of Association permit up to 5% of the divisible profit to be transferred to a contingency fund before the balance is divided between policyholders and shareholders. The proportion of divisible profit attributable to with-profits policyholders in the WPSF is defined by the Articles of Association as being at least 90%, with the balance attributable to shareholders. For virtually all business, the policyholders' proportion is currently 90%. Thus the WPSF is a "90:10" sub-fund.

### C2.2 Scottish Amicable Insurance Fund (SAIF)

SAIF is a closed sub-fund that contains the bulk of the business originally written by SALAS and acquired by PAC on 30 September 1997. It contains:

- SALAS's pensions and annuity business (with-profits and non-profit),
- SALAS's conventional with-profits life business, and
- the investment content of SALAS's unitised with-profits life business.

The balance of SALAS's business was transferred to the WPSF and is allocated to the SAA. As the with-profits investment element of SAA policies (i.e. the accumulation of premiums less charges) is invested in SAIF, it is managed with all other SAIF with-profits policies.

SAIF also contains the SAIF inherited estate. This inherited estate consists of assets in the sub-fund over and above the amounts that we would normally expect to pay out over time, if the sub-fund had remained open to new business, to SAIF and SAA policyholders as claim values (see PPFM paragraph 5.1.2). Under the terms of the SALAS Scheme, the SAIF inherited estate will be distributed to with-profits policyholders as an addition to the with-profits benefits arising in SAIF, including those relating to SAA policies.

SAIF is provided with financial support from the WPSF by means of the Scottish Amicable Capital Fund (SACF), in return for an annual charge. SACF is treated as part of the free assets of SAIF for the purposes of setting SAIF's bonus and investment policy. However, SACF remains in the WPSF and does not form part of the SAIF inherited estate. SACF cannot exceed 15 per cent of the with-profits assets in SAIF and will reduce in size as the SAIF sub-fund reduces as a result of policyholder payouts. SACF would be used to fund any deficit in the SAIF bonus smoothing account in accordance with the SAIF Principles of Financial Management (PFM) set out in the Scheme that transferred SALAS into PAC. These Principles are set out in Appendix A.

**Elements of SAIF and the WPSF that are relevant to SALAS business are shown in the diagram below:**

## WPSF

### Non-Profit Liabilities

Ex-SALAS business in the Scottish Amicable Account (SAA)

- Unitised with-profits life (excl. investment content)
- Non-profit life
- Unit-linked life

### PAC Inherited Estate

Scottish Amicable Capital Fund

## SAIF

### Ex-SALAS Liabilities (with-profits and non-profit)

- Pensions business
  - with-profits
  - non-profit
  - unit-linked
- Life business
  - conventional with-profits
  - unitised with-profits (investment content only)

### SAIF Inherited Estate

This diagram does not indicate relative sizes.

The Scheme which transferred SALAS into PAC states that the Scottish Amicable Funds (i.e. SAIF and SACF) must be managed in accordance with the specified SAIF PFM. These Principles:

- include the over-arching provision that the Scottish Amicable Funds should be managed in a sound and prudent fashion,
- provide a framework for setting bonus and investment policy for the Scottish Amicable Funds on a basis that is fair to both SAIF and SAA policyholders and other PAC policyholders, and
- require that the SAIF inherited estate be distributed over time to with-profits policyholders in SAIF and SAA.

The whole of the profit arising in SAIF, including profits or losses on its non-profit business, will be allocated to with-profits policyholders in SAIF and SAA (i.e. SAIF is a "100:0" sub-fund).

### C2.3 Defined Charge Participating Sub-Fund (DCPSF)

The Defined Charge Participating Sub-Fund (DCPSF) consists of two types of business.

The first type of business is the accumulated investment content of premiums paid (i.e. the accumulation of premiums less explicit charges) in respect of the Defined Charge Participating business, which is either:

- reinsured into PAC from PIA or other companies, or
- written through PAC's French branch (between 1 January 2001 and 31 December 2003), which on 1 January 2019 was transferred from PAC to PIA and reinsured back to PAC.

This business is defined as with-profits business on which policyholders incur only the charges stated explicitly in the policy (which include an annual management charge on the assets held within the DCPSF). The charges on the reinsured PIA business accrue to PIA, which bears all of the corresponding expenses. The charges on the PAC France Branch business accrue to the Non-Profit Sub-Fund (NPSF), which bears all of the corresponding expenses. Hence, the shareholders receive any profits or losses arising from the difference between the charges and expenses on this business.

Bonus smoothing accounts for business reinsured in from PIA, and for business written by the French branch, are maintained in the inherited estate within the WPSF. These bonus smoothing accounts are credited or debited as appropriate with any difference between claim payments made from the DCPSF and the relevant policies' underlying asset shares. For International Prudence Bond and Prudential International Investment Bond business invested in the PruFund Range of Funds (as defined in paragraph 1.3.8.5), the smoothing accounts are credited or debited as appropriate with any difference between the unit price and the net asset value per unit when units are created or cancelled as a result of premiums being received or claims being paid. It is intended that these smoothing transfers should generate no net gain to either sub-fund over the long term.

The second type of business in the DCPSF is the with-profits annuities business transferred from ELAS on 31 December 2007, which includes the business originally written by ELAS in Germany and Ireland which on 1 January 2019 was transferred from PAC to PIA and reinsured back to PAC.

For this business, the charges taken are defined within the ELAS Scheme of transfer. There is a 1% per annum deduction from the gross investment return credited to asset shares. This charge accrues to the NPSF, which bears all expenses; hence the shareholders receive any profits or losses arising from the difference between this charge and the expenses (including the capital charge payable by the NPSF to the WPSF) on this business. In addition, there is a maximum deduction of 0.5% per annum from the gross investment return per annum for the expected cost of guarantees. This charge accrues to the inherited estate within the WPSF, which bears the cost of the guarantees; hence the inherited estate within the WPSF receives any profits or losses arising from the difference between this charge and the actual cost of guarantees.

A separate bonus smoothing account for this business is maintained in the inherited estate within the WPSF. It is intended that transfers to and from this account should generate no net gain or loss to either the WPSF or DCPSF over the long term. Further information on the operation of the bonus smoothing account is included in paragraph 1.3.8.4 of this document.

The profits allocated to the transferring ELAS annuities arise from the investment returns earned on the underlying asset shares (less the charges described above).

The profit in the DCPSF arises solely from investment performance and is entirely attributable to DCPSF policyholders (i.e. the DCPSF is a "100:0" sub-fund).

### C2.4 Non-Profit Sub-Fund (NPSF)

The NPSF consists of such non-profit and unit-linked business as has been explicitly allocated to this sub-fund by the Directors.

It also includes non-PIA Defined Charge Participating business, excluding the business which was transferred from ELAS. The investment content of the Defined Charge Participating business held in the NPSF is allocated to the DCPSF. All charges for the Defined Charge Participating business held in the NPSF are credited to the NPSF, which bears all of the expenses of this business.

For the business transferred from ELAS (and which is allocated to the DCPSF), including that which on 1 January 2019 was transferred from PAC to PIA and reinsured back to PAC, the NPSF is credited with the value of a 1% per annum deduction from the gross investment return credited to the ELAS asset shares and bears all the expenses of this business. The NPSF pays an annual charge to the PAC inherited estate within the WPSF for the use of the economic capital supporting the business transferred from ELAS. This charge is calculated as 0.14% per annum of asset shares.

All the profit of the NPSF is attributable to shareholders (i.e. the NPSF is a "0:100" sub-fund).

### C2.5 Prudential Hong Kong Limited (PHKL)

Following court approval in Hong Kong and the UK, on 1 January 2014, PAC transferred its existing Hong Kong branch business to two new Hong Kong incorporated Prudential companies, one providing life insurance and one providing general insurance, so that the Hong Kong business could work more closely with Prudential's other Asian operations. Following the transfer, PAC ceased to write business in Hong Kong. All Hong Kong based business sold from 1 January 2014 is written directly into the Hong Kong incorporated Prudential companies.

Life insurance policies that were originally taken out by customers of PAC's Hong Kong branch were transferred to the new Hong Kong based life insurance company, Prudential Hong Kong Limited (PHKL), together with an appropriate amount of PAC's assets and liabilities. In practical terms, since the Hong Kong branch had both with-profit and non-profit policies, an appropriate amount was transferred from both the WPSF and the NPSF, as necessary, to cover the requisite assets and liabilities of those policies.

As part of the transfer, Prudential split the inherited estate of the WPSF and transferred an appropriate amount of it to PHKL.

The WPSF contains certain non-profit annuity business that was previously reinsured to PAL by the WPSF but was recaptured in August 2011. In order to achieve an equitable sharing of the risks and rewards of this business between PAC and PHKL, as part of the Hong Kong transfer, a reinsurance arrangement was put in place on 1 January 2014 between PAC and PHKL whereby PAC reinsured a proportionate share of the PAL and recaptured PAL business to PHKL. Following the transfer of the long-term insurance business of PAL to the WPSF on 1 October 2014, this business, which is now in the WPSF, remains reinsured to PHKL.

Following the transfer, the vast majority of the PAC With-Profits Fund remains in the UK and in particular, neither SAIF nor the DCPSF was split.

With effect from 14 December 2018, ownership of PHKL transferred from PAC to Prudential Corporation Asia. The transfer of ownership does not impact the proportion of non-profit annuities reinsured from the WPSF to PHKL.

## C3 Information about relevant Companies (other than PAC)

### C3.1 Scottish Amicable Life plc (SAL)

SAL was a wholly owned subsidiary of PAC until it was liquidated in 2011. SAL wrote unit-linked, non-profit and with-profits business from 1 October 1997 until 31 December 2002. At 31 December 2002, its business was transferred into the NPSF with the with-profits element allocated to the WPSF. All references in this PPFM to WPSF with-profits business apply to SAL with-profits business unless there is a specific reference to SAL business.

### C3.2 Prudential (AN) Limited (PANL)

PANL was a wholly owned subsidiary of PAC until it was liquidated in 2012. PANL wrote new with-profits life business from 10 December 2002 to 11 August 2004 and wrote unit-linked pensions business until 31 October 2010. At 31 October 2010 its with-profits business was transferred into the WPSF and its non-profit business was transferred into the NPSF. Prior to the transfer, its with-profits business was wholly reinsured to the WPSF and its policies shared in the divisible profits of the WPSF alongside PAC policies. All references in this PPFM to WPSF business also apply to the transferred PANL with-profits business.

### C3.3 Prudential International Assurance plc (PIA)

PIA is a wholly owned subsidiary of PAC which has transacted Defined Charge Participating business since March 2002. In addition, on 1 January 2019 PIA accepted the business originally written by PAC's branches in Poland, Malta and France and the former ELAS business, that had been originally written in Germany and Ireland which was transferred from ELAS to PAC on 31 December 2007. From 1 January 2019, PIA has also written business through a branch in Poland. All of PIA's with-profits policies are reinsured into PAC. The with-profits business written by the PAC and PIA branches in Poland and the PAC Malta branch are reinsured into the WPSF, while the ELAS business is reinsured into the DCPSF. For the business written in PAC France and the Defined Charge Participating business written directly by PIA, the investment content is reinsured in the DCPSF. For the Defined Charge Participating business written directly by PIA (including those policies written in Germany which were transferred to Canada Life Assurance (Europe) Ltd with effect from 1 January 2003), PIA and CLE pay an annual charge to the PAC inherited estate within the WPSF for the use of the economic capital supporting this business.

## D Conduct of Business Sourcebook (COBS) – operation of with-profits business

The operation of with-profits business is regulated by the rules and guidance set out in Chapter 20 of the Conduct of Business Sourcebook (COBS) of the FCA Handbook (formerly the Financial Services Authority). With effect from 1 April 2012, the FSA (our regulator at that time) made certain changes to the rules and guidance set out in Chapter 20 of COBS in relation to protecting with-profits policyholders. PAC sought clarification from the FSA following these changes and received Individual Guidance in relation to the factors it is required to take account of on two specific issues:

- the writing of new business; and
- setting the risk appetite of its With-Profits Fund.

Following handover from the FSA to the FCA, the FCA confirmed during 2013 that the Individual Guidance previously issued by the FSA remained valid.

On the first issue of factors relevant to the writing of new business, the FSA confirmed that PAC is not generally constrained in its use of the inherited estate to support the writing of new business by any requirement to take into account the prospect that existing policyholders may otherwise have of receiving a distribution, or a greater distribution, from the inherited estate. The FSA, however, identified the following as constraints on the use of an inherited estate by a with-profits firm such as PAC:

- writing new business that is priced on terms that are unlikely to allow the products to be self-supporting over their duration;
- writing new business that at the time it is written is self-supporting but will not foreseeably be sold in sufficient quantities such that the economic value of the future margins expected to emerge is not enough to cover the costs incurred in acquiring the business; and
- writing new business in volumes that increase at such a rapid rate that in the long term it has an adverse effect on a firm's financial strength.

In applying the above constraints on the use of an inherited estate for writing new business, the FSA noted that a proprietary with-profits fund such as PAC's is not required to take account of the tax liability arising on transfers to shareholders from the fund. The FSA further clarified that new business is not required to be self-supporting in the period temporarily following a material change in the business environment that is outside of a firm's control.

On the second issue, the FSA confirmed that in setting risk appetite and determining its approach to the cost of guarantees for its with-profits fund, PAC is generally not required to take into account the prospect of existing policyholders receiving a distribution out of the inherited estate. However, the FSA identified the following factors as relevant to the setting of a with-profits fund's risk appetite in this context:

- risk appetite should be understood to mean a firm's long term target position for the strength of its with-profits fund, underpinning its bonus and investment policy, which in conjunction with its available working capital, defines its ability to take risk from time to time;
- the risk appetite of a with-profits fund such as PAC's has to have regard not only to the financial strength of the fund, but also to representations that have been made by a firm to policyholders;
- whilst there is no requirement to take account of any interest of policyholders in a distribution of excess surplus when setting the risk appetite of a with-profits fund such as PAC's, a firm should not deliberately set or change its approach to risk appetite in order to prevent the emergence of excess surplus; and
- if a policy contains a guarantee, the pricing of the product should make proper allowance at the time it is written for the foreseeable cost of the guarantee(s).

Taking into account the Individual Guidance received from the FSA referred to above, PAC believes that its With-Profits Fund complies with the rules and guidance in Chapter 20 of COBS. PAC will therefore interpret the COBS rules and guidance, and operate the With-Profits Fund, having regard to the Individual Guidance. The comments made in sections E and F below take into account the Individual Guidance, and the discussions that accompanied it.

## E Policyholder and shareholder interests in the WPSF

PAC is, and always has been, a proprietary company, and the whole of the WPSF is legally and beneficially owned by PAC.

PAC's WPSF includes an inherited estate. This is the amount of money in the sub-fund in excess of that which PAC expects to pay out to meet its obligations to existing policyholders.

The inherited estate represents the major part of the working capital of the WPSF. It is available to support both current and future new business in PAC's with-profits sub-funds, and is used to provide solvency support, to allow investment freedom for policyholders' asset shares, and to provide the smoothing and guarantees associated with with-profits business. The Directors seek to manage the PAC inherited estate so that it continues to provide adequate working capital for the future security and ongoing solvency of PAC's with-profits business. There is no specific target for the size of the PAC inherited estate.

Whilst the WPSF remains open and the inherited estate remains fully utilised in supporting current and expected future new business, PAC believes that policyholders' reasonable expectations, and the fair treatment of policyholders, requires that:

(i) policyholders should receive benefits in line with smoothed asset shares (as defined in section 1 of the PPFM), or guaranteed benefits if higher, and

(ii) PAC should seek to manage its with-profits business in such a way as to maintain a strong enough inherited estate in the WPSF to help protect the security of policyholders' contractual benefits, and to allow the continuation of investment freedom, smoothing and the meeting of guarantees. It should be noted that, although PAC seeks to maintain a strong inherited estate through the prudent management of the risks that it takes on, a reduction in the size of the inherited estate as a proportion of the WPSF could nevertheless occur, for example as a result of adverse market conditions.

In the circumstances where the inherited estate is fully utilised in supporting current and expected future new business, PAC does not consider that policyholders have any expectation of a distribution of the inherited estate, other than through the normal process of smoothing and meeting guarantees in adverse investment conditions. In addition, and as is set out in more detail in sections 5 and 6 of the PPFM, in such circumstances PAC is not:

(i) required to take into account in setting risk appetite, and in its approach to the costs of guarantees, the prospect of existing policyholders receiving a distribution out of the inherited estate; or

(ii) constrained in the use of the inherited estate to support the writing of new business by a requirement to take into account the prospect that existing policyholders might otherwise have of receiving a distribution, or a greater distribution, from the inherited estate.

The approach taken by PAC in relation to conflicts of interest between policyholders and shareholders in relation to the management of the inherited estate is described in section 7 of the PPFM.

The WPSF exists for the purpose of writing new with-profits business, and managing the risks inherent in this business for the benefit of both policyholders and shareholders. On this basis, PAC continues to write new with-profits business, and to manage the associated risks within the with-profits sub-funds, providing that the Directors of PAC are satisfied that the new business is properly priced, the risks are properly managed, and the new business is likely to have no adverse impact on the reasonable benefit expectations of the company's in-force policyholders.

## F Risk management of PAC

In managing risk, the PAC Board is responsible for:

(i) determining the company's risk appetite which, in conjunction with the available working capital, determines the company's risk capacity from time to time, and

(ii) determining the financial management framework within which the overall risk level of the company is managed, having regard to that risk capacity, and

(iii) managing the overall risk level of the company and the With-Profits Fund, including its three sub-funds, having regard to that risk capacity and the financial management framework.

The WPSF's risk appetite defines the range of acceptable levels for the sub-fund's financial strength, and, together with the financial management framework, underpins how PAC manages its with-profits business, including setting bonus and investment policy (as described in sections 1 and 2 of the PPFM) and the maximum limits, if any, which may be placed on new business volumes (as described in section 6 of the PPFM). The risk appetite and financial management framework therefore provide the context within which decisions in relation to the management of PAC's with-profits business, including those which may involve conflicts of interest between policyholders and shareholders, are taken. Since, as discussed in section C above, the DCPSF and SAIF rely on the WPSF's inherited estate for capital support, decisions taken by PAC's Directors regarding the WPSF's risk appetite, risk capacity and risk level may affect all of PAC's with-profits policyholders.

The WPSF's risk appetite is set having regard to policyholders' reasonable expectations, based on PAC's policy documents, marketing information and other relevant materials. As noted in section E above, whilst the WPSF remains open and the inherited estate continues to be fully utilised in supporting current and expected future new business, PAC does not consider policyholders' reasonable expectations to extend to any expectation of a distribution of the inherited estate, other than through the normal process of smoothing benefits and meeting guarantees in adverse investment conditions. Consequently, when setting the WPSF's risk appetite, PAC is not required to take into account the prospect of existing policyholders receiving a distribution out of the PAC inherited estate. Although the firm's risk appetite is not set having regard to policyholders' contingent interest in any possible distribution, or greater distribution, of the inherited estate, neither is it set so as to deliberately prevent any possibility of such a distribution being made.

The WPSF's risk appetite may be amended in response to significant changes in the company's long-term financial strength or business environment (such as following a change in the WPSF's regulatory solvency requirements). However, the Directors would consider with-profits policyholders' reasonable expectations at the time of making any change.

With-profits policyholders may be exposed to a range of business and investment risks specific to the type of product held; further details are provided in various sections of the PPFM as follows:

- The overall risk level of the With-Profits Fund reflects both investment risk and business risks, which are described in sections 2 and 3 respectively.
- The level of investment-related risk for all business depends on the extent to which the future asset and liability cash flows may differ, including the extent to which the capital value of assets may differ from the value of the underlying policy guarantees when those assets are realised to pay policy benefits. For with-profits business, this risk is closely inter-related with the bonus distribution policy which is described in section 1.
- The risk capacity of the With-Profits Fund depends on the amount of working capital available, which is provided primarily by the PAC inherited estate as described in section 5.
- The amount of working capital required is affected by the type and volume of new business written, as described in section 6.

The key risk for the With-Profits Fund results from holding a high proportion of real assets (e.g. equities and property) to back smoothed liabilities which incorporate guarantees (mainly in the form of basic sums assured and the accumulated regular bonus additions).

As discussed in section 5, the PAC inherited estate provides capital support for both UK and overseas business, and the risk level of the WPSF thus reflects the aggregate risk level of all of the sub-fund's with-profits business, including that arising in its overseas branches. The Directors of PAC seek to ensure the fair treatment of policyholders in each territory, including that:

(i) the business written in each territory has a similar aggregate level of risk, and

(ii) an appropriate proportion of the inherited estate (which will generally be held in the UK) is denominated in the currency of the relevant territory.

