The Shepherds Friendly Society Limited

Principles and Practices of Financial Management
September 2018

Contents

1. Introduction

Purpose

1.1 This document sets out the Principles and Practices of Financial Management (the "PPFM") by which The Shepherds Friendly Society Limited (the "Society") conducts its with-profits business. It has been approved by the Society's Board of Management ("the Board") and was adopted at their meeting on 10th September 2018 and effective from 1st October 2018.

1.2 The purpose of the PPFM is to enable a better understanding of the way the Society conducts its with-profits business and, in particular, the principles and practices adopted by the Board in the application of its discretion. This improved understanding is intended to protect the interests of, and promote confidence among, with-profits policyholders.

1.3 Principles describe the enduring statements of the standards the Society adopts when managing the fund and are not expected to change often. Practices, on the other hand, describe the Society's current approach and will be subject to more frequent change but still within the Principles.

1.4 The format of this PPFM considers each key area where discretion is applied and sets out firstly the relevant Principles, followed by the Practices.

Changes to the PPFM

1.5 In the event that the Society determines that changes are required to any of the Principles, the Society will provide with-profits policyholders with at least three months prior notice. Changes to Practices must be similarly communicated but do not require prior notice.

1.6 No notice may be given if the Society considers that any change is necessary to correct an error or omission, if the change would improve clarity or presentation without materially affecting the PPFM's substance, or if the change is immaterial.

About the Society

1.7 The Society started as a sickness and benefits society as an amalgamation of various fraternal groups: The Royal Shepherds Sanctuary Benefit Society which was established in Yorkshire in the early 19th century, Ashton Unity which was formed in 1826 and the Ancient Order of Shepherds. Since that time the Society has grown to a multi-million pound operation looking after more than 96,000 members throughout the UK.

1.8 The Society is a Friendly Society, a mutual organisation, and there are no shareholders' interests to be considered. As a mutual, the with-profits policyholders share the business risk in full.

What business is covered by this PPFM?

1.9 The Society operates a single fund covering a variety of insurance contracts including:-

- traditional regular and single premium with-profits;
- Holloway income protection;
- stocks & shares individual savings account and Junior Stocks & Shares individual savings account;
- pure income protection;
- unit-linked Child Trust Funds and Junior individual savings account; and
- conventional non-profit contracts.

Each of these contract types is written in a notional sub fund. These are notional funds to facilitate management of the investments in each sub fund.

1.10 This PPFM covers the Society's traditional regular and single with-profits business only. Other contract types may be referred to within this PPFM only to the extent they impact on the management of the Society's traditional with-profits business.

Overarching financial objectives

1.11 The Society has four key financial objectives that affect with-profits policies that can be regarded as overriding the principles and practices contained elsewhere if they come into conflict. These are:

(a) To meet the contractual obligations to policyholders.
(b) To treat policyholders fairly and meet the reasonable expectations of with-profits policyholders.
(c) To meet the required tests of solvency and capital adequacy as needed by regulatory bodies.
(d) Subject to (a), (b) and (c), to maximise the financial returns to with-profits policyholders.

Governance arrangements

The Society has in place governance arrangements to ensure that the conduct of its with-profits business complies with this PPFM. These include:

- A Fair Members Benefit Committee (incorporating the With Profits Committee) whose role it is to advise the Board on matters affecting all Members of the Society.
- The Board overseas compliance with the PPFM in terms of the Investment Strategy, reviewing its continuing appropriateness in the light of changing circumstances with consideration to the needs of with-profit policyholders.
- Publication of an annual report from the Board to with-profits policyholders that confirms the Society's belief that it has complied with its obligations relating to its PPFM and setting out its reasons for that belief.

- Publication of an annual report from the Society's Actuary to with-profits policyholders on the key aspect of discretion exercised by the Board on matters affecting with-profits policyholders.
- Publication of any statement or report the Fair Members Benefit Committee requires to be made available to with-profits policyholders.

1.12 All relevant documents noted above, including the Fair Member Benefit Committee's Terms of Reference, are available on the Society's website at www.shepherdsfriendly.co.uk.

Glossary

1.13 Section 8 defines the key words and phrases used within this report.

2. The amount payable under a with-profits contract

Principles – amounts payable under a with-profits contract

2.1 The amount paid on maturity or death for a with-profits contract will be the initial guaranteed basic benefits plus annual and final bonuses that reflect the fair share of profits earned by the contract over the period of investment in accordance with the financial objectives as set out in 1.11. Importantly, they aim to provide policyholders with a return that reasonably reflects the experience of the traditional with-profits sub fund whilst the policy has been in-force subject to any smoothing.

2.2 Where a contract is eligible for a surrender value, the amount paid on surrender will have regard to the initial guaranteed basic benefits, bonuses accrued to the date of surrender and the desire to avoid surrenders causing a strain on the fund remaining for continuing policyholders.

2.3 A number of approximations are made in the methods used to determine payouts which are in line with the overall aim of sharing experience of the fund between policyholders. This reflects the relatively small size of the portfolio, its diversity in terms of policy type and duration, and the historic approach to bonus distribution.

2.4 Appropriate control mechanisms are in place should the Society wish to change in any way the methods it adopts in determining the amount payable under a with-profits contract. Such changes can be modifications to current methods or the adoption of entirely new methods. The Board or the Actuary can initiate changes. In either case the Actuary will undertake a report for the Board setting out the implications of the change and the Board will then decide whether to implement the change. All methods used, including amendments, are appropriately documented by the Actuary.

2.5 In applying the methods to determine the amounts payable under with-profits contracts there is a need to consider historical experience and, where appropriate, make assumptions about the past. In the light of new information, different methods or new techniques, the Society may change any assumptions used regarding the historical experience.

Principles – annual bonus

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

2.7 The Society also aims to set annual bonus rates that do not fluctuate widely on a year to year basis, and to give policyholders a reasonable expectation that similar bonuses can be declared in future years. Bonuses can only be declared if there is a surplus in the fund and the overriding requirement to remain solvent can mean, in the event of adverse experience, the Society may decide to declare a bonus rate that is significantly different to that in previous years. The decision may be taken to declare no bonus at all.

2.8 Where business has previously been pooled for the purposes of determining a bonus rate, the Society will generally continue to operate the same pool for annual bonus. Rates and amounts of any final bonus may be adjusted to bring total pay-outs into line with the asset share of the contract as described in 2.15. Should it become apparent that certain contracts within the pool would thereby be materially disadvantaged by other contracts, the Board may, on the advice of the Actuary, agree to revise the basis of the pooling arrangements.

2.9 Where circumstances change to such an extent that it would be unfair to existing or new business policyholders to share the same rates of bonus, the Board may, on the advice of the Actuary, decide to declare an alternative bonus series, amend the basis of the contract or withdraw the type of policy altogether.

Principles – final bonus

2.10 In determining the total payout on a contract becoming a claim, the Society may add a final bonus. The aim of any final bonus would be to increase the benefits guaranteed under a policy to the asset share of that policy as assessed by the experience throughout its lifetime within the fund.

Principles – smoothing

2.11 The Society seeks to smooth contractual (maturity and death) claim payouts on contracts of a similar type, size and term becoming claims in different periods of time. It is intended that smoothing will have a neutral effect on the fund over time.

2.12 Non-contractual claim payouts may be subject to less smoothing by virtue of the surrender bases adopted or any market value reduction ("MVR") applicable. Whilst changes are primarily made to reflect changes in underlying asset values, the Board reserve the right to take other economic and demographic experience factors into account in determining appropriate bases and MVR’s.

2.13 The total cost (and hence scale) of smoothing must inevitably be subject to the availability of adequate resources and cannot be allowed to grow too large in relation to the size of the fund. The key financial objectives as set out in 1.11 are relevant in this respect.

Practices – amounts payable under a with-profits policy

2.14 Sections 2.1 and 2.2 explain, in broad terms, how the amount payable under a with-profits policy is determined. However the specific mechanism by which payouts are set is by reference to each contract's asset share.