## G Governance arrangements for with-profits business

In addition to its other responsibilities, the PAC Board is responsible for the management of the company's with-profits business, including investment and bonus distribution policy. However, the SALAS Scheme established the Scottish Amicable Board to be responsible for the management (including investment and bonus policy) of the Scottish Amicable Funds. The SALAS Scheme also requires that a Monitoring Actuary be appointed in order to advise the Scottish Amicable Board as to the proper operation of the Scottish Amicable Funds in order to safeguard the interests and reasonable expectations of policyholders invested in SAIF.

In line with industry-wide regulatory requirements, the PAC Board has appointed:

- a Chief Actuary that provides the PAC Board with certain actuarial advice, and fulfils various statutory duties under the new regulatory reporting regime introduced on 1 January 2016,

- a With-Profits Actuary, who reviews material relevant to the operation of the with-profits business, with the specific duty to advise the PAC Board on the reasonableness of how discretion has been exercised in applying the PPFM and how any conflicting interests have been addressed, and
- a With-Profits Committee (WPC), comprising at least three members, all of whom are independent of Prudential, which provides an independent assessment of the way in which Prudential manages its with-profits business and how Prudential balances the rights and interests of policyholders and shareholders in relation to its With-Profits Fund.

The company prepares an annual report to with-profits policyholders setting out how it has complied with the PPFM. This report, which is available on request and at **pru.co.uk/ppfm**, includes details of how discretion has been exercised, how any conflicts of interest between different groups or generations of policyholders, and between policyholders and shareholders, have been addressed and a report from the With-Profits Actuary which states whether he or she considers that the report and the discretion exercised by the company in the year may be regarded as taking policyholders' interests into account in a reasonable and proportionate manner.

The WPC has the duty to report to the PAC Board, providing an assessment of compliance with the PPFM and how any conflicting rights have been addressed. If the WPC wishes to make a statement to with-profits policyholders in addition to the company's report described above, the company will make that report available. In addition, under the Scheme that transferred ELAS business to PAC, the WPC has responsibility for the application of some elements of discretion as defined by the Scheme.

# Principles and Practices of Financial Management

## Section 1 – Determining With-Profits Policy Values

### 1.1 Introduction

**1.1.1** The amount of profit available for distribution among with-profits policyholders and shareholders, the divisible profit, is determined annually by the Directors of PAC in accordance with its Articles of Association. Policyholders receive their distribution of profits by means of bonuses, or other methods as specified in the relevant policy documentation.

**1.1.2** Accumulating with-profits policyholders (i.e. holders of unitised and cash accumulation products, excluding PruFund) and conventional with-profits policyholders receive their share of the divisible profit by way of bonuses which are declared, generally yearly, in the following form:

- a regular bonus (also known as an annual or reversionary bonus) which may be added during the lifetime of a policy, so gradually increasing the guaranteed benefits, for example the benefit payable on death, and
- a final bonus (also known as a terminal or additional bonus) which may be added to policies when a claim is paid in a specified period.

The rates of regular and final bonus declared are generally different for each type of policy. Final bonus rates for each type of policy generally vary by reference to the period, usually a year, in which the policy commenced or each premium was paid.

The bonus rates applied to the with-profits annuities transferred from ELAS consist of a regular bonus which is used to determine the guaranteed annuity, and a combination of an Overall Rate of Return (ORR) and an Interim Rate of Return (IRR) which is used to determine the non guaranteed annuity. For this business the bonus rates do not vary according to the period in which the policy commenced. Depending on the level of regular bonus, ORR and IRR declared, the guaranteed annuity and non-guaranteed annuity may fall after application of the Anticipated Bonus Rate (ABR), and in respect of the non-guaranteed annuity, the Guaranteed Interest Rate (GIR).

PruFund policyholders receive their share of the divisible profit by means of an increase in the unit price at the Expected Growth Rate applicable to the selected fund, subject to adjustments when the unit price moves outside specified limits. Further information on Expected Growth Rates and the returns received by PruFund policyholders is given in paragraph 1.3.8.5 below.

The bonus rates applied to the Income Choice Annuity take the form of a Smoothed Return that is used to determine the non-guaranteed income and, if applicable, any increase in the guaranteed income (the Secure Level) as described in paragraph 1.3.8.6.

**1.1.3** A bonus becomes a contractual right only when it has been added to a policy but it remains subject to the Principles and Practices set out below (see in particular paragraph 1.3.6).

**1.1.4** This section sets out the Principles and Practices we use to work out the pay-out values including:

- the methods we use to work out the amount to pay to with-profits policyholders,
- the approach we take when we set regular bonus rates,
- the approach we take when we set final bonus rates, and
- the approach we take when we set Expected Growth Rates for PruFund business.

**1.1.5** The practices set out in paragraphs 1.3.1 to 1.3.7 below cover the majority of with-profits policies. There are some differences in approach for:

- SAIF with-profits policies,
- SAA with-profits policies, and
- some other types of with-profits policy, namely:
  - – policies originally issued by SAL,
  - – with-profits annuities,
  - – policies in the DCPSF,
  - – policies invested in the PruFund Range of Funds, and
  - – Income Choice Annuity.

Significant differences in practices are summarised in paragraph 1.4 for SAIF and SAA policies, and in paragraph 1.3.8 for other with-profits policies.

## 1.2 Principles

**1.2.1** The company seeks to treat all with-profits policyholders fairly. We aim to provide:

- pay-out values on death or maturity that are fair between different policy types and different generations of policyholder, and
- pay-out values on surrender, transfer or retirement (other than at the selected retirement date) that are also fair between those policyholders leaving and those remaining in the sub-fund.

**1.2.2** Pay-out values are managed through the bonus declaration process (or alternative profit distribution mechanisms as described in the policy document), with adjustments for surrender and transfer values being made through Market Value Reductions (MVRs) or the surrender value bases, as appropriate.

The main objectives of the company's bonus distribution policy are:

- to give each with-profits policyholder a return on the premiums paid reflecting the return on the underlying investments over the time the policyholder has held the policy, smoothing the peaks and troughs of investment performance, and
- to ensure that with-profits policyholders in each sub-fund receive a fair share of the profits distributed from that sub-fund by way of bonus additions to their policies.

**1.2.3** To retain flexibility in our investment policy and to protect the With-Profits Fund, for most types of with-profits product we aim to keep a substantial proportion of pay-out values in non-guaranteed form (i.e. payable as final bonus) and determine regular bonus rates accordingly.

**1.2.4** We set pay-out values by reference to the earnings of the underlying investments, except where guaranteed minimum benefits increase the total amount payable.

**1.2.5** Final bonus rates are set so that in normal investment conditions pay-out values change only gradually over time (i.e. we provide smoothed benefits). Our approach to smoothing is not dependent on the type of claim except when an MVR is applied or a change in surrender bases is made.

**1.2.6** Our intention is that smoothing profits and losses should balance out over time, so that in the long run with-profits policyholders in each sub-fund, or within a product group with a specific smoothing account, neither gain nor lose as a result of our smoothing policy. The cumulative cost of smoothing is monitored. The short-term cost of smoothing is constrained only by the impact that smoothing costs have on the risk level of the sub-fund and hence on the security and reasonable benefit expectations of continuing policyholders.

**1.2.7** Any change to the company's objectives and the methods used to achieve them, or any material change to the historical assumptions or parameters relevant to those methods (for example, previously applied investment returns, charges, or allocations of miscellaneous surplus), will be made as and when they are considered to be appropriate and compatible with treating customers fairly, and only with the approval of the Directors. Any change in respect of SAIF or SAA policies would also be approved by the Scottish Amicable Board and, in addition, court approval may be required if the SAIF Principles of Financial Management need to be changed. Certain changes in respect of the with-profit annuities transferred from ELAS would require review and approval by the With-Profits Committee, and in certain circumstances court approval may be needed.

## 1.3 Practices

### 1.3.1 Pay-out values

1.3.1.1 To meet our objectives for pay-out values, we target them on the asset shares (see paragraph 1.3.7) of sample policies or groups of sample policies. In general, and where appropriate, each sample policy represents only those policies which share a common rate of final bonus (i.e. policies of a particular type which were either issued in the same year or for which a premium was paid in that year). However, where such sample policies would each represent a comparatively small number of policies, we produce scales of final bonus rates that are targeted on the aggregate asset shares across groups of sample policies. Asset shares are calculated for all significant blocks of business.

1.3.1.2 The asset share of a sample policy is a fair value of the assets backing the policy, and is calculated by accumulating the premiums paid (less allowance for expenses and/or charges) at the actual rates of investment return earned on the underlying assets over the lifetime of the policy (allowing for the effect of tax on the investment returns and of tax relief on expenses for life business), making appropriate allowance for miscellaneous profits and losses.

1.3.1.3 When the Ordinary Branch (OB) assets and the Industrial Branch (IB) assets were merged in 1988, the company undertook to link IB policy bonuses to OB policy bonuses as follows:

- for IB policies issued before July 1988, total bonus additions will not be less than 90% of those on corresponding OB policies; and
- for IB policies issued from July 1988, total bonus additions will be 100% of those on corresponding OB policies.

Hence IB pay-out values depend on the corresponding OB pay-out values and do not reflect the IB asset shares, unless the IB value would produce a higher amount for business issued before July 1988. The relationship between IB and OB asset shares is reviewed annually.

**1.3.2** Regular Bonus Rates

1.3.2.1 Rates of regular bonus are determined for each type of policy primarily by targeting them at a prudent proportion of the long-term expected future investment return on the underlying assets. The expected future investment return is reduced as appropriate for each type of policy to allow for items such as expenses, charges, tax and shareholders' transfers. However, the rates declared may differ by product type, or by date of payment of the premiums or date of issue of the policy, if the accumulated annual bonuses are particularly high or low relative to a prudent proportion of the achieved investment return.

When target bonus levels change, the PAC Board has regard to the overall financial strength of the With-Profits Fund when determining the length of time over which it will seek to achieve the amended prudent target bonus level. Regular bonuses were gradually reduced between 1991 and 2004 to reflect the fall in investment returns associated with inflation rates that were generally lower than had been experienced in the 1970s and 1980s.

1.3.2.2 Regular bonus rates are declared, normally in February, for the forthcoming bonus declaration year for:

- all WPSF unitised with-profits products (except SAA and SAL unitised life with-profits products),
- DCPSF unitised with-profits products, and
- SAIF unitised with-profits pension products.

These bonuses are added daily to each policy but the rates of future accrual may be changed at any time during the bonus declaration year.

Regular bonus rates are declared, normally in February, in respect of the previous calendar year for:

- WPSF conventional with-profits products,
- SAA and SAL unitised life with-profits products,
- SAIF conventional with-profits products, and
- With-profit annuities transferred from ELAS.

For these latter products (except those with-profit annuities transferred from ELAS) an interim bonus rate is also declared for claims arising after the end of the calendar year but prior to the declaration for that year. For annuities transferred from ELAS, an IRR is declared which is intended to give credit for the expected investment return after the end of the calendar year until the next policy anniversary.

For WPSF cash accumulation products, the regular bonus rates declared, normally in February, apply for the year ending on the scheme revision date which falls in the next bonus year.

1.3.2.3 In normal investment conditions, we expect changes to regular bonus rates to be gradual over time and changes are not expected to exceed 1% p.a. over any year. However, the Directors retain the discretion whether or not to declare a regular bonus each year, and there is no limit on the amount by which regular bonus rates can change. If the WPSF was operating materially outside of its risk appetite, the PAC Board would expect to take a range of management actions to address this. Reductions in annual bonuses would typically be one of the actions that would be taken.

**1.3.3** Final Bonus Rates

1.3.3.1 A final bonus, which is normally declared yearly, may be added when a claim is paid, or when units of a unitised product are realised.

- Final bonus scales for WPSF and DCPSF unitised with-profits products and all SAIF and SAA products may be varied at any time. In particular, additional bonus declarations to reduce these bonus scales might be necessary (as part of a range of management actions) if the WPSF was operating materially outside of its risk appetite.
- Final bonus scales for WPSF conventional with-profits products are declared for policies becoming claims in the forthcoming bonus period, usually a year.

1.3.3.2 The rates of final bonus usually vary by type of policy and by reference to the period, usually a year, in which the policy commenced or each premium was paid. These rates of final bonus are determined by reference to the asset shares for the sample policies or groups of sample policies described in paragraph 1.3.1.1, but subject to the smoothing approach described in paragraphs 1.3.4.1, and 1.3.4.2.

In general the same final bonus scale applies to maturity, death and surrender claims except that:

- the total surrender value may be impacted by the application of an MVR (for accumulating with-profits business) and is affected by the surrender bases (for conventional with-profits business), and
- for SAIF and SAA policies, and policies transferred from SAL, the final bonus rates applicable on surrender may be adjusted to reflect expected future bonus rates.

Further details are given in paragraphs 1.3.6 and 1.3.8.1 below.

1.3.3.3 There may be an additional bonus on retirement for certain conventional with-profits deferred annuity contracts. Any additional bonus, which is dependent on sex and age at retirement, would increase the annuity. The rate of additional bonus for future retirements may be varied at any time.

**1.3.4** Smoothing of Maturity and Death Benefits

1.3.4.1 The smoothing approach differs between accumulating and conventional with-profits policies as follows:

For accumulating with-profits policies (i.e. unitised and cash accumulation with-profits policies):

- Pay-out values are smoothed primarily by looking at the change in the pay-out value on sample policies from one year to the next. However, we may also consider the change in pay-out values on sample policies of the same duration from one year to the next.

For conventional with-profits policies:

- Pay-out values are smoothed primarily by looking, for sample policies, at the change from one year to the next in the maturity values of corresponding policies of the same duration. However, we may also consider the change in the pay-out value on sample policies from one year to the next and, for deferred annuity policies, in the pension payable at vesting.

1.3.4.2 In normal circumstances we do not expect most pay-out values on policies of the same duration to change by more than 10% up or down from one year to the next, although some larger changes may occur to balance pay-out values between different policies. Greater flexibility may be required in certain circumstances, for example following a significant rise or fall in market values (either sudden or over a period of years), and in such situations the PAC Board may decide to vary the standard bonus smoothing limits to protect the overall interests of policyholders. Such a situation arose in February 2009 when pay-out values on most equivalent policies were reduced by amounts greater than 10% (i.e. outside of the normal limits).

**1.3.5** Target ranges for Maturity Benefits

1.3.5.1 We set a target range for the maturity payments that we shall make on our with-profits policies, expressed as a percentage of asset shares. The target range we use is 80% – 120%.

1.3.5.2 We have set this range as it allows us to target stable bonus rates and allows a reasonable degree of flexibility to smooth returns in periods of market volatility.

It also provides greater certainty to policyholders and minimises the risk of customers not receiving their fair share of the fund return or of receiving payments which are more than the fund can afford to the detriment of the remaining policyholders.

1.3.5.3 For all policies where it is reasonable to determine payouts based on asset shares we manage our business with the aim of ensuring that maturity payments for at least 90% of with-profits policies fall within the target range. In certain circumstances it is not reasonable to determine payouts based on asset shares (e.g. for IB policies, see paragraph 1.3.1.3).

1.3.5.4 In setting target ranges, we use sample policies for all product types. This approach is consistent with the approach outlined in 1.3.1. We do not expect the range of maturity benefits relative to asset shares to be materially different from the range that would apply if all policies were considered.

1.3.5.5 Bonus declarations are normally made with the intention that at least 90% of maturity payments are expected to fall within the target range in the period covered by the declaration. However, any substantial movement in the market value of the assets of the relevant with-profits sub-fund may take a significant proportion of pay-out values outside the target ranges. This may lead to a mid-year bonus declaration to bring more pay-out values within the target range.

**1.3.6** Surrender Values and Market Value Reductions (MVRs)

The approach to surrender values differs between accumulating and conventional with-profits policies.

1.3.6.1 Accumulating with-profits policies

- Surrender values are generally the pay-out values described in paragraph 1.3.4, less any discontinuance charge (also known as an early cash-in charge) that may be applied in accordance with the policy provisions. However, we may then apply an MVR to ensure that neither the security of the sub-fund nor the return to continuing policyholders is affected by paying surrender values significantly in excess of the value of the underlying assets.
- An MVR may apply if:
  - a policy is surrendered (partly or wholly),
  - benefits are taken from a pension policy either before or after the selected retirement date,
  - an investment is switched out of a with-profits investment fund into another fund (including the conversion of a with-profits annuity (issued by PAC) to a non-profit annuity), or
  - regular withdrawals are taken.
- The amount of any MVR on a policy will vary as the value of the sub-fund's assets changes.
- It is not our practice to apply MVRs which reduce surrender values below an amount fairly reflecting the value of the assets underlying the policy.
- On some policies, the impact of any MVR is reduced as policies approach maturity with the aim of ensuring that surrender values progress smoothly into maturity values. Typically, this is done over the last 5 years of the policy.
- All accumulating with-profits policies provide some specific guarantees at certain times – for example on death, terminal illness or the pre-selected retirement date. At these times no MVR can apply.
- Partial withdrawals are normally subject to an MVR; however, regular automatic withdrawals may have been set up with a guarantee that no MVR will apply. On a partial withdrawal, the asset share of the remaining part of the policy is not adjusted to reflect any difference between the surrender value and the asset share of the part surrendered (i.e. the asset share is reduced by the proportion that the withdrawal amount bears to the policy value before any MVR deduction).

1.3.6.2 Conventional with-profits policies

- Surrender values are derived by way of a formula, the parameters of which are set to broadly target asset shares – over the long term, less any deductions necessary to protect the interests of existing policyholders. The formula is based on the sum assured, regular bonus and final bonus applicable to the policy. The parameters in the formula differ by product and can be varied at any time. In setting surrender bases, we aim to ensure surrender values progress smoothly to maturity values. Typically, this is done over the last 5 years of the policy.

- The surrender bases are normally reviewed each year, although the level of surrender values is monitored more frequently to ensure they remain reasonable. Any changes to the surrender bases are designed primarily to reflect the changes in underlying asset values.
- For deferred annuity policies the cash claim value will reflect the current cost of providing the deferred annuity.

#### 1.3.6.3 Target ranges for surrender benefits

The target ranges for surrender benefits are the same as those applicable for maturity benefits, which are set out in paragraph 1.3.5.1. At the time of each surrender value review payouts are normally set such that, when expressed as a proportion of the asset share at the expected date of claim, payouts for over 90% of the sample policies are expected to fall in the range 80%-120% of asset share.

A fall in the market value of the assets of a with-profits sub-fund would lead to immediate changes in the application of MVRs to accumulating with-profits policies. This could lead to an increase in the size of MVRs already being applied, and to an extension to the range of policies to which an MVR is applied.

### 1.3.7 Asset share approach

#### 1.3.7.1 Overview

Asset shares are calculated as the accumulation of all items of income and outgo that are relevant to each policy type:

| | |
|---|---|
| **Income comprises credits for:** | Premiums |
| | Investment return (including unrealised gains) |
| | Miscellaneous profits |
| **Outgo comprises charges for:** | Tax, including an allowance for tax on unrealised gains |
| | Guarantees and smoothing |
| | Mortality and morbidity |
| | Shareholders' profit transfers |
| | Miscellaneous losses |
| | Expenses and commission (net of any tax relief) |

For policies where a partial encashment of with-profits benefits has been taken (for example, regular withdrawals, part surrenders, annuity payments or switches), the asset share will, in addition, be reduced to reflect the benefits that have been encashed.

Variations in asset share calculations for specific policy types are set out in paragraphs 1.3.8 for PAC and ex-ELAS policies and 1.4 for SAIF and SAA policies.

Sample asset shares are generally calculated for an average policy size assuming that the policies commenced, and cash flows occur, in the middle of each bonus or scheme year. Final bonus rates are based on asset shares projected to the middle of the bonus or scheme year.

#### 1.3.7.2 Investment Return

The asset shares for all the with-profits policies that are in a particular asset pool are credited with the investment return (including unrealised capital appreciation or depreciation) earned on the pool over each year, expressed as a single annual rate. Hence, asset shares are not credited with any part of the investment return earned on the inherited estate. The range of asset pools is described in paragraphs 2.1 and 2.3.3.

#### 1.3.7.3 Tax

For life assurance business, tax is payable on investment income and realised capital gains (after allowing for indexation relief) but is partially offset by tax relief on relevant expenses. Tax is charged to asset shares for life assurance product lines in the same way.

For approved pensions business, investment income and gains are not subject to taxation and likewise expenses are not relieved (except to the extent that they form part of the shareholders' profit on that business). Hence, no tax is charged to asset shares for approved pensions business product lines.

PAC is assessed for tax as a single shareholder-owned entity and the tax apportioned to sub-funds fairly, subject to the requirements that:

- the amount charged to SAIF is the amount that SAIF would pay if it were taxed as a mutual life assurance company. In effect any difference between the tax otherwise fairly apportionable to SAIF and the amount charged to SAIF falls to the PAC inherited estate, and

- the amounts charged to each of the WPSF and DCPSF are not greater than those which would be charged if each sub-fund individually comprised the entire with-profits fund of a UK proprietary life insurance company.

Any difference between the tax charged to asset shares in each sub-fund and the overall amount of tax charged to that sub-fund falls into the PAC inherited estate or the SAIF inherited estate as appropriate.

The tax rates assumed in calculating asset shares are amended when tax rates change. They are also reviewed periodically and may be retrospectively adjusted to reflect any significant cumulative difference between the tax charged to asset shares and the total tax paid in respect of the corresponding policies.

#### 1.3.7.4 Guarantees and Smoothing

For new WPSF business, an analysis is carried out from time to time to determine charges for smoothing and guarantees that the Directors of PAC believe are reasonable and fair for each type of product. The resulting charges are deducted in calculating asset shares and credited to the PAC inherited estate, which bears the costs of smoothing and guarantees as they emerge.

On policies other than with-profits annuity, Income Choice Annuity, those invested in the PruFund Range of Funds, or AVCs with applications received on or after 15 March 2019, the total deduction charged to asset shares over the lifetime of each policy is not currently more than 2% of asset shares, with the deduction building up to this level over the first few years of the policy.

For with-profits annuity contracts provided by PAC a deduction is made from the investment return credited to asset shares each year. This deduction is derived so that in aggregate its value is expected to cover the costs of guarantees over the lifetime of the portfolio of this business.

For Income Choice Annuity a deduction is made from the investment return credited to asset shares each year and an adjustment may also be made to the level of starting income. This adjustment may be positive or negative. The deduction from the investment return and the adjustments to starting income levels are derived so that, in aggregate, their value is expected to cover the cost of guarantees over the lifetime of the policy.

For AVCs with applications received on or after 15 March 2019, the guarantee charge we will apply over the lifetime of the plan is not currently more than 4% of asset shares, with the deduction building up to this level over the first few years of the policy.

The deductions made to cover the cost of smoothing and guarantees for new business are regularly reviewed and may be adjusted, for example in line with market conditions, changes in asset allocation and/or changes in business mix. The level of these charges can rise or fall as a result of these reviews.

For in-force business, the company keeps the level of charges under review and may alter these if necessary to protect the solvency of the With-Profits Fund.

For investments in the PruFund Range of Funds, see 1.3.8.5 for further information.

For the business transferred from ELAS and allocated to the DCPSF, including that which on 1 January 2019, was transferred from PAC to PIA and reinsured back to PAC, a deduction of up to 0.5% p.a. is made from the investment return credited to asset shares. This charge is transferred from the DCPSF to the WPSF and, in return, the WPSF meets the cost of guarantees. This charge is kept under review and may be amended but cannot exceed 0.5% p.a.

#### 1.3.7.5 Mortality and Morbidity

For WPSF, SAIF and SAA business, a mortality charge is deducted in calculating asset shares. This charge is calculated by applying a mortality rate to the excess of the benefit on death over the current value of the policy. Any difference between the aggregate mortality charge and the cost of death claims each year accrues to the appropriate inherited estate. A similar approach applies for morbidity costs.

For the business transferred from ELAS – to the extent that actual payments of income are less or more than expected in any calendar year because of heavier or lighter mortality than expected, the profit or loss will accrue to the WPSF. Should Prudential adopt a different mortality basis for this business, the effect of this change on the asset shares is subject to certain limits which are described in Appendix B.

### 1.3.7.6 Shareholder Profit

For a WPSF with-profits policy, the amount transferred to shareholders in respect of the bonuses credited to the policy is deducted in calculating asset shares. The basis of determining the amount to be transferred is described in paragraph 7.3.1. There is no such charge to the asset share of a DCPSF, SAIF or SAA policy.

Additional tax is payable as a consequence of the transfer of shareholder profits out of the WPSF. This has always been charged to the PAC inherited estate and it is expected that this will continue subject to the security of the sub-fund remaining satisfactory when the tax is paid (see paragraph 5.3.2.1).

### 1.3.7.7 Miscellaneous Profits and Losses

For WPSF business, miscellaneous profits and losses are reflected in asset shares as follows:

Profits and losses from:

- non-profit annuity business, written in the WPSF and also that transferred to the WPSF from PAL, written between 1 January 2000 and 30 June 2004, with the exception of Prudential Personal Retirement Plan (PPRP) vestings, and
- certain other non-profit UK business written in the WPSF are allocated each year to all UK with-profits product lines (other than the PruFund Range of Funds) as an addition or deduction in the calculation of asset shares.

Aggregate profits, or losses, on discontinuance of with-profits policies (other than profits or losses from smoothing) are calculated each year for certain product groups and credited to surviving policies in the calculation of asset shares for that product group. This aggregate profit or loss is the difference, in respect of discontinuing policies, between the asset share allowing for the expenses incurred in running the business and the asset share allowing for the charges taken to cover these expenses. These expenses include the actual cost of shareholder transfers.

Aggregate profits, or losses, that may emerge from any other UK business risk will be credited each year to asset shares across all UK product lines (other than the PruFund Range of Funds), unless the Directors have decided that specific losses should be borne by the PAC inherited estate (see paragraph 3.3.4).

### 1.3.7.8 Expenses and Commission

As described in paragraphs 1.3.7.6 and 3.3.4, certain costs allocated to the WPSF are charged to the PAC inherited estate and not to asset shares.

All other expenses, including commission, allocated to the WPSF are split into acquisition and administration expenses, and expressed as some or all of a rate per policy, a rate per cent of premium, a rate per cent of sum assured and as a reduction in the investment return. The relevant combination of these expense rates is normally deducted in calculating asset shares.

However, the net impact of the charges to asset shares for expenses and for items 1.3.7.5 to 1.3.7.7 above is limited as follows:

- for all new business since 1997, the aggregate projected deductions equals the aggregate projected policy-specific charges used when illustrating benefits at point of sale, while
- for many pension contracts, the net impact of these deductions has been limited to 1% p.a. since April 2001; this level of charge is not guaranteed to apply in future, and
- for certain other personal pension and corporate pension policies, an annual rate of charge is applied; the current level of charge is not guaranteed to apply in future.

Up to 31 December 2011 the excess of any costs incurred in excess of the amounts charged to asset shares (also referred to as cost over-runs) was borne by the PAC inherited estate. However, from 1 January 2012 onwards, the PAC Board has decided that new business in the WPSF should be priced such that it is expected to be financially self supporting over the lifetime of the business at the point the pricing assumptions are set. Where the business is not expected to be financially self-supporting at the point the pricing assumptions are set, shareholders will make an appropriate contribution to the WPSF. In considering whether new business is self-supporting, it should be noted that:

(i) the test of self-supporting does not include the tax liability arising from shareholder transfers on that business. As described in section 5.3.2.1 of the PPFM, this tax will be charged to the PAC inherited estate subject to the security of the sub-fund remaining satisfactory when the tax is paid; and

(ii) new business may temporarily not be self-supporting, resulting in cost over-runs which are borne by the PAC inherited estate, following a material change in the business environment which is outside of the firm's control. This reflects the fact that business cannot necessarily be re-priced immediately, and that the change in business environment (for example a market fall) may, in good faith, be believed to only be temporary.

### 1.3.8 Significant variations in practice for specific types of PAC policy

#### 1.3.8.1 Business originally issued by Scottish Amicable Life plc (SAL)

In calculating asset shares:

- the only relevant items of income and outgo are premiums, investment return, charges for tax, guarantees and smoothing, mortality and morbidity, and the explicit charges for expenses and profit specified on similar unit-linked policies; and
- credit for miscellaneous profit will be given only if the asset shares calculated using explicit charges with no allowance for miscellaneous profit are less than the asset shares calculated using actual expenses with allowance for miscellaneous profit and the distribution of profit to PAC shareholders.

If the difference between the charges deducted and the expenses incurred is less than the actual shareholder transfer, then this deficit accrues to the PAC inherited estate.

The final bonus rates for surrenders may differ from those for death or maturity claims to reflect expected future bonus rates.

#### 1.3.8.2 With-Profits Annuity

Asset shares are calculated by means of a retrospective accumulation of premiums paid, allowing for actual investment returns (net of charges, including those taken to cover the cost of guarantees) and the deduction of unsmoothed annuity payments. Asset shares are also adjusted to reflect the respreading of mortality surplus each year arising from releases of asset shares on deaths (the amount which is respread is based on the difference between the actual and expected mortality experience for the period under review). The unsmoothed annuity represents the annuity that would be paid before smoothing is applied and without allowance for any minimum guarantee that might apply.

The regular bonus declared each year has a permanent effect on the income received. This income will increase if the bonus declared is higher than the anticipated bonus rate selected by the policyholder or (subject to the minimum income guarantee) decrease if the bonus declared is lower than the anticipated rate.

An additional bonus may be declared each year which increases the income received for 12 months only. Additional bonuses can be amended at any time, but any additional income that is being paid will not be reduced before the next policy anniversary.

The regular and additional bonuses declared each year affect the income from the annuity policy anniversary which falls within the next bonus year.

The smoothing approach seeks to ensure that annuity income does not:

- fall by more than the selected anticipated bonus rate in a year,
- rise by more than 11% a year, less the selected anticipated bonus rate, or
- fall on the first policy anniversary.

Larger changes may, however, be required to balance pay-out values between different policies. Greater flexibility may also be required in certain circumstances, for example following a significant fall in market values (either sudden or over a period of years). In such situations the PAC Board could decide to vary the bonus smoothing limits to protect the overall interests of policyholders.

A With-Profits Annuity cannot be surrendered.

With-Profits Annuities written before 15 May 2000 cannot be converted to non-profit annuities. With-Profits Annuities written on or after 15 May 2000 but before 1 October 2001 can be converted to non-profit annuities at certain dates following the death of either the first life or the second life if the policies are joint life policies. With-Profits Annuities written on or after 1 October 2001 can be converted to non-profit annuities at certain dates. The amount of the non-profit annuity will depend on the then current alteration basis.

1.3.8.3 Defined Charge Participating Sub-Fund (DCPSF) business (non ELAS business)

In calculating asset shares, the only relevant items of income and outgo are premiums, investment return, claims payments for regular withdrawals and part surrenders, the charges for guarantees and smoothing and the explicit charges for expenses and profit specified by the policy.

The detail of the PruFund Range of Funds for International Prudence Bond and Prudential International Investment Bond are covered separately in paragraph 1.3.8.5 below.

1.3.8.4 Defined Charge Participating Sub-Fund (DCPSF) *(business transferred from ELAS including that which on 1 January 2019 was transferred from PAC to PIA and reinsured back to PAC ).*

The Scheme which transferred the ELAS with-profits annuities to PAC states that this business must be managed in accordance with the Principles of Financial Management (PFM) contained in that Scheme. The Scheme which transferred the German and Irish ELAS policies from PAC to PIA on 1 January 2019 dis-applied this obligation in respect of that business. However, PAC is still obliged to apply the same PFM in satisfaction of its obligations under the reinsurance arrangements for those German and Irish ELAS policies. The PFM is included in Appendix B, and this details the management of this business. This section summarises the important aspects.

(i) Investment Returns The investment return that is credited to asset shares will be determined by reference to the investment return which, before deduction of charges and adjustments for any tax liability or credit in accordance with applicable tax legislation, but net of unrecoverable tax, is the same as the rate of investment return earned by the WPSF (net of unrecoverable tax).

(ii) Asset Shares The asset shares will be calculated by means of a retrospective accumulation of the “initial asset share” transferred to PAC by ELAS, allowing for actual investment returns (net of charges, including those taken to cover the cost of guarantees).

This amount will be further adjusted by deducting unsmoothed annuity payments, any uplifts or reductions applied as a result of the longevity risk mechanism, and the respreading of mortality surplus each year arising from releases of asset shares on deaths (the amount which is respread is based on the difference between the actual and expected mortality experience for the period under review). The unsmoothed annuity is calculated as the annuity that is expected to exhaust the asset share over the remaining lifetime of the annuitants.

Under the longevity risk mechanism, mortality profits and losses are fed back into asset shares to the extent that expected mortality across the ex-ELAS annuities is different from that expected at the date of transfer. The amount of any loss or profit charged/credited to asset shares is limited to the equivalent of 0.5% of asset shares per annum. Any mortality profits or losses not charged to asset shares fall into the PAC inherited estate, as do differences between actual and expected mortality costs each year.

(iii) Bonuses A separate bonus series was set up for the with-profits annuities transferred from ELAS. No other with-profits business shares in this bonus series.

An ex-ELAS with-profits annuity has two elements that are tracked separately, the guaranteed income and the non-guaranteed income (Total Annuity), and the policyholder receives the larger of the two. Each element changes as described below.

Any regular (reversionary) bonus declared applies for the year starting on 1 April following the declaration. Any such bonus would have a permanent effect on the guaranteed income. The guaranteed income will increase from the previous year if the bonus declared is higher than the ABR selected by the policyholder, or decrease if the bonus declared is lower than the ABR. The level of regular bonus declared is expected to be zero for the foreseeable future. Some policies have a GIR which has been anticipated within the guaranteed income, and the level of regular bonus declared (if any) could differ for different levels of GIR.

The amount of Total Annuity is adjusted at annuity anniversaries by the ORR and IRR applicable at that time, less the ABR and less any GIR that applies to that policy.

The ORR generally reflects the earnings on the sub-fund over the calendar year ending 31 December prior to the announcement of the ORR each February. It is applied to the Total Annuity at the annuity anniversaries in the 12 month period following 1 April each year. The IRR generally reflects the expected earnings, expressed as an annual rate, on the fund since the end of the last calendar year for which an ORR has started to become effective. A proportion of the IRR, depending on the period between the end of the calendar year for the effective ORR and the annuity anniversary, is applied to the Total Annuity. When the IRR is applied, the proportion of the IRR that was applied to the Total Annuity at the previous annuity anniversary is removed.

Although the IRR can be changed at any time through the year to keep it in line with the return expected on the sub-fund in that year, it is the IRR that was effective on the annuity anniversary that is used in the calculation of the Total Annuity.

The bonuses applied to with-profits purchased life annuities transferred from ELAS will be the same as those applied to pensions annuities.

(iv) Smoothing In calculating the amount to be transferred to the smoothing account, it is necessary firstly to determine the cost of guarantee. The cost of guarantee is calculated as being the guaranteed annuity less the unsmoothed annuity (referred to above) and is subject to a minimum of zero.

The smoothing cost is then calculated as the annuity paid to the policyholder less the guarantee cost and the unsmoothed annuity.

In normal circumstances, the smoothing approach seeks to ensure that annuity income does not:

- Fall by more than the combined effect of the selected anticipated bonus rate and any guaranteed investment return, in any year.
- Rise by more than the smoothing cap, less the combined effect of the selected anticipated bonus rate and any guaranteed investment return, in any year. The smoothing cap is currently 11% and may be reviewed at any time by the PAC Board subject to approval by the WPC.

Greater flexibility may be required in certain circumstances, for example following a significant fall in market values (either sudden or over a period of years). In such situations the PAC Board could decide to vary the bonus smoothing limits to protect the overall interests of policyholders, subject to review, where appropriate, by the WPC.

The bonus smoothing account will be managed with the ongoing aim that it should always tend to zero subject to the need for short-term smoothing. In addition we will apply smoothing to ensure the objective of gradual, rather than erratic, changes in income.

If, under the provisions of the Scheme, PAC opts to terminate the scheme, any positive amount remaining in the bonus smoothing account will be distributed amongst the then remaining annuity policies by way of an enhancement to non-guaranteed income in a way considered fair by the WPC.

(v) Miscellaneous Profits and Losses No adjustments are made for any miscellaneous profits and losses for this business.

### 1.3.8.5 PruFund Range of Funds

A list of the investment funds that comprise the PruFund Range of Funds is given in Appendix C.

When new money is invested in the PruFund, it is used to buy units in the fixed rate account corresponding to the selected investment fund. New investments into the fixed rate account are moved into the selected investment fund on a monthly basis for Prudential Retirement Account (Series E) and on a quarterly basis for all other PruFund products.

For all policies invested in the PruFund Range of Funds, with the exception of Prudential Retirement Account business, Annual Management Charges (AMCs) are applied by explicit unit deduction. The Prudential Retirement Account business invests in a different series of PruFund Funds, which use a different pricing approach, whereby allowance for the AMC is included in the unit price, and other product charges (including for any optional guarantees) are taken by explicit unit deduction. Part of the AMC is a charge for smoothing and the fixed rate of return that is paid when premiums are waiting to be invested. The Directors of PAC believe these charges are reasonable and fair in relation to the costs of smoothing and guarantees that are expected to be incurred by PruFund funds over the long term.

Note that each of the Growth, Growth Pension, Cautious, Cautious Pension and Growth & Income Funds (including those available under International Prudence Bond and Prudential International Investment Bond) has an associated Protected Fund on which an investment guarantee applies. However, the Protected Funds are not available on Prudential ISA or Prudential Retirement Account business. For those policies which have invested in a Protected Fund, an explicit charge for the investment guarantee is made by unit deduction, in addition to the AMC.

The Prudential Retirement Account product offers an optional investment guarantee on the PruFund Growth Pension and PruFund Cautious Pension funds, this is offered via a guarantee sub-account rather than a separate Protected PruFund fund. For policies that have the investment guarantee a charge is made for the guarantee via explicit unit deductions.

An optional Minimum Income Guarantee (MIG) is available on certain PruFund funds accessed via the Prudential Retirement Account. The guarantee is available on vested funds only, and a charge is made for the guarantee via explicit unit deductions.

Any cancellation of units as a result of switches, transfers or withdrawals from the PruFund Range of Funds may be subject to a delay of up to 28 days from the date of receipt of a request to cancel units. The unit price on the final day of the delayed period will be used as the price of the units for these purposes.

Where policies are invested in one of the PruFund Range of Funds, they participate in profits by means of an increase in the unit price of the selected investment fund.

Expected Growth Rates are annualised rates which are set quarterly by the Prudential Directors, having regard to the investment returns expected to be earned on the assets of the funds over the long-term.

The unit price will change on a daily basis at the relevant Expected Growth Rate (which is published on each quarter date) unless the unit price moves outside specified limits, as set out below:

(i) On or between quarterly investment dates (or monthly investment dates in the case of Prudential Retirement Account (Series E)):

- for the PruFund Growth (including Euro and US Dollar), PruFund Growth & Income, PruFund Risk Managed 3, PruFund Risk Managed 4 and PruFund Risk Managed 5 funds, if the net asset value per unit and the average net asset value per unit over the previous 5 working days are both 10% (or more) above/below the unit price, the unit price will be increased/decreased so that it is 2.5% below/above the net asset value per unit.

- for the PruFund Cautious (including Euro and US Dollar), PruFund Risk Managed 1 and PruFund Risk Managed 2 funds, if the net asset value per unit and the average net asset value per unit over the previous 5 working days are both 8% (or more) above/below the unit price, the unit price will be increased/decreased so that it is 2% below/above the net asset value per unit.

(ii) In addition, on a quarterly investment date (or monthly investment date in the case of Prudential Retirement Account (Series E)):

- for the PruFund Growth (including Euro and US Dollar), PruFund Growth & Income, PruFund Risk Managed 3, PruFund Risk Managed 4 and PruFund Risk Managed 5 funds, if the net asset value per unit is 5% (or more) above/below the unit price, the unit price is repeatedly increased/decreased by half the difference between the unit price and the net asset value per unit until the net asset value per unit is within 5% above/below the unit price.

- for the PruFund Cautious (including Euro and US Dollar), PruFund Risk Managed 1 and PruFund Risk Managed 2 funds, if the net asset value per unit is 4% (or more) above/below the unit price, the unit price is repeatedly increased/decreased by half the difference between the unit price and the net asset value per unit until the net asset value per unit is within 4% above/below the unit price.

The net asset value per unit is calculated by Prudential in accordance with the policy provisions.

The current smoothing limits for each PruFund Fund are detailed in Appendix C. These limits may change in future.

Whilst in the fixed rate account, investments will grow at the Expected Growth Rate for the selected investment fund, and while charges will apply as normal during this period, the investment will not be subject to any adjustments when the unit price moves outside the specified limits.

For each of the PruFund Range of Funds, except those Funds available under International Prudence Bond and Prudential International Investment Bond, a smoothing account is maintained within the inherited estate of the WPSF that is credited or debited as appropriate with any difference between the unit price and the net asset value per unit when units are created or cancelled as a result of premiums being received or claims being paid.

Funds from the PruFund Range of Funds available under International Prudence Bond and Prudential International Investment Bond are written in the DCPSF. For this business a smoothing account is maintained within the inherited estate of the WPSF that is credited or debited as appropriate with any difference between the unit price and the net asset value per unit when units are created or cancelled as a result of premiums being received or claims being paid.

The company may reset the unit price of a fund to protect the With-Profits Fund, and the interests of all our With-Profits policyholders. In this situation the unit price would be adjusted to be the same as the net asset value per unit on that working day, but thereafter the unit price will continue to grow in line with the Expected Growth rate of that fund.

The company may also suspend the smoothing of the unit price for a period of consecutive days to protect the With-Profits Fund, and the interests of all our With-Profits policyholders. In this situation the unit price would be adjusted to be the same as the net asset value per unit on that working day, and thereafter will continue to move in line with the net asset value per unit until the suspension of smoothing is lifted.