2.15 The asset share of a contract that started after 31 December 2004 is built up from its start date and is calculated at periodic intervals as:-

asset share at the start of period
plus premiums received in the period (including any associated tax relief)
plus the investment return earned by the assets allocated to with-profits contracts
plus a share of profits or less a share of losses arising on the Society's other business
less the cost of providing life cover or other risk benefits
less the costs of selling and administering the contract
less an adjustment for tax appropriate for the class of business

2.16 The asset share of a contract starting before 1 January 2005 is based on its "fair value" as at 31 December 2004. This "fair value" is, except for with-profits bonds and unitised with-profits pensions business, based on a realistic estimate of the benefits each contract could provide on maturity or earlier death having regard to prospective future investment returns, premiums, expenses (as set out in policies' key features) and claims. The "fair value" of with-profits bonds and unitised with-profits pensions business is determined based on an accumulation of past premiums in line with the Society's actual investment experience (or best estimate asset allocations and index returns where no better data is available) allowing for expenses set out in disclosed key features documents. The calculation of asset share after 31 December 2004 is then based on the approach set out in paragraph 2.15.

2.17 On maturity and surrender, the Society aims to ensure that at least 90% of all payouts are within 80%-120% of their asset shares. On death the payout is based on the initial guaranteed basic benefits plus the annual bonuses awarded to the date of claim plus a final bonus amount as if the contract had matured at the date of claim.

2.18 On maturity and death, the Society guarantees that the payout will be no less than the initial guaranteed basic benefit plus the annual bonuses awarded to the date of the claim. No guarantees apply on surrender.

2.19 In applying the approach outlined above, the Society needs to make allowance for (and therefore assumptions covering) a number of economic and demographic parameters. The former might include past and assumed future investment returns, interest and inflation rates. The latter might include expenses, mortality and sickness, withdrawal rates etc. The determination of the relevant assumptions is undertaken by performing appropriate investigations and analyses of the Society's past experience and consideration of expectations for future experience.

2.20 The investment return used in the asset share calculations is based on the return earned by the assets backing with-profits contracts. Before 1 January 2013 these returns reflected the annualised return on all the Society's assets. From 1 January 2013 the returns reflect that earned by the assets the Board hypothecates to the traditional with-profits sub fund.

2.21 The Board may, at its discretion, also adjust asset shares following a review of the Society's surplus. This may arise for example from losses or profits arising on the Society's non-profit contracts.

2.22 When considering the allowance for the cost of life cover, an approximate allowance is made based on the overall mortality experience of the fund.

2.23 The allowance for the cost of sales and administration are currently based on those disclosed within key features documents issued at point of sale. Any difference between these allowances and the Society's actual expenses is charged or credited to the Society's surplus.

2.24 When considering the allowance for tax, parameters and assumptions are used which, when applied to the fund, results in a charge similar to that applying in practice. Bonus rates and payouts reflect the tax status of the relevant contracts. However as the Society has not paid any tax for a number of years, nor is likely to do so, no deduction for tax is currently made in the determination of asset shares.

2.25 Where the Solvency Ratio falls below or exceeds its target range (see section 6.11), some adjustment to asset shares may be made at the discretion of the Board. Typically these may emerge either in the form of changes to annual or final bonuses or some combination of the two. Such changes can only be made where the circumstances permit or require them and should not be regarded as necessarily repeatable events

2.26 In line with the principle at 2.3, a number of approximations are used in the application of the methods and which carries over to the parameters and assumptions used. Generally these are shared across generations of with-profits policyholders and across different types of with-profits policies.

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

Practices – annual bonuses

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

2.29 The Society will also conduct investigations and projections to establish the appropriate proportion of bonus and payout to be paid in final (non-guaranteed) form. The proportion is assessed and takes into account the targeted surplus position (at 6.11) and investment policy mix (at 3.14).

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

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

2.32 As described in 2.7, the Society's aim is to set annual bonus rates that will not change often and will try to avoid large fluctuations. The Society does not have any maximum amount by which annual bonus rates would alter. In a situation where solvency was under threat, or there is not expected to be sufficient surplus in the fund, the Society may act to reduce annual bonus rates significantly. In adverse financial circumstances, it may decide not to declare a bonus at all.

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

Practices – final bonus

2.34 Final bonus rates are declared at the discretion of the Board on the advice of the Actuary. The levels of final bonus rates are reviewed at regular intervals, not less frequently than annually, but more frequently when significant changes in investment market dictate.

2.35 A final bonus may be paid on claims by death, surrender or maturity that is sufficient to bring the payout into the range set out in 2.17.