The PruFund Range of Funds are split such that a unit price reset or a suspension of smoothing can be performed on each class of business independently of the others. This split between the classes of business is given in Appendix C.

1.3.8.6 Income Choice Annuity

(i) Introduction The Income Choice Annuity is an annuity where the income paid to the policyholder has two elements that are calculated separately for each policy year – the guaranteed income (the Secure Level) and the non-guaranteed income. The policyholder receives the higher of the two.

(ii) Non-Guaranteed Income At policy commencement the policyholder can choose a level of starting non-guaranteed income from within a range that we calculate. Associated with this choice will be a Required Smoothed Return. This is the Smoothed Return required each year to maintain the non-guaranteed income selected by the policyholder throughout their remaining lifetime.

A Smoothed Return is declared each year and varies by bonus year of issue. It is calculated using a similar approach to that used when calculating Final Bonus on other contracts. In particular, the Smoothed Return is calculated to target payouts on asset share (as described in 1.3.1). The asset share is calculated using the approach set out in 1.3.7 subject to the variations in (v) below.

The non-guaranteed income is adjusted at annuity anniversaries with the new level of non-guaranteed income calculated as follows:

Previous non-guaranteed income x
(1 + Smoothed Return)/(1 + Required Smoothed Return).

Hence the non-guaranteed income will increase if the Smoothed Return is higher than the Required Smoothed Return and will decrease if the Smoothed Return is lower than the Required Smoothed Return.

The Smoothed Return can be amended at any time, but will not impact what is paid to the policyholder until the next policy anniversary.

(iii) Guaranteed Income (Secure Level) A starting Secure Level is set at policy commencement.

The Secure Level can never go down. For policies issued before 7 November 2011, and for any policies issued on or after 7 November 2011 which are based on quotes issued prior to that date and accepted within the guarantee period, the Secure Level increases at each policy anniversary by 50% of any positive difference between the new non-guaranteed income and the actual income payable in the year leading up to the current policy anniversary. For all other policies the Secure Level is fixed at outset for the lifetime of the policy.

(iv) Option to change the non-guaranteed income On every policy anniversary the policyholder will be given the opportunity to change the level of their non-guaranteed income by selecting from a range that we calculate at the time. The lower level of the range will never be less than the Secure Level. If the policyholder decides to select a new level then their Required Smoothed Return will change accordingly. There is no change to their Secure Level.

We can change the range of available Required Smooth Returns at any time, for example, in April 2016 the maximum available Required Smoothed Return was reduced to 4.5% in response to expectations of lower future interest rates. Policyholders may choose a new level of non-guaranteed income within the range we set. We can withdraw this option, or postpone the policyholder's request to change income, if this is considered necessary to protect the sub-fund.

(v) Asset Shares Asset shares are calculated by means of a retrospective accumulation of premiums paid, allowing for actual investment returns (net of charges, including those taken to cover the cost of guarantees) and the deduction of unsmoothed annuity payments. Asset shares are also adjusted to reflect the respreading of mortality surplus each year arising from releases of asset shares on deaths (the amount which is respread is based on the difference between the actual and expected mortality experience for the period under review). The unsmoothed annuity represents the annuity that would be paid before smoothing is applied and without allowance for any minimum guarantee that might apply (see (vi)).

(vi) Smoothing In normal investment conditions, the smoothing approach seeks to ensure that policyholders' non-guaranteed income does not

- fall by more than the Required Smoothed Return,
- rise by more than 12% a year, or
- fall on the first policy anniversary.

Larger changes may, however, be required to balance pay-out values between different policies. Greater flexibility may also be required in certain circumstances, for example following a significant fall in market values (either sudden or over a period of years). In such situations the PAC Board could decide to vary the bonus smoothing limits to protect the overall interests of policyholders and hence the Smoothed Return could be negative.

(vii) Conversion to a non-profit annuity An Income Choice Annuity cannot be surrendered but it can be converted to a non-profit annuity at certain dates. The terms offered on conversion will depend on the alteration basis in-force at the time.

The policyholder's fund available for conversion to a non-profit annuity is the current value of expected future payments under the Income Choice Annuity.

The value of this fund may be reduced to ensure that neither the security of the WPSF nor the return to continuing policyholders is affected by using a conversion value significantly in excess of the underlying assets. Any reduction will vary as the value of the WPSF's assets changes.

1.3.9 New bonus series
Any new type of product generally constitutes a new bonus series (i.e. it has rates of regular and final bonus that are appropriate to that type of product).

We would introduce a new bonus series for an existing type of product if we did not expect to be able to fairly accommodate the difference between the experience of the old and new business by using the flexibility in our bonus structure. This might arise from a difference in the investment mix, a change in the investment environment, or a difference in the exposure to business or insurance risk. The introduction of a new series would limit the impact of the experience of the business written under either bonus series on the bonus rates of the other series.

### 1.4 Variations for Scottish Amicable Insurance Fund (SAIF) and Scottish Amicable Account (SAA) with-profits policies

1.4.1 The Scheme which transferred the business of SALAS to PAC included the Principles of Financial Management (PFM) by which the Scottish Amicable Funds must be managed. The bonus policy agreed by the Scottish Amicable Board is consistent with the PFM.

In general, SAIF and SAA policies are managed in the same way as WPSF policies. The following paragraphs set out the significant differences in Practices.

1.4.2 In targeting pay-out values, asset shares for SAIF and SAA policies are increased by a claims enhancement factor. The factor is applied to asset shares with the aim of distributing the SAIF inherited estate, but not the assets in the SACF, over the remaining lifetime of the with-profits policies in SAIF and SAA.

The claims enhancement factor is reassessed at least every three years and is expressed as a percentage increase to the asset shares. It is a uniform percentage for business that has been in force for 10 years or more, with a proportionately lower percentage at shorter durations.

1.4.3 The approach to smoothing for maturity and death benefits for SAIF and SAA policies is similar to that for WPSF policies, except that in normal circumstances pay-out values on policies of the same duration may go up or down by a maximum of 15% for single premium policies and up or down by 7% about the long-term trend for annual premium policies. Greater flexibility may be required in certain circumstances, for example following a significant rise or fall in market values (either sudden or over a period of years), and in such situations the Scottish Amicable Board may decide to vary the standard bonus smoothing limits to protect the overall interests of policyholders. Such a situation arose in February 2009 when pay-out values on most equivalent policies were reduced by amounts greater than the normal limits. In addition, all pay-out values for SAIF and SAA policies must move at least one-third of the way towards asset share when moving downwards and at least one-quarter of the way towards the asset share when moving upwards.

**1.4.4** The calculation of asset shares for SAIF and SAA with-profits business differs from that for WPSF with-profits business in the following ways.

- Asset shares are calculated for sample policies using Scottish Amicable's approach at 31 December 1996, and are accumulated by reference to the subsequent investment performance, expense and taxation experience of SAIF.
- The SACF support charge, equivalent to 1% p.a. of the mean value of SACF, is deducted from asset shares.
- Prior to 2003 the cost of meeting annuity rate guarantees was charged to asset shares in the year in which it arose. The Scottish Amicable Board decided that this might introduce significant unfairness between policyholders if the cost of guarantees were to change significantly in future. From 2003, guaranteed annuity rate costs have been met as follows:
  - from 2003 until the end of 2015, an annual deduction of 0.25% was levied on asset shares,
  - from 2016 until the end of 2017, an annual deduction of 1.00% was levied on asset shares,
  - from 2018, an annual deduction of 1.25% is levied on asset shares, and
  - any additional costs are met from the SAIF inherited estate and reflected in the claims enhancement factor for all SAIF and SAA with-profits policies.
- The accumulation of profits and losses from smoothing and other guarantees are allocated to a bonus smoothing account. The size of the bonus smoothing account is regulated by a yearly percentage deduction from, or addition to, asset shares which is credited or debited to the bonus smoothing account. The smoothing charge/credit, which is subject to a maximum charge of 0.4% p.a., is reassessed at least every three years with the intention of eliminating any deficit or surplus on the smoothing account over the remaining life of the policies.
- There is no shareholder profit transfer associated with bonuses declared on SAIF and SAA with-profits policies.
- The accumulation of asset shares includes an allocation of 0.25% p.a. in respect of miscellaneous surplus from non-profit and unit-linked business. The extent to which the actual miscellaneous surplus differs from 0.25% p.a. is reflected in the claims enhancement factor.
- The level of expenses charged to SAIF until the end of 2007 reflected the fixed fees per policy agreed under the tariff agreement set out in the SALAS Scheme. Thereafter the charges reverted to cost, on a basis equivalent to that being charged for WPSF business, subject to the resulting costs for SAIF policies being no greater than those applicable to corresponding policies sold by PAC.
- Asset shares for unitised with-profits life business and all conventional with-profits business reflect the actual level of expenses incurred by the sub-fund. In accordance with the SALAS Scheme, asset shares for unitised with-profits pensions business reflect the specific policy charges on similar unit-linked policies rather than the actual level of expenses incurred.

# Section 2 – Investment strategy

## 2.1 Introduction

In this section we describe the significant aspects of our investment strategy, including the use of asset pools, which may consist either of physically separate assets or of notionally separate assets (also known as "hypothecated" asset pools), consisting of a different mix of the classes of assets held in a sub-fund.

Recent and historical information on the asset mix of the with-profits sub-funds is available from our website **pru.co.uk**.

The practices set out in paragraph 2.3.1 to 2.3.7 below cover the vast majority of with-profits policies. There are some differences in approach for the Risk Managed PruFunds which are summarised in paragraph 2.3.8.

## 2.2 Principles

**2.2.1** The PAC Board is responsible for setting the investment strategy of the company, and manages this strategy as part of the management of the overall risk level of the company and the With-Profits Fund. It determines investment policies for each asset pool that are compatible with the overall strategy and with maintenance of the ongoing solvency of the With-Profits Fund. The overall risk management procedure is described in section F of the Introduction to the PPFM.

**2.2.2** The company's investment strategy is to seek to secure the highest total return (allowing for the effect of taxation and investment expenses) whilst:

- maintaining an acceptable overall risk level (having regard to the currency, nature and outstanding duration of the liabilities) for the With-Profits Fund,
- maintaining an appropriate and broad mix of suitable investments, and
- protecting appropriately the relative interests of all groups of policyholders.

**2.2.3** The company's investment strategy permits the use of any investment instrument, including derivatives, provided the type has been approved by the Board, as recorded in the Investment Management Agreements between the company and its investment managers applicable from time to time.

**2.2.4** The company seeks to include all with-profits policies in a common asset pool wherever it is appropriate for them to share a common investment policy. For the majority of products a single common asset pool is appropriate but the Board may decide that certain products require a separate pool, for example:

- to generate a different asset mix,
- to support a specific product feature,
- to support a product expressed in a different currency, or
- where required by legislation.

**2.2.5** No investment strategy relies on assets outside of the asset pool unless their utilisation has been formally agreed by the Board.

**2.2.6** All assets of the WPSF, the Scottish Amicable Insurance Fund (SAIF) and the Defined Charge Participating Sub-Fund (DCPSF), other than any investments identified in paragraph 2.3.6, would normally be available to be traded.

## 2.3 Practices

2.3.1 The company's investment practices are reviewed at least annually by the PAC Board and, for the Scottish Amicable Funds, the Scottish Amicable Board.

The company's investment practices are mainly set out in a number of Investment Management Agreements, Investment Services Management Agreements and Investment Policy Documents. These agreements and documents include:

- a list of approved types of investment (including types of derivatives),
- benchmark asset mixes for each asset pool,
- permitted variations (typically 5% of the asset pool) in asset mix as a result of tactical asset allocation decisions (i.e. if it is considered that investment returns over the shorter term are likely to differ significantly from the expected long-term returns),
- limitations on credit risk, and
- limitations on counterparty exposures.

The limits are set in accordance with the sub-fund's risk appetite as agreed by the relevant Board. The risk appetite is determined on the assumption that the with-profits sub-funds are managed on a stand-alone basis, and do not rely on shareholder resources with the exception of the specific circumstances described in paragraph 5.3.2.2.

If the WPSF was operating materially outside of its risk appetite, the PAC Board would expect to take a range of management actions to address this. Increasing the proportion of fixed interest stocks and cash would typically be one of the actions that would be taken.

An increase up to a combined proportion of 100% of each sub-fund's assets may be made to protect the with-profits sub-funds in extreme investment conditions.

Derivatives are used for the purposes of Efficient Portfolio Management or reduction in investment risk. The main use is of:

- exchange traded futures to implement changes in asset mix, including tactical deviations from the strategic asset mix,
- options and futures to help match the liabilities arising from guarantee costs, and
- currency forwards to reduce the exchange rate exposure arising from holding overseas assets.

Investment in any appropriate new or novel investment instruments, or in any new country, which is proposed by the investment managers, requires Board approval prior to implementation.

2.3.2 Formal reviews of all aspects of the investment policy occur at least once a year.

2.3.3 A separate asset pool will be established when there is a legal requirement or when the company identifies policies for which achievement of its overall acceptable risk level requires a significantly different asset mix.

Separate asset pools are usually maintained for each sub-fund. Within each sub-fund separate asset pools are held as appropriate to the different nature of the liabilities (e.g. with-profits, non-profit, unit-linked) and, usually, for liabilities in each different currency.

- For most WPSF policies assets are held within the main WPSF asset pool; however separate asset pools are operated for:
  - certain with-profits products which have a more cautious investment policy than the main WPSF asset policy (e.g. the PruFund Cautious Funds from the PruFund Range of Funds),
  - certain with-profits retirement annuity contracts expected to reach their vesting date in the near- to medium-term, where the guaranteed benefits significantly exceed asset shares and the likelihood of any final bonus becoming payable is regarded as remote*,
  - SACF, which has an asset mix as close as possible to that of the SAIF,
  - non-profit non-annuity liabilities within the WPSF, which are backed by a combination of government and corporate bonds of approximately the same overall duration as the liabilities,

– non-profit annuity liabilities within the WPSF, backed mainly by government and corporate bonds whose cash flows match the annuity liability cash flows as they emerge,

– assets backing the cost of guarantees and other liabilities on with-profits products, and

– assets backing the PAC inherited estate.

* The asset shares for this business continue to be credited with the return earned on the main WPSF asset share pool, but, for risk management purposes, the assets backing the policies are held in a separate asset pool to allow investment in assets that will closely match the expected liability cashflows.

- For SAIF policies, most assets are held within the main SAIF asset pool. The benchmark asset mix for SAIF's main pool differs from that of the WPSF's main pool to reflect the relative strength of the two sub-funds. A separate asset pool is operated for non-profit liabilities, which are backed by a combination of government and corporate bonds of approximately the same overall duration as the liabilities. Separate asset pools are also held for assets backing guaranteed annuity rates and the SAIF inherited estate.
- For the non ELAS business in the DCPSF, there are two asset pools relating to liabilities denominated in the Euro and the US Dollar. Liabilities denominated in Sterling in the DCPSF are backed by liabilities in the main asset pool of the WPSF.

Any with-profits policyholder whose policy is not credited with the returns on the main WPSF asset pool has been informed of the asset pool backing the policy, either as part of the sales process or on the demutualisation of SALAS.

Some asset pools held within the WPSF & DCPSF are what are known as "hypothecated". This means that rather than actually holding separate assets in respect of this pool, the assets are still part of the main WPSF/DCPSF asset pool. The reason why we may use hypothecated asset pools is that where an asset pool is relatively small, the difficulties in obtaining a suitably diversified portfolio of actual assets, and the disproportionately high costs of administering a separate pool, mean that it is beneficial to hypothecate these assets as part of the main WPSF/DCPSF pool rather than hold them separately. However, investment returns for a hypothecated asset pool are calculated based on the asset mix that would apply if these assets were actually a separate pool.

Currently, the following funds have hypothecated asset pools:

- Prudence Bond Optimum Bonus Fund
- PruFund Growth & Income Fund
- PruFund Risk Managed 1 Fund and PruFund Risk Managed 1 Pension/ISA Fund*
- PruFund Risk Managed 2 Fund and PruFund Risk Managed 2 Pension/ISA Fund*
- PruFund Risk Managed 3 Fund and PruFund Risk Managed 3 Pension/ISA Fund*
- PruFund Risk Managed 4 Fund and PruFund Risk Managed 4 Pension/ISA Fund*
- PruFund Risk Managed 5 Fund and PruFund Risk Managed 5 Pension/ISA Fund*
- PruFund Cautious (Euro) Fund
- PruFund Cautious (US Dollar) Fund
- AVC Deposit Fund
- The Prudential Personal Pension Deposit Fund

*There is a single hypothecated asset pool covering both the "Fund" and "Fund and Pension/ISA Fund" options for each of these categories (but separate pools for each of the Risk Managed 1, Risk Managed 2, etc categories).

**2.3.4** A stochastic asset/liability model is used to identify the range of asset mixes for each with-profits asset pool that would be consistent with the risk appetite of the with-profits sub-fund (see section F of the Introduction to the PPFM) which has been set by the PAC Board and, where appropriate, by the Scottish Amicable Board. The company selects from that range an appropriate strategic asset mix for the pool, consisting of a diversified portfolio of assets which is intended to maximise the expected long-run investment return, subject to the risk level and liquidity needs of the asset pool. The model allows for all significant types of investment risk, including mis-matching risk, market risk and credit risk.

**2.3.5** The investment policy for with-profits business is to invest in a highly diversified portfolio of UK and overseas assets. This policy aims to avoid large losses connected with default or bankruptcy of an individual company and also generates country diversification. The assets may include any available assets which enhance the risk/return balance; they will consist mainly of exchange-traded equity and bond investments, but may also include less liquid investments such as direct property or private equity and debt. The mix of assets held also takes account of the need to maintain adequate liquidity within the sub-funds. Liquidity is monitored on an ongoing basis to ensure the cash-flow requirements of the funds are met. The investments will not contain shares in Prudential plc, but may contain shares in subsidiary companies.

**2.3.6** There are no assets of the WPSF, SAIF or the DCPSF which would not normally be traded. However, the level of trading in respect of the assets backing the non-profit annuity liabilities would be expected to be lower than for other business, in line with the broad intention to hold these assets to maturity in order to match the liability cash flows.

**2.3.7** In setting the investment policies for the with-profits asset pools, the directors do not rely on assets held outside the pool except that:

- the investment policy for the WPSF with-profits pools have regard to the availability of shareholder resources as described in paragraph 5.3.2.2.
- the DCPSF investment policy relies on capital support from an appropriate proportion of the PAC inherited estate, and
- the investment policies for SAIF rely on the solvency support provided by SACF to pursue an investment policy appropriate to an open sub-fund (i.e. higher real assets (i.e. equity and property) than would otherwise be appropriate for a closed sub-fund).

**2.3.8** There are significant variations in practice for Risk Managed PruFunds.

The asset mix for these investment funds is determined solely with the aim of maximising the returns over the medium to long term for a pre-determined risk profile.

The risk profile of these funds is managed by the company using long term volatility limits.

# Section 3 – Business Risks

## 3.1 Introduction

The With-Profits Fund is exposed to business risk, which is defined as all risks (and rewards) of the long-term business other than those connected to investment returns (which are addressed in section 2).

In this section we describe how we manage and control such business risks, both to protect the security of the With-Profits Fund and to limit any adverse impact on with-profits policies.

Business risks may arise from a range of factors, including changes in the economic and/or regulatory environment, demographic changes, product design features (e.g. guarantees), selling and marketing practices and currency and geopolitical risks. There can be no certainty that all potential risks have been identified. The extent to which with-profits policies are exposed to these risks will inevitably change over time.

## 3.2 Principles

**3.2.1** The PAC Board is responsible for the control of business risks within the management of the overall risk level of the company and for the maintenance of the ongoing solvency of the With-Profits Fund. The overall risk management procedure is described in section F of the Introduction to the PPFM.

3.2.2 The Board seeks to ensure that:

- all material or significant risks are identified,
- an appropriate charge is made for all significant risks, and
- the sub-fund bearing a particular business risk receives such charges and any profits or losses arising from that business risk.

3.2.3 For products which are exposed to business risks, allowance will be made for all relevant profits and losses arising from business risks when determining pay-out values unless the Directors have decided that specific losses will be borne by the inherited estate.

## 3.3 Practices

3.3.1 With-profits policyholders are not exposed to risks arising from general insurance business, which is written outside the With-Profits Fund.

3.3.2 With-profits policies normally share in the profits or losses from business risks arising within the With-Profits Fund through the allowance for miscellaneous surplus or through the allowance for expenses included in the calculation of asset shares. However, under the terms of their policy conditions some with-profits policies, in particular DCPSF policies and policies invested in the PruFund Range of Funds, are not exposed to certain specified risks. Business originally written in PAC's Polish branch which on 1 January 2019 was transferred from PAC to PIA and reinsured back to PAC, as well as business written by PIA Poland and reinsured into PAC, will not share in miscellaneous profits or losses arising within the With-Profits Fund in respect of non-Polish business and the Polish business is not itself expected to generate miscellaneous profits or losses.