2.36 The practices governing the approach to setting the amounts payable under a with-profits policy are set out in 2.14 to 2.27. In simple terms, the approach to setting final bonus is to determine the amount required to uplift the guaranteed basic benefit plus attaching annual bonuses to the asset share of the contract at the date of claim. The scale is smoothed and is based on a percentage of the declared annual bonuses per year of duration. For unitised with-profits pensions business and with-profits bonds and ISAs the scale is based on a percentage of the fund (or attaching annual bonus) per year of duration.

2.37 A MVR may apply to certain claims under unitised with-profits pensions business, with-profits bonds and ISAs subject to contractual MVR free events. Current practice is to set MVRs independently of any final bonus and so both may apply in the case of some with-profits bond and ISA claims.

2.38 The MVR is intended to protect the interests of policyholders remaining in the fund from the losses which might be incurred where funds are withdrawn following a significant fall in the value of underlying assets. It is applied to policies which would otherwise give rise to a gain significantly above that justified by the investment performance over the period the policy has been in force , particularly if that is relatively short and the volume of withdrawals is large.

Practices – smoothing

2.39 The Society does not operate a formal smoothing algorithm that would determine how quickly amounts payable might change. Current practice is to consider the extent to which the amounts payable under a with-profits contract and those expected in the near future require material support from the Society's surplus. In economic and demographic circumstances that adversely affect the fund or the solvency of the Society, the Board could adjust payments very rapidly.

2.40 The current smoothing methodology does not differentiate between generations and types of with-profits policies.

2.41 The Society's current approach to smoothing is to limit the change in amounts payable under a with-profits contract to 15% from one declaration to the next in normal circumstances. However, the Board can, on the advice of the Actuary, depart from this 15% limit.

2.42 MVRs are set primarily with fairness and simplicity in mind having regard to the asset share calculations and the size of any fall in the value of underlying assets. There is no deliberate smoothing applied other than that implicit in the simplified form and frequency of change. To date a fairly simple flat or stepped scale percentage by duration has been applied (subject to certain conditions). This does not, however, preclude the Board, on the advice of the Actuary, from adopting a more sophisticated and dynamic approach in future.

2.43 Some with-profits bonds contain a 5% MVR free income withdrawal option facility. MVRs may still be applied to any withdrawals that exceed the 5% income withdrawal facility.

3. Investment strategies

Principles

3.1 The overall aim of the Society's investment strategy is to maximize, as far as is reasonably practicable, the returns to with-profit policyholders in line with their reasonable expectations, while meeting:

(a) Contractual obligations to all the Society's policyholders.
(b) The required tests of solvency and capital adequacy as needed by regulatory bodies.

3.2 Different investment strategies apply to the following sub funds which will be relevant to the type of liability and policyholder expectation involved:-

- Traditional regular and single premium with-profits & Holloway income protection
- Pure income protection
- Non-profit whole of life
- Unit-linked Child Trust Fund (CTF) & Junior Individual Savings Account (JISA)
- Surplus

3.3 The investment strategy will on the advice of the Actuary be set by the Board for each sub fund depending on policyholder expectations, contractual obligations of the particular contract, the Society’s overall financial position and the risk appetite of each individual sub fund as in 3.14.

3.4 The investment strategy takes into account the nature and term of the liabilities by considering appropriate assets for different contracts. This will involve investing in a broad spread of assets with the aim of satisfying the different expectations and needs of different types of policyholders subject always to an acceptable degree of risk. This broad spread applies by both asset class and individual holding.

3.5 The asset classes that the Society will consider are UK and overseas equities, fixed interest investments (such as gilts and other bonds), index linked investments, property, cash and other investments on the recommendation of the Actuary and agreement by the Board.

3.6 The Society will consider the use of derivative instruments in its investment strategy. Such assets will generally be used to implement changes in investment policy through efficient portfolio management or as a means to hedge the degree of investment risk.

3.7 The Society imposes limits on counterparty exposures.

3.8 The Society's holdings of assets that would not normally be traded is limited to shares in any subsidiary company controlled by the Society. These assets are held because the Board regards them as adding value to the fund.

3.9 The Board holds regular reviews of all its investments so as to ensure they remain a worthwhile and useful investment of the fund.

Practices

3.10 The Board will periodically determine if the asset allocation for each sub fund is appropriate to delivering policyholder expectations whilst also ensuring the Society continues to meet its solvency capital requirements.

3.11 The Board after having determined the asset allocation for each sub fund will instruct the Investment Mangers to make appropriate investments accordingly.

3.12 Investments are monitored on a monthly basis by the Senior Management Team. If changes are urgently needed to the asset allocation, for example because of market volatility, the Board will meet by tele-conference to make appropriate decisions.

3.13 Asset allocation is also assessed from the viewpoint of the solvency capital requirement. Regard is also paid as to the likely future development of solvency under a range of scenarios using results of dynamic solvency testing as contained in the Financial Condition Report as part of the Own Risk Solvency Assessment (ORSA) process. Where solvency is threatened, robust monitoring and risk management procedures are in place to establish if and the extent to which equities need to be sold to protect solvency. Implicit in the assessment is the requirement to meet any short to medium term contract payments with suitably matched assets.

3.14 The various asset allocations reflect the Society's appetite for risk in respect of how each sub fund invests and are shown below.

Sub fund	Investment risk appetite	Investment parameters
With–profits (Conventional with-profits & Holloway income protection).	Medium-high	A maximum of 80% may be invested in equities and property. A maximum of 60% may be invested in fixed interest and cash. A minimum of 60% of fixed interest investments must be investment grade.
Pure income protection	Low	100% investment in fixed interest and cash. A minimum of 100% of fixed interest investments must be investment grade.
Non-profit whole of	Low	A minimum of 80% must be

life		invested in fixed interest or cash. A minimum of 80% of fixed interest investments must be investment grade.
Surplus	Medium	A minimum of 40% must be invested in fixed interest or cash. A minimum of 80% of fixed interest investments must be investment grade. A maximum of 60% may be invested in an equities or “absolute return” type of managed funds

3.15 No assets are currently needed to cover the liabilities of the Society’s pure income protection and non-profit whole of life contracts.

3.16 Assets backing the Society's unit-linked CTF & JISA liabilities are fully matched by holdings of Legal & General Accumulation Units.

3.17 Any proposal to invest in a new or novel investment instrument would require approval by the Board on advice from the Actuary.

4. Business Risk

Principles

4.1 As a mutual insurer undertaking long term insurance business, all activities of the Society potentially impact the amounts payable to with-profits policyholders (including Holloway income protection which has an investment element).

4.2 Routinely, business risks for the fund will include the acquisition and maintenance of new contracts of insurance. New business arrangements are covered in Section 7.

4.3 The Society currently has one wholly owned subsidiary and may decide to invest in further subsidiaries in the future. The risks associated by investing in the current subsidiary are considered minimal as the subsidiary is undertaking activities which were previously undertaken by the Society itself.

4.4 If the Society seeks to diversify into a business activity where it does not have an existing competency or previous experience then any such investment will be subject to a full risk assessment referred to in 4.5.

4.5 Any new venture involving a material investment, resource or risk will be subject to a full cost benefit justification and risk assessment. The Society has set a materiality level for deciding if such an investment is material which states that to be considered material the investment would need to be either in excess of 5% of the Society's total assets as a standalone investment or, if it exceeded that figure in conjunction with investments already made in similar assets, then it would be material. The aim is to ensure that the projected benefits from the perspective of with-profits policyholders generally are competitive (as against alternative investment opportunities) having proper regard for their appetite for risk. Entering into any new and material area of business risk requires the approval of the Board who will also consider the advice of the Actuary in the matter.

4.6 There are no general limits on the size of business risk that is taken on by the fund. However, the risk assessment and management procedures in place (covering both existing and new risks) are designed to ensure that the Society is able to meet its key financial objectives as set out in 1.11 on an on-going basis. By virtue of its constitution, any compensation costs from a business risk can only be borne by the single fund.

Practices

4.7 The Society has established robust procedures, systems and controls covering the mitigation and management of business risk. These encompass both the existing and the taking on of any new business risks and involve consideration of both the probabilities of occurrence and impact. The Board reviews these on a regular basis through its Audit and Risk Committees and its continuous programme of internal audit and compliance control activities. The Society has established an Own Risk Solvency Assessment which incorporates extensive risk management techniques.