For with-profits annuities transferred from ELAS, the Scheme of transfer requires that these policies are not exposed to, and will not incur any adjustments for, profits or losses arising from, PAC's other policies, experience or business activities. However, these policies will be exposed in extreme circumstances if PAC were unable to meet or reserve for its guaranteed liabilities.

3.3.3 Profits and losses on business risks are dealt with as follows:

- those in respect of the WPSF will accrue to WPSF accumulating and conventional with-profits policyholders as part of the miscellaneous profits or losses credited to their asset shares (see paragraph 1.3.7.7), except to the extent that the Board may decide that specific losses should accrue to the PAC inherited estate;
- those in respect of the SAIF will accrue to SAIF and SAA with-profits policyholders; therefore they are very unlikely to have an impact on policyholders in the other sub-funds.

Unless they are allocated to the PAC inherited estate, profits and losses on business risks will generally be allocated to with-profits policyholders in accordance with where the relevant risk arises.

Profits and losses from business risks are not expected to be large because of the company's approach to managing risk, with the possible exception of the exposure to non-profit annuity business in the WPSF (see paragraph 3.3.4), and guaranteed annuity rates and guaranteed minimum rates of return in SAIF (see paragraph 3.3.5).

3.3.4 For with-profits business, other than that in SAIF and SAA, specific aspects of business risk are managed as follows:

- WPSF accumulating and conventional with-profits policies are exposed to the level of expenses incurred, and such risks may be increased by poor persistency. The level of expenses is controlled as part of the budgetary process. Expenses are charged to asset shares, except as described in paragraphs 5.3.2.1 and 5.3.2.2.
- Smoothing profits and losses arising from surrenders are controlled by managing the MVR policy and surrender bases of accumulating and conventional with-profits policies respectively. Any differences between the surrender value paid and the underlying asset share accrue:
  - for WPSF business other than business in the PruFund Range of Funds, to the PAC inherited estate, and
  - for DCPSF business and business within the PruFund Range of Funds (see paragraph C2.3 of the introduction to the PPFM and paragraph 1.3.8.5 of the PPFM), to the relevant bonus smoothing account held within the PAC inherited estate.
- Mortality risks for WPSF with-profits business are managed through the new business underwriting process and through regular investigations of mortality trends.

Profits and losses arising from any difference between the amount charged to asset shares for mortality risks and the actual mortality cost incurred for with-profits business accrue to the PAC inherited estate.

- Any charges for, or costs of, guarantees for WPSF and DCPSF business transferred from ELAS accrue to the PAC inherited estate. WPSF policies currently have:
  - a minimal exposure to guaranteed annuity rates, and
  - a modest exposure to guaranteed minimum bonus rates on some group cash accumulation business at various rates:
    - 4.75% p.a. on premiums paid in scheme years ending before 15 March 1997,
    - 2.5% p.a. on premiums paid in scheme years ending between 15 March 1997 and 30 December 2003 (inclusive), and
    - 0.01% p.a. on premiums paid in scheme years ending after 30 December 2003.

The charges for, or costs of, guarantees for other business written in the DCPSF accrue to the relevant bonus smoothing account.

- WPSF with-profits policies written in the UK, with the exception of policies invested in the PruFund Range of Funds and policies transferred from SAL, are exposed to all profits or losses from UK non-profit business within the WPSF (mainly immediate annuities and term assurance, but also some whole life, endowment assurance and deferred annuity business). The main risks from non-profit annuity business are:
  - a higher than anticipated increase in life expectancy for annuitants, or
  - a higher than anticipated default rate on the associated assets (mainly bonds), or
  - a widening of credit spreads on the associated assets.

Profits and losses from such risks are reflected in asset shares through the adjustment for miscellaneous surplus, as described in paragraph 1.3.7.7.

- WPSF policies other than policies invested in the PruFund Range of Funds are exposed to operational risks, including product mis-selling or the issue of misleading literature; any consequential customer compensation in respect of events which occurred on or before 31 July 2009 would normally be paid from the WPSF as an expense. However, as described in paragraph 5.3.2.2, the PAC Board decided that all expenses and compensation for the mis-selling of PAC with-profits pension policies should be charged to the PAC inherited estate. Customer compensation in respect of events which occurred after 31 July 2009 is charged to the PAC NPSF.
- PAC and Prudential plc have entered into a legally enforceable capital support arrangement (CSA) under which Prudential plc has an obligation to provide PAC with capital support, up to an agreed maximum aggregate level, in the event of PAC's solvency falling below specified levels. The capital support provided to PAC under the CSA will include any capital support that might be required as a result of the PAC Pension mis-selling cost assurance in relation to with-profits business (see Section 5.3.2.2). The capital support under the CSA is available until 31 December 2028 unless PAC ceases to be a subsidiary of Prudential plc. In this latter event the CSA would terminate and Prudential plc would be obliged to use its best endeavours to secure replacement capital support arrangements with the group acquiring control of PAC or negotiate in good faith alternative arrangements with PAC, depending on the circumstances.

**3.3.5** SAIF and SAA with-profits policies are exposed to corresponding business risks on all business in SAIF, and are treated in a similar way. These policies have exposure to:

- a significant volume of guaranteed annuity rates, although derivatives have been purchased to reduce the impact of any substantial reduction in fixed interest yields on the cost,
- a guarantee on certain SAIF accumulating with-profits pension business that the minimum rate of regular bonus will be 4% p.a. on all units purchased,

- a guarantee on certain SAIF accumulating with-profits pension business that the minimum rate of regular bonus will be 4% p.a. on all units purchased before 1 January 2006 and 0.1% p.a. on all units purchased subsequently, and
- a guarantee on certain SAIF accumulating with-profits pension business that the minimum rate of regular bonus will be 4% p.a. on all units purchased before 1 January 2006 only.

The costs of guarantees are reflected in asset shares and the claims enhancement factor, as described in paragraph 1.4.4.

Mis-selling costs in respect of with-profits business sold by SALAS are charged to the SAIF inherited estate and therefore affect pay-outs to SAIF and SAA policyholders.

3.3.6 The risk that results from holding a high proportion of real assets (e.g. equities and property) to back smoothed liabilities which incorporate guarantees is managed by keeping the annual bonus rates to a prudent proportion of the long-term expected investment return (see paragraph 1.3.2.1), and by restricting the sub-funds' holdings of real assets to suitably prudent levels. The cost of such guarantees and smoothing falls to the PAC and SAIF inherited estate as appropriate (see paragraphs 1.3.7.4 and 1.4.4).

## Section 4 – Charges and Expenses

### 4.1 Introduction

In this section we describe the way in which we allocate expenses and apply charges to our with-profits business.

### 4.2 Principles

4.2.1 The overall aim of the expense charging and allocation methodology is to seek to ensure that all expense allocations are fair between policyholders and shareholders, between different sub-funds and between different groups of policyholders.

4.2.2 The principle underlying the company's expense allocation methods is that all expenses should be allocated on a consistent basis according to the nature of the activity or where the resulting benefit is expected to arise.

4.2.3 Any significant change to our bases and methods of expense allocation and apportionment, or of exercising discretion to apply expenses to particular categories of business, would be made only if consistent with the above Principles.

### 4.3 Practices

4.3.1 Total PAC costs are allocated to sub-funds and product groups using methods that ensure that each sub-fund and product group receives all of its direct expenses and an appropriate share of all other expenses, including overhead expenses. Any significant change to our expense allocation methods would be approved by the Chief Actuary, the With-Profits Actuary and the Chief Financial Officer of PAC.

4.3.2 Paragraphs 1.3.7.8, 1.3.8, 1.4.4, 5.3.2.1 and 5.3.2.2 set out how (if at all) charges for expenses affect asset shares and thus affect the benefits payable on with-profits policies.

4.3.3 All but a small volume of services are provided under formal intra-group or contractual third party outsourcing arrangements. External arrangements are provided at market prices. Intra-group arrangements are provided at cost, or subject to a profit margin or target profit level that is appropriate for the risks taken by, and the capital requirements of, the service provider. Fees for investment management services are subject to a profit margin.

4.3.4 All outsourcing arrangements, whether intra-group or with third parties, are reviewed regularly to confirm that they remain appropriate and are operating in accordance with the relevant agreement between PAC and the service provider. Fees are re-negotiated when appropriate. The two most significant intra-group arrangements (for investment management and policy administration) can be terminated at 12 and 6 months notice respectively.

4.3.5 The Chief Actuary and the With-Profits Actuary, with regard to advice from the WPC, review each year the fairness to each category of with-profits policy of the expense allocation and associated practices, including intra-group and external servicing and reinsurance agreements. This review also considers the fairness to with-profits policyholders of any intra-group asset transfers (e.g. of infrastructure) and the exercise of discretion to apply expenses to particular categories of policy.

## Section 5 – Management of the Inherited Estate

### 5.1 Introduction

**5.1.1** This section describes the inherited estates in the Prudential With-Profits Fund, and describes how they are managed and the uses to which they may be put.

**5.1.2** An inherited estate is the amount of money in a with-profits fund in excess of the amounts that a company expects to pay out to meet its obligations to existing policyholders. These latter amounts are equal to the with-profits policyholders' accumulated asset shares, plus any additional payments that may be required by way of smoothing or to meet guarantees.

There are two inherited estates in Prudential's With-Profits Fund, the PAC inherited estate in the WPSF and the SAIF inherited estate in SAIF.

**5.1.3** The PAC inherited estate represents the major part of the working capital of Prudential's With-Profits Fund. It is available to support both current and future new business in PAC's with-profits sub-funds, both in the UK and overseas, and is used to provide solvency support, to allow investment freedom for policyholders' asset shares, and to provide the smoothing and guarantees associated with with-profits business.

**5.1.4** The PAC inherited estate has arisen over many years from a number of sources. PAC believes that no group of in-force policyholders has made any contribution to the inherited estate.

**5.1.5** The PAC inherited estate, like the whole of the with-profits sub-funds, belongs to the company, and the Directors decide how it is used to support the with-profits business. Whilst the WPSF remains open and the inherited estate remains fully utilised in supporting current and expected future new business, PAC does not consider that policyholders have any expectation of a distribution of the inherited estate, other than through the normal process of smoothing and meeting guarantees in adverse investment conditions. Accordingly, PAC is not constrained in its use of the inherited estate to support new business written on the basis described in section 6 of the PPFM by a requirement to take into account the prospect that existing policyholders might otherwise have of receiving a distribution, or a greater distribution, from the inherited estate. In setting risk appetite and in its approach to the cost of guarantees, PAC is similarly not required to take into account the prospect of existing policyholders receiving a distribution out of the inherited estate.

**5.1.6** If, in the opinion of PAC's Directors, the WPSF's inherited estate was no longer fully utilised in supporting current and expected future new business, then an "excess surplus" would exist in the sub-fund. In such circumstances, the Directors would comply with the insurance company regulations regarding the treatment of excess surplus that were in force at the time the excess surplus arose. The current regulations state that if a firm has a with-profits fund containing an excess surplus, and to retain that surplus would be a breach of the FCA's and PRA's Principle 6 (Customers' interests), then the firm should make a distribution from that with-profits fund. If the WPSF were to close to new with-profits business, it is unlikely that there would be any immediate reduction in the requirement to maintain the inherited estate as, in such circumstances, it is likely that it would be fully utilised as working capital to support the in-force business.

**5.1.7** In March 2007 Prudential announced that it was exploring the possibility of a reattribution of the PAC inherited estate. After extensive assessment Prudential decided in June 2008 that it would not proceed with a reattribution as it believes the current operating model for the WPSF is in the best long-term interests of both current and future policyholders and shareholders.

**5.1.8** The inherited estate in SAIF will be distributed to SAIF and SAA with-profits policyholders in accordance with the SAIF Principles of Financial Management which are part of the Scheme approved by the court which transferred SALAS into PAC.

## 5.2 Principles

5.2.1 The company seeks to manage the PAC inherited estate held in the WPSF so that it continues to provide adequate working capital for the future security and ongoing solvency of the With-Profits Fund.

5.2.2 The PAC Board manages the overall business having regard to the size of the PAC inherited estate. This reflects the inherited estate's role as the working capital of the With-Profits Fund which largely determines the risk capacity of the fund. The inherited estate absorbs, at least in the short term, the impact of any substantial changes affecting the With-Profits Fund. There is no specific target for the size of the PAC inherited estate.

5.2.3 The Scottish Amicable Board manages the overall risk level for SAIF in a similar way, having regard to the existence of SACF, the size of the SAIF inherited estate as a proportion of SAIF and the requirement to distribute the inherited estate equitably as an addition to with-profits benefits.

## 5.3 Practices

5.3.1 The PAC inherited estate currently supports the with-profits business in-force, and the new with-profits business being written in the WPSF on the basis described in section 6 of the PPFM, by:

- providing the benefits associated with smoothing and guarantees,
- permitting investment flexibility for the sub-fund's assets, and
- meeting the regulatory capital requirements, which demonstrate solvency.

Transfers to or from the PAC inherited estate occur every year as part of the normal process of smoothing pay-out values and as a consequence of the tax basis applicable to SAIF (see paragraph 1.3.7.3); larger transfers from the inherited estate may occur as a result of meeting guarantees in adverse investment conditions.

It is also used to support business in other sub-funds in return for an appropriate charge; for example it supports SAIF and the DCPSF in return for a yearly charge.

5.3.2 The PAC inherited estate may also be used for any other purposes as considered appropriate by the Directors. This may include implementing inter-fund transactions with the 0:100 sub-funds which are appropriately priced and absorbing the costs of significant events, such as a fundamental change in its long-term business and the cost of providing redress for past mis-selling, without affecting the bonus and investment policies of existing policyholders. The costs of fundamental change may include investment in new technology, redundancy and restructuring costs, regulatory and legal change and the funding of other appropriate activities related to long-term insurance, including acquisitions.

5.3.2.1 Currently, the PAC inherited estate bears the following costs:

- the additional tax payable by the With-Profits Fund as a result of the distribution to shareholders of their part of the WPSF divisible profit, as permitted by insurance company regulations, (see paragraph 1.3.7.6), and
- in respect of business issued by Scottish Amicable Life plc, any cost of shareholder transfer in excess of the difference between the level of charge deducted and the level of expenses incurred.

These items will continue to be charged to the PAC inherited estate only for as long as the security of the sub-fund remains satisfactory at the time the cost is paid.

Up to 31 December 2011 the PAC inherited estate also bore the costs of any expenses written-off since 1997 (see paragraph 1.3.7.8). However, from 1 January 2012 onwards, the PAC Board has decided that new business in the WPSF should be priced such that it is expected to be financially self supporting over the lifetime of the business at the point the pricing assumptions are set. Where the business is not expected to be financially self-supporting at the point the pricing assumptions are set, shareholders will make an appropriate contribution to the WPSF (further detail on the test of self supporting is described in section 6 below).

5.3.2.2 The PAC Board decided that the costs associated with the PAC personal pensions mis-selling review were abnormal and so should not impact on asset shares, and that they should be met from the PAC inherited estate.

So that the resulting reduction in the inherited estate would have no adverse impact on policyholder pay-out values, Prudential stated in 1998 that deducting personal pensions mis-selling costs from the inherited estate would not impact the company's bonus or investment policy for WPSF policies. The company gave an assurance that if this unlikely event were to occur, it would make available support to the With-Profits Fund from shareholder resources for as long as the situation continued, so as to ensure that WPSF policyholders were not disadvantaged.

The assurance was designed to protect both existing WPSF policyholders at the date it was announced, and policyholders who subsequently purchased policies while the pension mis-selling review was continuing. This review was completed on 30 June 2002 and consequently the assurance has not applied to new WPSF business issued since 1 January 2004. New business in this context consists of new policies, new members to existing pension schemes plus regular and single premium top-ups, transfers and switches to existing arrangements.

The assurance will continue to apply to any WPSF policy in force as at 31 December 2003, both for premiums paid before 1 January 2004 and for subsequent regular premiums (including future fixed, retail price index or salary-related increases and Department for Work and Pensions rebates).

This assurance is achieved in practice by monitoring the accumulated cost of personal pension mis-selling, and adding this amount back to the capital of the fund whenever the company is taking bonus or investment decisions. This accumulated cost is calculated at any time as the provision held in the WPSF in respect of as yet unpaid potential future mis-selling costs, plus the accumulated value of past mis-selling costs, allowing for the net investment return these amounts would have earned had they remained as free assets of the WPSF.

The amount of capital support available under the terms of the assurance will reduce over time as the company pays claims on the policies covered by the assurance. The amount of capital support reduces by the ratio of the current asset share value of such policies remaining in force at the calculation date, to the asset share value, at 31 December 2003, of all policies then covered by the assurance adjusted for the net investment return earned on the asset shares since that date.

The bonus and investment policy for each type of WPSF with-profits policy is currently the same irrespective of whether or not the assurance applies. Hence removal of the assurance for new business has had no impact on policyholder returns and this is expected to continue for the foreseeable future.

**5.3.3** The investment strategy for the PAC inherited estate, excluding any assets which would not normally be traded (see paragraph 2.3.6), is determined in accordance with the overall investment strategy (see section 2). The PAC inherited estate currently has a different asset mix to that of the assets backing with-profits policies. This is to help meet guarantees and maintain regulatory solvency in adverse market conditions. The asset mix of the PAC inherited estate is regularly reviewed to ensure it remains appropriate.

**5.3.4** The investment strategy for the SAIF inherited estate is determined in accordance with the overall investment strategy (see section 2) and the SAIF Principles of Financial Management (see Appendix A). The SAIF inherited estate currently has a different asset mix to that of the assets backing with-profits policies. The ability to have a different investment mix allows the flexibility required in order to help meet guarantees, maintain regulatory solvency and ensure the sub-fund is managed in a sound and prudent fashion, which is particularly important during adverse market conditions. The asset mix of the SAIF inherited estate is regularly reviewed to ensure it remains appropriate.

5.3.5 There is no specific target for the size of the PAC inherited estate. However, a significant reduction in the size of the PAC inherited estate as a proportion of the with-profits sub-funds, or a significant increase in the with-profits sub-funds' regulatory capital requirements as a proportion of the inherited estate, would be likely to result in the WPSF being materially outside of its risk appetite. A range of management actions would then be expected to be taken by the PAC Board in order to address this.

5.3.6 In accordance with the SALAS Scheme, the SAIF inherited estate will be distributed progressively to SAIF and SAA with-profits policyholders as they become claims. When SAIF is eventually merged into the WPSF in accordance with the SAIF Principles of Financial Management, the balance of the SAIF inherited estate will be attributed to the asset shares of the remaining SAIF and SAA with-profits policyholders.

# Section 6 – Volumes of new business and arrangements on stopping new business

## 6.1 Introduction

6.1.1 PAC is currently open to new with-profits business, which may be written in the UK or overseas in either the WPSF or the DCPSF. SAIF is closed to new business except for a small volume of contractual increases to existing arrangements. The operation of SAIF, as a closed sub-fund, is defined by the SAIF Principles of Financial Management.

6.1.2 PAC seeks to write new with-profits business in the WPSF in both the UK and overseas which is expected to be financially self supporting over the lifetime of the contracts at the point the pricing assumptions are set. Where the business is not expected to be financially self-supporting at the point the pricing assumptions are set, shareholders will make an appropriate contribution to the WPSF. Given this approach, when writing new business, PAC is not constrained by any requirement to take into account the prospect that existing policyholders might otherwise have of receiving a distribution, or a greater distribution, from the PAC inherited estate in the event of an excess surplus arising in the WPSF.

6.1.3 In considering whether new business is self supporting, it should be noted that:

(i) the test of self supporting does not include the tax liability arising from shareholder transfers on that business. As described in paragraph 5.3.2.1 of the PPFM, this tax is paid from the WPSF's inherited estate subject to the security of the sub-fund remaining satisfactory at the time the tax is paid; and

(ii) new business may temporarily not be self supporting following a material change in the business environment which is outside of the firm's control. This reflects the fact that business cannot necessarily be re-priced immediately, and that the change in business environment (for example a market fall) may, in good faith, be believed to only be temporary.

6.1.4 In this section we describe the way in which we review limits on the quantity and type of new business accepted and the actions we would take if we ceased to take on a significant amount of new business.

## 6.2 Principles

6.2.1 The PAC Board manages the types and volumes of new business accepted as part of its management of the overall risk level of the company and for the maintenance of the ongoing solvency of the With-Profits Fund.

6.2.2 In the event that the With-Profits Fund became closed to with-profits business or the volume of new with-profits business became negligible, it would be necessary to review the position and put in place a plan for the management of the inherited estate over the long term. Any proposal for the reattribution, or the ultimate distribution, of any part of the inherited estate between policyholders and shareholders would need to take into account all the relevant factors and claims on the estate.

### 6.3 Practices

**6.3.1** As explained in section E of the introduction to the PPFM, the PAC Board manages the types and maximum volumes of new business accepted by the company and its subsidiary, PIA, having regard to the WPSF's risk appetite. If the WPSF was operating materially outside of its risk appetite, the PAC Board would expect to take a range of management actions to address this. Reviewing the types and volumes of new business being accepted by the with-profits sub-funds would typically be one of the actions that would be taken.

**6.3.2** There is no immediate prospect of the company closing the WPSF to new with-profits business. Although it is not easy to predict the circumstances under which such a decision would become appropriate, it might occur if the volume of new business declined to a negligible level and there was no apparent prospect of the volume recovering. However, if the WPSF were to close to new with-profits business, it is unlikely that there would be any immediate reduction in the requirement to maintain the inherited estate as, in such circumstances, it is likely that it would be fully utilised as working capital to support the in-force business.

**6.3.3** The directors of PAC may impose a limit on the size of investments held by one individual, if necessary to protect the With-Profits Fund.

## Section 7 – Equity between with-profits policyholders and shareholders

### 7.1 Introduction

**7.1.1** As with all proprietary with-profits sub-funds, the normal operation of the WPSF results in conflicts of interest arising between policyholders and shareholders, and between different groups of policyholders, and PAC seeks to resolve these conflicts of interest fairly. While the company remains open, and the inherited estate remains fully utilised in supporting current and expected future new business, PAC recognises the following interests:

(i) policyholders' interests in relation to the maintenance of their reasonable benefit expectations, including the security of their guaranteed benefits; and

(ii) shareholders' interests in the continuing operation of the business, including writing new business, and managing t he market, credit, insurance and other risks associated with that business.

**7.1.2** PAC's governing body will take the interests of both policyholders and shareholders into account in decisions it takes in relation to the operation of PAC's with-profits business. This section of the PPFM describes how the PAC Directors balance the interests in the WPSF of with-profits policyholders and shareholders. Further information on how the Directors manage conflicts of interest in relation to the inherited estate, and the writing of new business in the WPSF, is given in sections 5 and 6 respectively of the PPFM.

**7.1.3** In managing conflicts of interest between with-profits policyholders and shareholders, PAC's philosophy is that policyholders' reasonable expectations are created and influenced primarily by policy documents and other relevant materials that are published by PAC. Policyholders' reasonable expectations may therefore evolve over time but, once created, PAC's Directors consider that the WPSF should be operated in a way that has regard to those expectations.

**7.1.4** As set out in section C of the introduction to the PPFM, profits of SAIF and the DCPSF are attributable wholly to policyholders, and profits of the NPSF are wholly attributable to shareholders. Therefore, issues of equity between policyholders and shareholders for these sub-funds are largely confined to the equity of the expense apportionment (see section 4 of the PPFM).

### 7.2 Principles

**7.2.1** The company seeks to treat all customers fairly at all times, balancing any conflicting interests that arise between the various groups and generations of policyholders or between policyholders and shareholders.

**7.2.2** The proportion, or minimum proportion, of the relevant divisible profit (as defined in paragraph 1.1.1) to be allocated to each type of with-profits policy is specified via the sub-fund structure, as described in section C of the Introduction to the PPFM. The actual proportion applicable in the WPSF may be varied from year to year, any substantial overall reduction in the policyholders' proportion being subject to specific regulatory requirements.

### 7.3 Practices

7.3.1 Bonuses and pay-out values are determined as set out in section 1 and the divisible profits are calculated, after any transfer to a contingency fund, as an amount equal to the cost of bonuses on the regulatory reporting basis plus the associated shareholder transfer.

For this purpose:

- the cost of regular bonuses is the amount added to policyholders' accounts, or in the case of conventional with-profits business, the change in guaranteed liability on the statutory reporting basis as a result of the bonus addition, reduced by the cost of guaranteed bonuses on Group Cash Accumulation business,
- the cost of final bonuses is generally the amount paid on claims, net of any market value reduction, and
- the cost of bonus is adjusted for any difference between the actual cost and the expected cost of the previous year's bonuses, including the amount of final bonus allowed for in paid-up policy, surrender and transfer values after the application of any MVR.

Taxation on all With-Profits Fund assets is provided for (and in due course paid from) the appropriate sub-fund before determination of the divisible profit. The additional tax payable by the With-Profit Fund as a result of the distribution to shareholders of their part of the WPSF divisible profit is paid from the PAC inherited estate (see paragraph 1.3.7.6).

7.3.2 If the regulators change the statutory reporting basis, which is used to calculate the cost of bonus, the impact would need to be assessed at that time. A change in the basis for calculating the cost of bonus would not normally lead to any change in the division of profits between policyholders and shareholders; however, the allocation would be reviewed on any major change in the valuation approach.

7.3.3 As part of treating with-profits customers fairly the PAC Board has determined that:

- it may change the allocation of new non-profit business between the WPSF and the NPSF; any such amendments will not adversely affect the rights of WPSF with-profits policyholders at the time of the amendment to share in the profits from existing non-profit business then within the WPSF;
- any transfer of assets or business out of the With-Profits fund or between sub-funds which might affect with-profits policyholders must be at fair value (i.e. on market related terms);
- it will consider the suitability for the With-Profits Fund of any investment proposed for the benefit of the company as a whole and only accept into the With-Profits Fund:
  - investments which, by the nature of the asset, could be a natural part of the investment portfolio (e.g. an initial investment in a new unit trust); these investments are made subject to any additional costs or risks being compensated for appropriately, or
  - investment in a subsidiary where the underlying business has similar risks to insurance business which the With-Profits fund might write directly. The aggregate size of such subsidiaries is limited by the constraints implied by the management of the overall risk level of PAC.
- from 1 January 2012, PAC will seek to price new with-profits business in the WPSF such that it is expected to be financially self supporting (as described in section 6) over the lifetime of the business at the point the pricing assumptions are set. As is further described in section 6, where the business is not expected to be financially self-supporting at the point the pricing assumptions are set, shareholders will make an appropriate contribution to the WPSF.

# Appendix A

## Scottish Amicable Insurance Funds – Principles of Financial Management (PFM)

This appendix reproduces the Principles of Financial Management defined in 1997. The terminology used relates to documentation agreed as part of the Scheme of Transfer of SALAS business and therefore differs from that used in the Principles and Practices of Financial Management.

1. The affairs of the Scottish Amicable Funds shall be conducted in a sound and prudent fashion.

2. The investment and bonus policies for the Scottish Amicable Insurance Fund shall have regard to the interests and expectations (as modified by this Scheme) of the holders of Policies allocated to the Scottish Amicable Insurance Fund, Excluded Policies which would have been so allocated if they were Transferred Policies and Unitised With Profits Policies referred to in Paragraph 27.1 (Relevant Policies) and shall be determined as if the Scottish Amicable Capital Fund represented free assets of the Scottish Amicable Insurance Fund. Such investment and bonus policies shall not be constrained in any way other than by the financial position of the Scottish Amicable Funds and in accordance with the principles specified in this Schedule.

3. The investment policy for the Scottish Amicable Funds:

(a) shall be substantially the same as the investment policy followed for business in the Other Long Term PAC Funds as appropriate to the nature of the liabilities, shall follow similar investment principles, in terms of asset allocations, to the Other Long Term PAC Funds and shall be conducted with a view to ensuring so far as reasonably practicable the same returns for policyholders of Relevant Policies by asset class as for policyholders of the Other Long Term PAC Funds;

(b) shall have regard to any statement of intent on investment in equities made in the Circular; and

(c) shall provide for maintaining the maximum equity backing ratio possible subject to such constraints as may be necessary to reduce the risk of statutory insolvency to a similar level as for the Other Long Term PAC Funds. The risk of statutory insolvency shall be determined on bases and assumptions which are no more cautious than those applied to the Other Long Term PAC Funds but the Scottish Amicable Capital Fund shall be ignored to the extent that taking it into account would otherwise permit a higher equity backing ratio than the greater of (a) that of the Other Long Term PAC Funds and (b) 85%.

4. The bonus policy for Relevant Policies:

(a) shall be determined by reference to the financial position, performance and experience of the Scottish Amicable Insurance Fund as if the Scottish Amicable Capital Fund represented free assets of the Scottish Amicable Insurance Fund, and in such a manner as to distribute equitably all the assets of the Scottish Amicable Insurance Fund (including all future surplus arising in the fund but excluding assets in the Scottish Amicable Capital Fund) over the remaining life of the Relevant Policies;

(b) shall aim to distribute the surplus assets in the Scottish Amicable Insurance Fund in excess of those already earmarked for distribution to policyholders under Scottish Amicable's current bonus policy so as to provide a uniform percentage enhancement (reassessed from time to time in accordance with Paragraph 6 below) to projected claim values, subject to adjustment for policies which have been in force for less than ten years;

(c) shall smooth payouts in a manner consistent with the selected equity-oriented investment policy of the Scottish Amicable Insurance Fund, and the need to reduce to acceptable levels (determined on bases and assumptions which are no more cautious than those applied to the Other Long Term PAC Funds), the expected cost of operating the smoothing policy of the Scottish Amicable Insurance Fund as described in Paragraph 9 below; and

(d) shall be such as to provide an attractive amount of guaranteed bonus for holders of Relevant Policies consistent with the selected equity-oriented investment policy and the need to reduce to acceptable levels (determined on bases and assumptions which are no more cautious than those applied to the Other Long Term PAC Funds), the risk of statutory insolvency as described in Paragraph 3(c) above and the expected cost of operating the smoothing policy of the Scottish Amicable Insurance Fund as described in Paragraph 9 below.

5. Asset Share records shall be maintained and referred to in setting bonus rates in order to ensure equity between different groups of policyholders.

   Asset Shares shall be determined as at the Effective Date using Scottish Amicable's approach at 31 December 1996 and shall be accumulated in the future using a consistent approach, by reference to the investment performance, expense and taxation experience of the Scottish Amicable Insurance Fund.

   The future accumulation of Asset Shares shall include an allocation of 0.25% per annum in respect of miscellaneous surplus from non-profit and unit-linked business, and an allocation or deduction of a smoothing credit or charge determined in accordance with the principles referred to in Paragraph 8 below.

6. Payouts at maturity shall be targeted on 100% of Asset Shares with the addition of an enhancement to reflect the distribution or surplus assets referred to in Paragraph 4(b) above.

   The level of enhancement shall be set at the Effective Date, and shall be reassessed at least triennially, to provide a uniform percentage enhancement to the projected claim values of all Relevant Policies remaining in force at the time.

   The enhancement shall be determined by the Appointed Actuary (since 1 January 2016, the Chief Actuary) and approved by the Monitoring Actuary using the best estimate at the time, on realistic assumptions, of the projected claim values and the value of future miscellaneous surplus (including any surrender surplus), – and shall exclude any deficit or surplus on the smoothing account referred to in Paragraph 7 below.

7. A smoothing account shall be maintained to which shall be credited the difference between claim payments (excluding the enhancement described in Paragraph 6 above) on Relevant Policies, and Asset Shares. A smoothing charge or allocation may be levied against, or credited to, Asset Shares, and the amount of such charge or allocation shall be credited to, or deducted from, the smoothing account.

8. Subject to Paragraph 9 below, the intention at all times shall be to aim for neither surplus nor deficit in the smoothing account, and the level of the charge or allocation referred to in Paragraph 7 above shall be determined as the percentage per annum of Asset Shares, which is expected to eliminate any deficit or surplus on the smoothing account over the remaining life of the policies, after allowing for smoothing costs which may be expected to arise as a result of guarantees or underlying trends in claim values. The charge or allocation shall be reassessed at least triennially, but in any event any charge shall not exceed the amount set out in Paragraph 9 below.

9. The maximum charge shall be set prior to the Effective Date so that the expected cost to the Other Long Term PAC Funds of smoothing in relation to the Scottish Amicable Insurance Fund is equal to the greater of:

(a) the present value of 75% of the fees payable by the Scottish Amicable Insurance Fund to the Other Long Term PAC Funds in respect of the Scottish Amicable Capital Fund, less the expected cost to the Other Long Term PAC Funds of any restrictions on investment freedom resulting from the provision of capital support to the Scottish Amicable Insurance Fund by means of the Scottish Amicable Capital Fund; and

(b) the present value of 35% of the fees payable by the Scottish Amicable Insurance Fund to the Other PAC Funds in respect of the Scottish Amicable Capital Fund, calculated assuming that the maximum permitted amount of the Scottish Amicable Capital Fund is outstanding at all times.

10. The maximum smoothing charge shall be agreed by the Appointed Actuary of PAC and the Appointed Actuary of Scottish Amicable prior to the Effective Date, and in the event of agreement not being reached by the Effective Date shall be referred for final determination to an Umpire appointed in accordance with Schedule 10.

The level of smoothing charge or allocation determined from time to time shall be determined (subject to the maximum referred to in Paragraph 9 above) by the Appointed Actuary and shall be subject to approval by the Monitoring Actuary.

11. Upon the merger of the Scottish Amicable Insurance Fund with the Other Long Term PAC Funds in accordance with Paragraph 32 of the Scheme:

(a) the enhancement referred to in Paragraph 6 above relating to the remaining Relevant Policies shall be reassessed so that the remaining assets of the Scottish Amicable Insurance Fund plus the amount of any deficit in the smoothing account together with the value of future surplus projected to arise in the Scottish Amicable Insurance Fund shall be distributed to the remaining Relevant Policies as a uniform enhancement to expected claim values by means of an enhancement to asset shares (such enhancement to be determined by the Appointed Actuary and agreed by the Monitoring Actuary); and

(b) thereafter, the bonuses payable on the remaining Relevant Policies shall be determined by reference to the enhanced Asset Shares, accumulated at the rate of investment return with additions for premiums and with deductions for expenses, taxation and risk benefits which reflect the performance and experience of the whole of the Long Term Fund and subject to the smoothing policy applied to other With-Profits Policies in the Long Term Fund. Any further smoothing charges which may be levied against Asset Shares shall not exceed the maximum charge referred to in Paragraph 9 above. For the avoidance of doubt, no deductions shall be made in respect of shareholder transfers or shareholder tax, and no further allocations shall be made in respect of miscellaneous surplus or otherwise, other than the 0.25% allocation referred to in Paragraph 5 above.

# Appendix B

## ELAS With-Profits Annuities – Principles of Financial Management

This appendix reproduces the Principles of Financial Management agreed as part of the Scheme of Transfer of ELAS business to PAC. The terminology used relates to documentation agreed as part of the Scheme of Transfer of ELAS business and therefore differs from that used in the Principles and Practices of Financial Management. The Scheme is available on request.

### 1. The Transferring Policies Bonus Series

On the Effective Date, the Transferee will create a new bonus series (the "Transferring Policies Bonus Series") and the Transferring Policies will be allocated to and from the Transferring Policies Bonus Series. The Transferring Policies Bonus Series will not be merged or amalgamated with any other bonus series and no other policies, in whole or in part, will be allocated to the Transferring Policies Bonus Series. None of the Transferring Policies will be transferred from the Transferring Policies Bonus Series at any time after the Effective Date.

### 2. Income after the Effective Date

2.1 Immediately following the Effective Date (and, for the avoidance of doubt, this reference to Effective Date shall refer to the time and date in the definition of "Effective Date"):

(a) each Transferring Policy will have the same level of Guaranteed Income as it had immediately prior to the Effective Date;

(b) each Transferring Policy will have a level of Post-Smoothing Non-Guaranteed Income equal to the level of Post-Smoothing Non-Guaranteed Income in respect thereof immediately prior to the Effective Date; and

(c) until a new bonus rate is announced by the Transferee with respect to the Transferring Policies on or after the Effective Date, any bonus rate, interim or otherwise, which is applicable to the policy immediately prior to the Effective Date will continue to apply.

2.2 The rates from time to time determined by the Transferee as the rates of Non-Guaranteed Bonus to be applied to the Transferring Policies will be applied in determining the Post-Smoothing Non-Guaranteed Income in respect of each Transferring Policy in accordance with the established practice for the calculation thereof (being initially the established practice of the Transferor but subject to changes from time to time made by the Transferee consistently with applicable law and regulation and with the consent of the Transferee With-Profits Committee).

### 3. Maintenance of separate Asset Shares for the Transferring Policies

The Individual Asset Shares attaching to the Transferring Policies shall be maintained separately from the asset shares of all other policies of the Transferee. The Transferring Policies shall have no exposure to, and shall incur no adjustment for, profits and losses arising from the Transferee's other policies, experience or business activities (save to the extent of unavoidable indirect exposure as a result of the effects of such profits and losses on the Transferee's overall financial position).

### 4. Exhaustion of Aggregate Asset Share over the lifetime of the Transferring Policies

(a) The Transferee will determine the amounts of Pre-Smoothing Non-Guaranteed Income in respect of the Transferring Policies in a manner calculated to exhaust the Aggregate Asset Shares (including any adjustment of the Aggregate Asset Share as a result of the Aggregate Augmentation Amount) of the Transferring Policies over the lifetime of the Transferring Policies, allowing for the Transferee's expectations of future mortality, in line with the Transferee PPFM from time to time. The Transferee will allow for its expectations of future mortality by using a mortality basis which the Transferee With-Profits Committee confirms at the start of each calendar year to be a best estimate basis for the Transferring Policies (without any known margins for prudence) for expected mortality during the remaining lifetimes of the Transferring Policies.

(b) Bonuses announced and paid on the Transferring Policies will be calculated with the aim of fully distributing the achieved returns on the underlying investments over the time the Transferring Policies are in force, allowing for smoothing of the peaks and troughs of investment performance in accordance with paragraph 7 (Smoothing) of these Principles of Financial Management and other factors more fully described below.

(c) The Aggregate Asset Share held in the Transferee DCPSF will only fund such part of any payment made under a Transferring Policy as constitutes the Pre-Smoothing Non-Guaranteed Income in respect of such payment, and not any additional amount by which the Guaranteed Income in respect of such payment exceeds the Pre-Smoothing Non-Guaranteed Income in respect of such payment.

(d) For any Transferring Policy an Incurred Cost of Guarantee may occur whenever a payment is made under the policy. The Incurred Cost of Guarantee in respect of any payment is the Guaranteed Income in respect of that payment less the Pre-Smoothing Non-Guaranteed Income in respect of that payment, subject to a minimum of zero. The Transferee WPSF shall pay the Incurred Cost of Guarantee in respect of all payments under Transferring Policies.

**5. Investment return of the WPSF Asset Pool to be credited to the Transferring Policies**

(a) The asset mix backing the Transferring Policies will be identical to the asset mix of the Transferee WPSF Asset Pool.

(b) The Aggregate Asset Share will be credited in each year by a rate of investment return which (before deduction of charges and adjustments for any tax liability or credit in accordance with applicable tax legislation, but net of unrecoverable tax) is the same as the rate of investment return earned by the Transferee on the Transferee WPSF Asset Pool (net of unrecoverable tax) (the "Gross Rate of Investment Return"), and the Individual Asset Share of each Transferring Policy shall be credited accordingly.

(c) In determining the investment return to be credited to the Individual Asset Share of any Transferring Policy, the Transferee may adjust the Gross Rate of Investment Return for any tax liability or credit of the Transferee arising out of or in consequence of that Transferring Policy in accordance with applicable tax legislation which is properly allocable to such Transferring Policy.

(d) In determining the Gross Rate of Investment Return, the Transferee will not treat the Transferring Policies less favourably than it treats other policies for which the crediting of investment return to asset shares is determined by reference to the investment return of the Transferee WPSF Asset Pool and will not make adjustments for miscellaneous profits or losses or on account of smoothing.

(e) Except as required by paragraph 8 of these Principles of Financial Management, the Transferee will not apply different rates of Non-Guaranteed Bonus to different Transferring Policies and will not apply different rates of Guaranteed Bonus to different Transferring Policies having the same GIR.

(f) Asset pools other than the Transferee WPSF Asset Pool, with asset mixes different to the Transferee WPSF Asset Pool, may operate within the Transferee WPSF for certain specific categories of business but the Transferring Policies will not participate in the investment return of such asset pools.

**6. Mortality experience**

(a) To the extent that actual payments of income on the Transferring Policies are less or more than expected in any calendar year because of heavier or lighter mortality than expected, the profit or loss shall be for the account of the Transferee WPSF, and such transfers shall be made between the Transferee DCPSF and the Transferee WPSF as are necessary to achieve this.

(b) For the purposes of determining what annuity payments on the Transferring Policies are "expected" to be made in any period for the purposes of paragraph 6(a), the Transferee shall use the mortality basis or a combination of mortality bases which the Transferee With-Profits Committee has confirmed in advance of and for purposes of that period to be a best estimate basis or best estimate bases for the Transferring Policies (without any known margins for prudence) for expected mortality during the remaining lifetimes of the Transferring Policies, and for this purpose the Transferee will ensure that the Transferee With-Profits Committee gives such a confirmation for an appropriate period not less than once per year and that, in so far as they relate to the same period, the mortality basis confirmed is the same as the mortality basis confirmed by the With-Profits Committee for purposes of paragraph 4(a).

(c) At the end of each calendar year, the Transferee shall adjust the Individual Asset Shares of all the Transferring Policies which remain in force at that time in a manner which redistributes amongst those remaining policies, in a manner which is fair to all holders of those remaining policies having regard to these Principles of Financial Management, the amount of the Individual Asset Shares that would have been released or reduced if the actual incidence of deaths of Transferring Annuitants during such calendar year had exactly matched the expectations included in the mortality basis or mortality bases used for expected mortality in that calendar year in accordance with paragraph 6(b) of these Principles of Financial Management.

(d) Subject to paragraph (e), the Transferee may from time to time adopt a different mortality basis for its management of the Transferring Policies representing its changed expectations of future mortality and the lifetime of Transferring Policies over which Individual Asset Shares are expected to be distributed in the form of Pre-Smoothing Non-Guaranteed Income.

(e) The Transferee may only adopt a different mortality basis for its management of the Transferring Policies if the Transferee With-Profits Committee has given its consent, which the Transferee With-Profits Committee will only give if:

  (i) it is satisfied that the new mortality basis to be adopted by the Transferee is fair to both the Transferring Policies and the Transferee WPSF and represents a best estimate basis for the expected future mortality experience of the Transferring Policies;

  (ii) in forming its assessment for adopting a different basis (including for the purposes of paragraph (i) above), it has taken into account the historic mortality experience of the Transferring Policies as well as the expected future mortality experience of the Transferring Policies.

(f) Where the Transferee adopts a different mortality basis for its management of the Transferring Policies, the following provisions may require a payment to be made from the Transferee WPSF to the Transferee DCPSF or from the Transferee DCPSF to the Transferee WPSF. On each occasion when the Transferee adopts a different mortality basis for its management of the Transferring Policies, the Transferee With-Profits Committee shall consider whether the following provisions apply.

(g) The Estimated Mortality Change shall be calculated, being the amount given by:

  (i) the Aggregate Policy Value at the time of the change in mortality basis, calculated using the Core Reserving Basis, including the mortality basis included in the Core Reserving Basis;

  MINUS

  (ii) the Aggregate Policy Value at the time of the change in mortality basis, calculated using the Core Reserving Basis but with the mortality basis therein replaced by the new mortality basis.

(h) Where the Estimated Mortality Change is positive, the Mortality Impact shall be calculated as the percentage rate which, if applied on a compound basis as an annual increase to Post-Smoothing Non-Guaranteed Income from the time of the change in mortality basis onwards, would produce an increase in the Aggregate

Policy Value equal to the Estimated Mortality Change (this valuation to be carried out using the Core Reserving Basis, but with the mortality basis therein replaced by the new mortality basis).

(i) Where the Estimated Mortality Change is negative, the Mortality Impact shall be calculated as the percentage rate which, if applied on a compound basis as an annual reduction to Post-Smoothing Non-Guaranteed Income from the time of the change in mortality basis onwards, would produce a reduction in the Aggregate Policy Value equal to the absolute value of the Estimated Mortality Change (this valuation to be carried out using the Core Reserving Basis, but with the mortality basis therein replaced by the new mortality basis).

(j) If the first such Mortality Impact is less than or equal to 0.50% per annum then the Non-Chargeable Mortality Transfer Amount will be zero and no payment shall be due in respect of it from the Transferee WPSF or the Transferee DCPSF.

(k) If the first such Mortality Impact is greater than 0.50% per annum then the Non-Chargeable Mortality Transfer Amount will be calculated in accordance with paragraph 6(l) of these Principles of Financial Management, and:

  (i) if the Non-Chargeable Mortality Transfer Amount is negative, the Transferee WPSF will pay to the Transferee DCPSF an amount equal to the absolute value of the Non-Chargeable Mortality Transfer Amount, and the Aggregate Asset Share shall be increased by the absolute value of the Non-Chargeable Mortality Transfer Amount and the Individual Asset Share of each Transferring Policy shall be increased proportionately; and

  (ii) if the Non-Chargeable Mortality Transfer Amount is positive, the Transferee DCPSF will pay to the Transferee WPSF an amount equal to the Non-Chargeable Mortality Transfer Amount, and the Aggregate Asset Share shall be reduced by the Non-Chargeable Mortality Transfer Amount and the Individual Asset Share of each Transferring Policy shall be reduced proportionately.

(l) The Non-Chargeable Mortality Transfer Amount will be zero if the Mortality Impact is less than or equal to 0.50% per annum. Otherwise, the Non-Chargeable Mortality Transfer Amount will be calculated as the amount given by:

  (i) the Aggregate Policy Value at the time of the change in mortality basis calculated using the Core Reserving Basis, including the mortality basis included in the Core Reserving Basis;

  MINUS

  (ii) the Aggregate Policy Value at the time of the change in mortality basis calculated using the Core Reserving Basis but with the mortality basis therein replaced by the new mortality basis and assuming, where the Estimated Mortality Change is positive, that an annual compound increase of 0.5% per annum is applied to the Post-Smoothing Non-Guaranteed Income from the time of the change in mortality basis onwards or, where the Estimated Mortality Change is negative, that an annual compound reduction of 0.5% per annum is applied to the Post-Smoothing Non-Guaranteed Income from the time of the change in mortality basis onwards.

(m) Whenever a change is made to the mortality basis, the Mortality Impact shall be recalculated; the new Mortality Impact shall replace, not add to, any previous Mortality Impact, save that the previous Mortality Impact shall be used as described in paragraph 6(n)(i) below.

(n) In the event that there has been a change in mortality basis which resulted in a Non-Chargeable Mortality Transfer Amount which was not zero and the mortality basis is subsequently changed again, the following will be calculated at the time of that subsequent change to the mortality basis:

  (i) the Non-Chargeable Mortality Transfer Amount that would apply for a change of the mortality basis from the mortality basis included in the Core Reserving Basis to the then current mortality basis as though it were the first and only change in mortality basis since the Effective Date, but based on the Mortality Impact calculated at the time of the previous change (“NCMTACurrent”); and

(ii) the Non-Chargeable Mortality Transfer Amount that would apply for a change of the mortality basis from the mortality basis included in the Core Reserving Basis to the new mortality basis as though it were the first and only change in mortality basis since the Effective Date (“NCMTANew”).

If NCMTACurrent is greater than or equal to NCMTANew then a payment shall be made to the Transferee DCPSF from the Transferee WPSF in an amount given by:

(1) NCMTACurrent;

MINUS

(2) NCMTANew, and the Aggregate Asset Share shall be increased by the amount of the payment, and the Individual Asset Share of each Transferring Policy shall be increased proportionately.

If NCMTACurrent is less than NCMTANew then a payment shall be made from the Transferee DCPSF to the Transferee WPSF in an amount equal to the absolute value of the amount given by:

(3) NCMTANew;

MINUS

(4) NCMTACurrent, and the Aggregate Asset Share shall be reduced by the amount of the payment and the Individual Asset Share of each Transferring Policy shall be reduced proportionately.

This process will be repeated every time there is a change in the mortality basis used by the Transferee for its management of the Transferring Policies.

## 7. Smoothing

7.1 Under normal circumstances, smoothing shall be applied in respect of the Transferring Policies according to the following principles:

(a) Smoothing will operate to ensure that the amount of Post-Smoothing Non-Guaranteed Income in respect of a Transferring Policy, before allowing for the impact of the Guaranteed Income, shall not:

(i) in the case of Low Start Annuity Policies:

(1) fall below its then current amount from time to time; or

(2) rise above its then current amount from time to time in any year by a percentage greater than the Smoothing Cap;

(ii) in the case of Transferring Policies other than Low Start Annuity Policies:

(1) fall below its then current amount from time to time in any year by a percentage exceeding the percentage given by:

$$100\% \times \left[ 1 - \frac{(1)}{(1 + ABR) \times (1 + GIR)} \right]$$

where:

“ABR” means the anticipated bonus rate applicable under that Transferring Policy, expressed as a decimal; and

“GIR” means the guaranteed interest rate applicable under that Transferring Policy, expressed as a decimal; or

(2) rise above its then current amount from time to time in any year by a percentage exceeding the percentage given by:

$$100\% \times \left\{ \left[ \frac{(1+SC)}{(1 + ABR) \times (1 + GIR)} \right] - 1 \right\}$$

where:

"SC" means the Smoothing Cap, expressed as a decimal; and "ABR" and "GIR" have the meanings given in paragraph 7.1(a)(ii)(1).

(b) The Smoothing Cap, which shall be capable of alteration by the Transferee with the approval of the Transferee With-Profits Committee, will initially be 11%. The level of the Smoothing Cap will be stated as a practice in the Transferee's PPFM.

(c) Smoothing will also be applied as necessary to ensure the objective of gradual, rather than erratic, changes in bonus rates.

**7.2** Greater flexibility in smoothing than is permitted by paragraph 7.1 of these Principles of Financial Management may be required in certain circumstances, for example following a significant fall or rise in market values (either sudden or over a period of years). In such situations, the Transferee may decide to vary the bonus smoothing limits referred to in paragraph 7.1 to protect the overall interests of all policyholders of the Transferee. When determining whether smoothing rules and limits for the Transferring Policies should be changed, the Transferee will apply the same principles as it would for other with-profits business as stated in the Transferee PPFM from time to time, taking account of the balance of the Transferring Policies Smoothing Account.

**7.3** The Transferee shall follow the following practices in respect of the Transferring Policies:

(a) The Transferring Policies Smoothing Account will be held within the Transferee WPSF and will contain a nominal balance denominated in pounds sterling at all times (which balance may be positive or negative).

(b) Subject to paragraph 7.3(c) of these Principles of Financial Management:

(i) where the Pre-Smoothing Non-Guaranteed Income in respect of the Transferring Policies exceeds the Post-Smoothing Non-Guaranteed Income in respect of the Transferring Policies, the balance of the Transferring Policies Smoothing Account will increase by the amount determined in accordance with paragraph 7.3(e) or 7.3(f) of these Principles of Financial Management, as applicable; and

(ii) where the Pre-Smoothing Non-Guaranteed Income in respect of the Transferring Policies is less than the Post-Smoothing Non-Guaranteed Income in respect of the Transferring Policies, the balance of the Transferring Policies Smoothing Account will decrease by the amount determined in accordance with paragraph 7.3(e) or 7.3(f) of these Principles of Financial Management, as applicable.

(c) Except as provided in paragraph 7.3(h) of these Principles of Financial Management, the amount held in the Transferring Policies Smoothing Account will change if and only if the application of smoothing changes a payment actually made under a Transferring Policy from the amount that it would have been if smoothing had not been applied – by comparing (i) the higher of the Guaranteed Income and the Post-Smoothing Non-Guaranteed Income in respect of the Transferring Policies with (ii) the higher of the Guaranteed Income and the Pre-Smoothing Non-Guaranteed Income in respect of the Transferring Policies.

(d) For any Transferring Policy at any time where a payment is made which is affected by the application of smoothing, the Pre-Smoothing Payment Amount shall be equal to the higher of the Guaranteed Income in respect of that payment and the Pre-Smoothing Non-Guaranteed Income in respect of that payment. The Post-Smoothing Payment Amount shall be equal to the higher of the Guaranteed Income in respect of that payment and the Post-Smoothing Non-Guaranteed Income in respect of that payment.

If the Pre-Smoothing Payment Amount is not equal to the Post-Smoothing Payment Amount there shall be a Smoothing Cost associated with the application of smoothing in relation to that payment.

(e) Where there is a Smoothing Cost associated with the application of smoothing in relation to a payment and the Guaranteed Income in respect of that payment is less than the Pre-Smoothing Non-Guaranteed Income in respect of that payment, the Smoothing Cost shall be equal to:

(i) the greater of the Guaranteed Income in respect of that payment and the Post-Smoothing Non-Guaranteed Income in respect of that payment;

LESS

(ii) the Pre-Smoothing Non-Guaranteed Income in respect of that payment.

(f) Where there is a Smoothing Cost associated with the application of smoothing in relation to a payment and the Guaranteed Income in respect of that payment is greater than the Pre-Smoothing Non-Guaranteed Income in respect of that payment, the Smoothing Cost shall be equal to:

(i) the Post-Smoothing Non-Guaranteed Income in respect of that payment;

LESS

(ii) the Guaranteed Income in respect of that payment, subject to a minimum Smoothing Cost of zero.

(g) Any Smoothing Cost, positive or negative, shall be DEDUCTED from the balance of the Transferring Policies Smoothing Account (so that the balance of the account is reduced where the Smoothing Cost is positive and increased where the Smoothing Cost is negative).

(h) The Transferring Policies Smoothing Account will itself be adjusted by the Gross Rate of Investment Return and adjusted for any other tax liability or credit of the Transferee arising out of or in consequence of the Transferring Policies in accordance with applicable tax legislation, and reduced by charges as provided in paragraph 9.1(b) of these Principles of Financial Management.

(i) The Transferring Policies Smoothing Account will have a value of zero at the Effective Date, and shall be managed with the ongoing aim that it should always tend to zero, subject to the need for short-term smoothing.

### 8. Deferred Cost Policies

The Transferee will make deductions from bonuses on Deferred Cost Policies of 0.5 per cent per annum for 2008, 2009 and 2010 (consistently with the practice of the Transferor prior to the Effective Date).

### 9. Charges

9.1 Notwithstanding any provisions contained in the policy conditions of the Transferring Policies and any representations, warranties or undertakings made before the Effective Date in relation to the Transferring Policies by any person other than the Transferee, the Transferee may impose charges on each Transferring Policy on the basis set out below:

(a) by way of arithmetic deduction from the gross investment return that would otherwise be credited to the Individual Asset Share of such Transferring Policy:

(i) 1.0% per annum of the Individual Asset Share throughout the lifetime of the policy for expenses, to be credited to the Transferee NPSF; and

(ii) a maximum of 0.5% per annum of the Individual Asset Share throughout the lifetime of the policy for the expected cost of guarantees, to be credited to the Transferee WPSF; and

(b) by way of arithmetic deduction from the gross investment return that would otherwise be applied to the Transferring Policies Smoothing Account of:

(i) 1.0% per annum of the balance of the Transferring Policies Smoothing Account for expenses, to be credited to the Transferee NPSF (or debited to the Transferee NPSF where the balance of the Transferring Policies Smoothing Account is negative); and

(ii) a maximum of 0.5% per annum of the balance of the Transferring Policies Smoothing Account for the expected cost of guarantees, to be credited to the Transferee WPSF (or debited to the Transferee WPSF where the balance of the Transferring Policies Smoothing Account is negative).

**9.2** These charges may be applied irrespective of whether the Guaranteed Income in respect of the Transferring Policy exceeds the Pre-Smoothing Non-Guaranteed Income in respect of the Transferring Policy.

**9.3** Subject to paragraphs 9.4 and 9.5, no other charges will be imposed on any Transferring Policy (whether by deduction from the Individual Asset Shares or the Aggregate Asset Share or from the Transferring Policies Smoothing Account or from bonuses or from gross investment return or otherwise), including without limitation in respect of investment management, transaction expenses arising from the transfer of the Transferring Policies to the Transferee, capital support provided for the benefit of such policies, whether from the Transferee WPSF or otherwise, or mortality (but without prejudice to any requirement for the Transferee DCPSF to make payment to the Transferee WPSF in accordance with paragraph 6 of these Principles of Financial Management).

**9.4** Paragraph 9.3 shall not prevent the Transferee from determining the gross investment return for the Transferring Policies in the same manner as it determines the gross investment return for other policies for which the crediting of investment return to asset shares is determined by reference to the investment return of the Transferee WPSF Asset Pool, provided that in determining the gross investment return for the Transferring Policies the Transferee shall make no deduction in respect of investment management, transaction expenses arising from the transfer of the Transferring Policies to the Transferee, capital support provided for the benefit of such policies, whether from the Transferee WPSF or otherwise, or mortality (but without prejudice to any requirement for the Transferee DCPSF to make payment to the Transferee WPSF in accordance with paragraph 6 of these Principles of Financial Management).

**9.5** Notwithstanding this paragraph 9, the Transferee may make deductions from the Aggregate Asset Share or from the gross investment income that would otherwise be credited thereto:

(a) in accordance with paragraph 16.7 of the Scheme; or

(b) where it has suffered a loss in connection with the transfer to it of the WPA Business in respect of which it has a claim against the Transferor and, in the opinion of the Transferee With-Profits Committee, it is proper for all or part of such loss to be absorbed by the Transferring Policies because they would otherwise retain an improper benefit as a result of the circumstances which gave rise to the loss.

**9.6** Without prejudice to future crediting to the Transferee NPSF of charges deducted under paragraph 9.1(a)(i) or 9.1(b)(i) of these Principles of Financial Management, any crediting of charges from the Transferee NPSF to the Transferee WPSF in accordance with paragraph 9.1(b)(i) will not give rise to any requirement for subsequent reimbursement to the Transferee NPSF.

### 10. Changes in charges for guarantees

#### (a) Reduction

If, at any time after the Effective Date, the Target Equity Backing Ratio is reduced by a material amount (being a reduction of the Target Equity Backing Ratio below a percentage which is an integral multiple of 5) either in a single step or series of steps then the reduction will be notified to the Transferee With-Profits Committee. The Transferee will produce recommendations as to whether there should be a reduction in the on-going charges for guarantees for the Transferring Policies, and by how much they should be reduced, and the Transferee With-Profits Committee will review the Transferee's recommendations and consider whether the on-going charges for guarantees should be reduced. Any resulting reduction shall be applied on a consistent basis as between the Transferring Policies and the Transferee's other with-profits policies.

(b) Increase

If the ongoing charges for guarantees applied to the Transferring Policies have been reduced below the maximum level of 0.5% per annum pursuant to paragraph 10(a) of these Principles of Financial Management and subsequently the Target Equity Backing Ratio is increased by a material amount (being an increase of the Target Equity Backing Ratio above a percentage which is an integral multiple of 5) either in a single step or a series of steps then the increase will be notified to the Transferee With-Profits Committee. The Transferee will produce recommendations as to whether there should be an increase in the on-going charges for guarantees for the Transferring Policies, and by how much they should be increased, and the Transferee With-Profits Committee will review the Transferee's recommendations and consider whether the on-going charges for guarantees should be increased. Any resulting increase shall be applied on a consistent basis as between the Transferring Policies and the Transferee's other with-profits policies, save that the increase of the on-going charges for guarantees applied to the Transferring Policies will not be such as to increase these charges above the maximum level of 0.5% per annum permitted by paragraph 9 (Charges) of these Principles of Financial Management.

(c) Review of guarantee charges

Any review of the on-going charges for guarantees which is applied to any of the Transferee's with-profits policies will also include, on a consistent basis, a review of the on-going charges for guarantees applied to the Transferring Policies, in each case taking into account the amount of any up-front guarantee charge (including, in the case of the Transferring Policies, the Post-Augmentation Up-front Guarantee Charge). The Transferee will produce recommendations as to whether there should be an increase or a reduction in the on-going charges for guarantees for the Transferring Policies, and by how much they should be increased or reduced, and the Transferee With-Profits Committee will review the Transferee's recommendations and consider whether the on-going charges for guarantees should be increased or reduced. Any resulting increase or reduction in those charges as a result of such a review will be applied on a consistent basis as between the Transferring Policies and the Transferee's other with-profits policies, save that any increase in the on-going charges for guarantees applied to the Transferring Policies will not be such as to increase these charges above the maximum level of 0.5% per annum permitted by paragraph 9 (Charges) of these Principles of Financial Management.

**11. Amendment of terms of management of the Transferring Policies**

The terms on which the Transferee will be permitted to manage the Transferring Policies may be amended in any of the following circumstances:

(a) to the extent required to facilitate a restructuring of the long-term insurance fund of the Transferee provided that paragraphs 4, 5, 6, 8, 9 and 10 of these Principles of Financial Management are not amended, save that references to the Transferee WPSF and the Transferee NPSF may be replaced by references to any other funds or sub-funds of the Transferee, and provided that the effect of this Schedule is not changed to the material detriment of the Transferring Policies;

(b) at any time after 2009 provided that paragraphs 4, 5, 6, 8, 9 and 10 of these Principles of Financial Management are not amended, save that references to the Transferee WPSF and the Transferee NPSF may be replaced by references to any other funds or sub-funds of the Transferee, and provided that the effect of these Principles of Financial Management is not changed to the material detriment of the Transferring Policies; or

(c) to the extent required in order to enable the Transferee to comply with applicable law and regulation.

Any such amendment will require the approval of the Transferee With-Profits Committee and will be notified to the FSA in advance of the amendment taking effect.

**12. Application to Excluded Policies**

These Principles of Financial Management shall apply mutatis mutandis to the manner in which the Transferee is required to carry out its obligations in respect of the Excluded Policies under the Excluded Policies Reassurance Agreement and, except to the extent that the context otherwise requires, each reference in these Principles of Financial Management to the "Transferring Policies" shall be treated as being a reference to both the Transferring Policies and the Excluded Policies.

### 13. Interim arrangements

These Principles of Financial Management are subject, in respect of the first year following the Effective Date, to the Interim Arrangements.

### 14. Application of Uplift

(a) On the Income Uplift Date, the Aggregate Asset Share of the Transferring Policies will be amended in accordance with paragraph 16.3(b) or paragraph 16.4 of the Scheme, as applicable.

(b) Where the Aggregate Augmentation Amount is positive, the bonuses announced by the Transferee in respect of the Transferring Policies in 2009 shall be increased to distribute an amount corresponding to the full amount of the benefit received by the Transferee by reason of having received the Transferring Assets on the Effective Date but not having uplifted the Post-Smoothing Non-Guaranteed Income in respect thereof until the Income Uplift Date.

(c) Where the Aggregate Augmentation Amount is negative, paragraph 16 of the Scheme will not result in a change in Post-Smoothing Non-Guaranteed Income. Accordingly, in the absence of this paragraph 14(c), the Post-Smoothing Non-Guaranteed Income in respect of the Transferring Policies would exceed the amounts that the Aggregate Asset Share would normally have supported in accordance with these Principles of Financial Management. The amount of any resulting overpayments of income may be recovered by the Transferee by:

    (i) reducing future bonuses of the Transferring Policies; and/or

    (ii) with the approval of the Transferee With-Profits Committee, reducing the Post-Smoothing Non-Guaranteed Income in respect of the Transferring Policies at any time on or after the Income Uplift Date.

### 15. Relaxation of the Scheme

(a) Other than paragraph 6 of this Scheme, paragraph 9 (Charges) of these Principles of Financial Management, paragraph 14 of this Scheme (to the extent necessary to cause paragraph 9 (Charges) of these Principles of Financial Management to continue to apply) and any provision required for the interpretation of the foregoing paragraphs, all of which shall continue to apply until all of the Transferring Policies have terminated, the Scheme shall, at the election of the Transferee, cease to apply at any time after the realistic liabilities of the Transferring Policies have fallen below the Minimum Threshold Amount.

(b) Where the Transferee elects that the Scheme shall cease to apply under paragraph 15(a) of these Principles of Financial Management, any positive amount allocated to the Transferring Policies Smoothing Account will be distributed amongst the Transferring Policies by way of an enhancement to the Post-Smoothing Non-Guaranteed Income in respect thereof in a manner considered to be fair in all the circumstances by the Transferee With-Profits Committee.

### 16. Interest in the inherited estate of the Transferee WPSF

The Transferring Policies will have no interest in any possible future distribution or reattribution of the inherited estate of the Transferee WPSF.

# Appendix C

## PruFund Range of Funds

The PruFund Range of Funds consists of the investment funds given in the table below along with the products that can invest in these funds.

| PruFunds Fund | Products that can invest in this fund |
|---|---|
| PruFund Growth Pension/ISA Fund | Prudential Flexible Retirement Plan, Trustee Investment Plan, Prudential ISA, Prudential Retirement Account |
| PruFund Cautious Pension/ISA Fund | Prudential Flexible Retirement Plan, Trustee Investment Plan, Prudential ISA, Prudential Retirement Account |
| PruFund Growth Fund | PruFund Investment Plan, Prudential Investment Plan, Flexible Investment Plan |
| PruFund Growth & Income Fund | PruFund Investment Plan |
| PruFund Cautious Fund | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 1 Fund[1] | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 1 Pension/ ISA Fund[1] | Prudential Flexible Retirement Plan, Trustee Investment Plan, Pension Choices Plan, Prudential ISA, Prudential Retirement Account |
| PruFund Risk Managed 2 Fund[2] | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 2 Pension/ ISA Fund[2] | Prudential Flexible Retirement Plan, Trustee Investment Plan, Pensions Choices Plan, Prudential ISA, Prudential Retirement Account |
| PruFund Risk Managed 3 Fund[3] | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 3 Pension/ ISA Fund[3] | Prudential Flexible Retirement Plan, Trustee Investment Plan, Pensions Choices Plan, Prudential ISA, Prudential Retirement Account |
| PruFund Risk Managed 4 Fund[4] | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 4 Pension/ ISA Fund[4] | Prudential Flexible Retirement Plan, Trustee Investment Plan, Pension Choices Plan, Prudential ISA, Prudential Retirement Account |
| PruFund Risk Managed 5 Fund | Prudential Investment Plan |
| PruFund Risk Managed 5 Pension/ ISA Fund | Prudential Retirement Account (Series E only), Prudential ISA |
| PruFund Growth (Sterling) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Cautious (Sterling) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Growth (Euro) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Cautious (Euro) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Growth (US Dollar) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Cautious (US Dollar) Fund | International Prudence Bond, Prudential International Investment Bond |

Notes:

1 Known prior to 21 January 2019 as PruFund 0-30 Fund/PruFund 0-30 Pension/ISA Fund
2 Known prior to 21 January 2019 as PruFund 10-40 Fund/PruFund 10-40 Pension/ISA Fund
3 Known prior to 21 January 2019 as PruFund 20-55 Fund/PruFund 20-55 Pension/ISA Fund
4 Known prior to 21 January 2019 as PruFund 40-80 Fund/PruFund 40-80 Pension/ISA Fund

Note that a fund labelled Pension/ISA refers to single PruFund fund that uses two different names depending on the type of product through which it is accessed. For example the fund is named PruFund Growth Pension Fund when accessed through a pensions product and the same fund is named PruFund Growth ISA Fund when accessed through an ISA.

For the purposes of a unit price reset or suspension of smoothing, the PruFund Range of Funds are split such that either action can be performed on each class of business independently of the others. This split is given in the following table:

| PruFunds Fund | Products that can invest in this fund |
|---|---|
| PruFund Growth Pension/ISA Fund | Prudential Flexible Retirement Plan, Trustee Investment Plan, Prudential ISA |
| PruFund Growth Pension Fund | Prudential Retirement Account (Series D) |
| PruFund Growth Pension Fund | Prudential Retirement Account (Series E) |
| PruFund Cautious Pension/ISA Fund | Prudential Flexible Retirement Plan, Trustee Investment Plan, Prudential ISA |
| PruFund Cautious Pension Fund | Prudential Retirement Account (Series D) |
| PruFund Cautious Pension Fund | Prudential Retirement Account (Series E) |
| PruFund Growth Fund | PruFund Investment Plan, Prudential Investment Plan, Flexible Investment Plan |
| PruFund Growth & Income Fund | PruFund Investment Plan |
| PruFund Cautious Fund | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 1 Fund | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 1 Pension/ ISA Fund | Prudential Flexible Retirement Plan, Trustee Investment Plan, Pension Choices Plan, Prudential ISA |
| PruFund Risk Managed 1 Pension Fund | Prudential Retirement Account (Series D) |
| PruFund Risk Managed 1 Pension Fund | PruFund Retirement Account (Series E) |
| PruFund Risk Managed 2 Fund | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 2 Pension/ ISA Fund | Prudential Flexible Retirement Plan, Trustee Investment Plan, Pensions Choices Plan, Prudential ISA |
| PruFund Risk Managed 2 Pension Fund | Prudential Retirement Account (Series D) |
| PruFund Risk Managed 2 Pension Fund | Prudential Retirement Account (Series E) |
| PruFund Risk Managed 3 Fund | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 3 Pension/ ISA Fund | Prudential Flexible Retirement Plan, Trustee Investment Plan, Pensions Choices Plan, Prudential ISA |
| PruFund Risk Managed 3 Pension Fund | Prudential Retirement Account (Series D) |
| PruFund Risk Managed 3 Pension Fund | Prudential Retirement Account (Series E) |
| PruFund Risk Managed 4 Fund | Flexible Investment Plan, Prudential Investment Plan |
| PruFund Risk Managed 4 Pension/ ISA Fund | Prudential Flexible Retirement Plan, Trustee Investment Plan, Pension Choices Plan, Prudential ISA |
| PruFund Risk Managed 4 Pension Fund | Prudential Retirement Account (Series D) |
| PruFund Risk Managed 4 Pension Fund | Prudential Retirement Account (Series E) |
| PruFund Risk Managed 5 Fund | Prudential Investment Plan |
| PruFund Risk Managed 5 Pension/ ISA Fund | Prudential ISA |
| PruFund Risk Managed 5 Pension Fund | Prudential Retirement Account (Series E) |
| PruFund Growth (Sterling) Fund | International Prudence Bond, Prudential International Investment Bond |

| PruFunds Fund | Products that can invest in this fund |
|---|---|
| PruFund Cautious (Sterling) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Growth (Euro) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Cautious (Euro) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Growth (US Dollar) Fund | International Prudence Bond, Prudential International Investment Bond |
| PruFund Cautious (US Dollar) Fund | International Prudence Bond, Prudential International Investment Bond |

The smoothing limits across the PruFund Range of Funds are:

| PruFund Funds | Quarterly smoothing limit | Monthly smoothing limit (applies to Prudential Retirement Account Series E only) | Daily smoothing limit | Gap after adjustment (applies to daily smoothing limit only) |
|---|---|---|---|---|
| PruFund Growth Fund | 5.0% | N/A | 10.0% | 2.5% |
| PruFund Growth & Income Fund | 5.0% | N/A | 10.0% | 2.5% |
| PruFund Cautious Fund | 4.0% | N/A | 8.0% | 2.0% |
| PruFund Risk Managed 1 Fund | 4.0% | N/A | 8.0% | 2.0% |
| PruFund Risk Managed 2 Fund | 4.0% | N/A | 8.0% | 2.0% |
| PruFund Risk Managed 3 Fund | 5.0% | N/A | 10.0% | 2.5% |
| PruFund Risk Managed 4 Fund | 5.0% | N/A | 10.0% | 2.5% |
| PruFund Risk Managed 5 Fund | 5.0% | N/A | 10.0% | 2.5% |
| PruFund Growth Pension/ISA Fund | 5.0% | 5.0% | 10.0% | 2.5% |
| PruFund Cautious Pension/ISA Fund | 4.0% | 4.0% | 8.0% | 2.0% |
| PruFund Risk Managed 1 Pension/ ISA Fund | 4.0% | 4.0% | 8.0% | 2.0% |
| PruFund Risk Managed 2 Pension/ ISA Fund | 4.0% | 4.0% | 8.0% | 2.0% |
| PruFund Risk Managed 3 Pension/ ISA Fund | 5.0% | 5.0% | 10.0% | 2.5% |
| PruFund Risk Managed 4 Pension/ ISA Fund | 5.0% | 5.0% | 10.0% | 2.5% |
| PruFund Risk Managed 5 Pension/ ISA Fund | 5.0% | 5.0% | 10.0% | 2.5% |
| PruFund Growth (Sterling) Fund | 5.0% | N/A | 10.0% | 2.5% |
| PruFund Cautious (Sterling) Fund | 4.0% | N/A | 8.0% | 2.0% |
| PruFund Growth (Euro) Fund | 5.0% | N/A | 10.0% | 2.5% |
| PruFund Cautious (Euro) Fund | 4.0% | N/A | 8.0% | 2.0% |
| PruFund Growth (US Dollar) Fund | 5.0% | N/A | 10.0% | 2.5% |
| PruFund Cautious (US Dollar) Fund | 4.0% | N/A | 8.0% | 2.0% |

The smoothing limits shown in the table above for the PruFund Cautious (including Euro and US Dollar), PruFund Risk Managed 1, and PruFund Risk Managed 2 funds came into effect on 26 November 2018. Prior to this the smoothing limits on these PruFund funds were 5% and 10%, in line with the other PruFund funds.

# Appendix D

## Summary of Abbreviations

| Abbreviation | Definition |
|---|---|
| ABR | Anticipated Bonus Rate (applicable to With-Profits annuity only) |
| AMC | Annual Management Charge |
| CFPPFM | Consumer Friendly Principles and Practices of Financial Management |
| CLE | Canada Life Assurance Europe Limited |
| COBS | Conduct of Business Sourcebook |
| DCPSF | Defined Charge Participating Sub-Fund |
| ELAS | Equitable Life Assurance Society |
| FCA | Financial Conduct Authority |
| FSA | Financial Services Authority (replaced by PRA and FCA in 2013) |
| GIR | Guaranteed Interest Rate (applicable to ELAS annuity only) |
| IRR | Interim Rate of Return (applicable to ELAS annuity only) |
| NPSF | Non-Profit Sub-Fund |
| ORR | Overall Rate of Return (applicable to ELAS annuity only) |
| PAC | The Prudential Assurance Company Limited |
| PAL | Prudential Annuities Limited |
| PANL | Prudential (AN) Limited |
| PFM | Principles of Financial Management (for SAIF) |
| PGHK | Prudential General Insurance Hong Kong Limited |
| PHKL | Prudential Hong Kong Limited |
| PIA | Prudential International Assurance plc |
| PPFM | Principles and Practices of Financial Management |
| PRA | Prudential Regulation Authority |
| RSR | Required Smoothed Return (applicable to income Choice Annuity only) |
| SAA | Scottish Amicable Account |
| SACF | Scottish Amicable Capital Fund |
| SAIF | Scottish Amicable Insurance Fund |
| SAL | Scottish Amicable Life plc |
| SALAS | Scottish Amicable Life Assurance Society |
| WPSF | With-Profits Sub-Fund |

# Glossary

| Term/Phrase | Definition |
|---|---|
| Accumulating with-profits | A form of with-profits fund where the investor buys units whose value increases in line with any declared regular bonuses and to which a final bonus may be added when the units are cashed in. |
| Aggregate asset share | Total asset share for the specified product line. |
| Aggregate policy value | Total policy value for the specified product line. |
| Appointed Actuary | Under the supervisory regime that existed prior to 1 January 2005, the Appointed Actuary role described the actuary appointed by the company to provide advice to the company's board. This is the (broadly) equivalent statutory actuarial role to the Actuarial Function Holder role in place from 1 January 2005 to 31 December 2015 and the current Chief Actuary role. Outside the UK, a number of countries operate regimes with an Appointed Actuary role. |
| Asset share | The premiums paid, less deductions for partial encashment of benefits, expenses, guarantees, tax and other charges, plus any allocations of miscellaneous profits accumulated at the investment return achieved on the relevant assets of the with-profits fund. |
| Benchmark (asset mix) | The target fund investment position, typically expressed as the target percentages of the total asset holdings to be invested in certain asset classes such as equities and fixed interest. Often used to measure fund performance or set investment limits. |
| Bonus year | Bonus rates are calculated or applied according to a Bonus year rather than a calendar year – for most products the Bonus year runs from 1st April to 31st March (for PruBond products the Bonus year runs from 1st March to 28th February). |
| Cash claim value | The amount of transfer value required to support the annuity. |
| Chief Actuary | The Chief Actuary is a Fellow of the Institute and Faculty of Actuaries appointed by a company to provide certain actuarial advice to the company's board, and fulfil various statutory duties under the new regulatory reporting regime introduced on 1 January 2016. |
| Conventional with-profits | Conventional with-profits contracts have a basic sum assured to which bonuses are added. The basic sum assured is the minimum amount paid out on a claim. |
| Core reserving basis | The reserving basis set out in Schedule 4 of the ELAS scheme |
| Counterparty exposures | The risk to each party of a contract that the counterparty will not live up to its contractual obligations. |
| Defined Charge Participating | Business with explicit defined charges that are invested in the 100:0 Defined Charge Participating Sub-Fund (DCPSF). This includes with-profits annuity business originally transferred from ELAS. |
| Divisible profits | Profits arising that can be distributed to policyholders and, if applicable, shareholders. |
| Efficient portfolio management | This is the construction of an asset portfolio so as to achieve the maximum expected return for a given level of risk. |
| Endowment assurance | A life assurance policy that pays out a lump sum after a specific period of time or on the earlier death of the policyholder. An endowment assurance can be used as a vehicle for saving or as a way to repay a mortgage. |
| Equity backing ratio | The amount of real investments (for example equity, property etc) that are held, expressed as a percentage of total assets. The equity-backing ratio gives a measure of the exposure of the insurance company to more volatile, return seeking, investments. |

| Term/Phrase | Definition |
|---|---|
| Final Bonus (also known as Terminal or Additional Bonus) | A bonus which may be applied on exit from the fund. Final bonus is not guaranteed and can be removed at any time. |
| Individual Guidance | Specific guidance from the regulator that applies to a particular individual or company, reflecting their particular circumstances, rather than general guidance relating to all (relevant) individuals or companies |
| Industrial Branch (IB) Business | Business sold door-to-door by agents who collected the premium in cash. Generally whole of life or endowment plans. These products are no longer sold. |
| Inherited estate | An inherited estate is the amount of money in a with-profit fund in excess of the amounts that a company expects to pay out to meet its obligations to existing policyholders. In respect of with-profits policyholders, these latter amounts are equal to the policyholders accumulated asset shares, plus any additional payments that may be required by way of smoothing or to meet guarantees. |
| Interim Bonus | A bonus added when maturity of a with-profits policy or death of the assured occurs between normal bonus declaration dates. |
| Investment Return | The return achieved (profits and losses) from an investment used to evaluate the efficiency of an investment or to compare the efficiency of a number of different investments. |
| Longevity risk | The risk to which the company could be exposed as a result of customers living longer than expected. |
| Market Value Reduction (MVR) | When money is taken out of an accumulating/unitised with-profits policy, an adjustment may be made to the value of the withdrawal if the value of the underlying assets (asset share) is less than the value of the policyholder's plan including bonuses (claim value). This adjustment is known as a market value reduction. |
| Monitoring Actuary | A Fellow of the Institute and Faculty of Actuaries appointed in accordance with the SALAS scheme, to provide the Scottish Amicable Board with advice on all matters envisaged by the Scheme. The Monitoring Actuary has full access to the management of the Scottish Amicable funds. |
| Mortality costs | The cost of providing life cover. The face amount of the policy multiplied by the probability that it will have to be paid out as a claim on death. |
| Net asset value per unit | The unsmoothed unit price for PruFund investments. |
| Ordinary Branch (OB) Business | Business for which premiums are paid by cheque, direct debit or other banking means and not with a cash payment (as opposed to Industrial Branch business). |
| PAC Board of Directors | The Prudential Assurance Company Limited Board of Directors is the group of individuals elected by its shareholders to represent them in overseeing management of the company. They are responsible for ensuring the company manages the With-Profits Funds in line with the Principles and Practices set out in this document. |
| Principles | The Principles define the overarching standards adopted in managing PAC's with-profits business to maintain the long-term solvency of the fund for current and future policyholders and describe the approach used:<br>• in meeting our duty to with-profits policyholders, and<br>• in responding to longer-term changes in the business and economic environment. |

| Term/Phrase | Definition |
|---|---|
| Practices | The Practices describe the approach used:<br>• in managing PAC's with-profits business, and<br>• in responding to changes in the business and economic environment in the shorter-term. |
| Regulatory Solvency | The required minimum level of assets in excess of liabilities including any required regulatory buffer. |
| Reversionary/Regular bonus | A bonus applied on a regular basis to the policy which, once added, cannot be removed. |
| Risk appetite | PAC's long term target position for the strength of its With-Profits Fund, underpinning its bonus and investment policy, which in conjunction with its available working capital, defines its ability to take risk from time to time; |
| Risk capacity | The financial ability to take on risk. |
| Risk level | Measure of how much risk a firm has taken on. |
| Smoothed return | Bonus rate declared for Income Choice Annuity business |
| Smoothing | Process used to dampen, insofar as possible, the impact of volatile experience (such as market movements) on claim values, with the aim that pay-out values progress smoothly from one year to the next. |
| Sourcebook (COBS) | A handbook setting out the FCA rules that apply to a firm with respect to 1) designated investment business and 2) long-term insurance business in relation to life policies. |
| Surrender | The early termination of an insurance product by the policyholder. |
| Unitised with-profits | Another term for accumulating with-profits business, as defined above. |
| With-Profits Actuary (WPA) | Under the supervisory regime introduced on 1 January 2005, the WPA is appointed by a company to review material relevant to the operation of the with-profits business, with the specific duty to advise the company's board on the reasonableness of how discretion has been exercised in applying the PPFM and how any conflicting interests have been addressed. |
| With-Profits Committee (WPC) | A committee comprising at least three members, all of whom are independent of the company, which provides an independent assessment of the way in which the company manages its with-profits business and how the company balances the rights and interests of policyholders and shareholders in relation to its With-Profits Fund. |
| With-Profits Fund | The With-Profits Fund is the fund where PAC's with-profits business is written. This is divided into 3 sub-funds, the With-Profits Sub-Fund (WPSF), the Scottish Amicable Insurance Fund (SAIF) and the Defined Charge Participating Sub-Fund (DCPSF). With-Profits policyholders are eligible to participate in the profits of the With-Profits Fund through discretionary distributions. |
| Working capital | The capital of a business which is used in its day-to-day trading operations. For a with-profits fund, the working capital is also known as the inherited estate. |

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