4.8 The principles and practices set out in Section 2 deal with all aspects affecting pay-outs under with-profits contracts. Profits or losses arising from business risks arising from new and existing policies are applied to the surplus sub fund for distribution to the Society's with-profits policyholders at the point at which an excess surplus is identified.

4.9 Any compensation costs arising in connection with a business risk are borne by the surplus sub fund.

5. Charges and expenses

Principles

5.1 The aim of the Society's approach to apportioning expenses to policies is that it should be fair and appropriate.

5.2 The basis upon which expenses are apportioned seeks to reflect the drivers and the activities that give rise to such expenses. A basis change might be introduced to reflect changes to these drivers or activities (e.g. new outsourcing arrangements). It might also be introduced to accommodate new business methods and practices (e.g. new distribution). It may simply be introduced to improve the current apportionment basis in the light of new information.

Practices

5.3 The Society's expenses are almost wholly attributable to the management of the business operations. Expenses cover the acquisition of business (including commission) and the maintenance of business that includes administration, investment management, retention and communication activities as well as other structure costs. Some costs may be directly attributable to particular classes of business whereas others will need to be apportioned according to appropriate bases. Apportionment bases may also be required to split acquisition from maintenance costs.

5.4 The basis on which expenses are apportioned reflects the drivers and the activities that give rise to such expenses. Bases used include those based on time analysis, numbers of policies, percentage of premium, mean fund size or, indeed, a factoring up of direct costs. The apportionment bases used from time to time have regard to ease of application and consistency as well as fairness.

5.5 Any expenses included and apportionment bases adopted must be appropriate for the purpose and compliant with any relevant rules and guidance. In general all costs will be included and apportioned but circumstances can arise where adjustments may be appropriate, for example, in determining the amounts payable under with-profits policies. By way of example, adjustments may be made to allow for the amortisation of significant development costs, non-recurrent expenditure and (providing it is of sufficient size) subsidy by the Society's surplus.

5.6 There are no current circumstances under which the Society will charge expenses at an amount other than cost except to the extent of any adjustments referred to in 5.4. These adjustments, of course, do not ultimately affect the costs attributable to with-profits policyholders (including Holloway income protection) as a class.

5.7 The main outsourced services are those covering investment management , the provision of actuarial services , the provision of IT infrastructure support, software development , internal audit , and the management of the portfolio of pensions business. None of the outsourcers are connected parties. The standard of service delivered by providers is monitored and where appropriate tender processes are conducted for new providers and therefore these may be subject to change from time to time. Only the provider of investment management is considered to be a key outsourced service.

5.8 For the purposes of apportioning expenses, such expenses will be decided by the Board as being the individual sub fund's fair share of the overall costs of the Society. Interest on any loans made to the individual sub funds and any transfers as decided appropriate by the Board will also be classed as expenses set against the individual sub fund.

5.9 As the Society is a mutual, there are no issues associated with the existence of any shareholder interests.

6. Management of the Society's surplus

Principles

6.1 The term "surplus" (sometimes known as the inherited estate) refers to the excess of the realistic value of assets over the realistic value of liabilities determined in line with regulatory rules. For this purpose, the value of the with-profits liabilities needs to take into account the reasonable bonus expectations of the policyholders. In other words, it is the surplus capital available on top of what is necessary to cover policyholder's reasonable expectations.

6.2 The Society will manage its surplus for the benefit of all its members. The purposes for which it will be applied include supporting the Society's solvency capital requirements, its investment and bonus policy (including smoothing) and its capacity to write new business. It may from time to time be used to meet certain expenses or business risks. The management of surplus must, therefore, have the immediate and future requirements in mind insofar as each of these purposes is concerned.

6.3 The implications of the preferred scale of the surplus will reflect the purposes set out in 6.2. For example, it enables the investment strategy as set out in Section 3 to be pursued with the prospect of higher investment returns. It can enable higher levels of new business to be written which can help contain or reduce unit costs. It can enable greater smoothing in terms of payouts and reduce the immediate impact of financial shocks due to economic change or business risk. To the extent that the size of surplus currently lies outside of the target range, payouts may also be affected by the need to replenish or reduce the level of the Society's surplus.

6.4 As the Society has no shareholders, there are no issues concerning any attribution of value as between policyholders and shareholders.

6.5 There are no constraints on the Society's freedom to deal with the surplus as a result of previous dealings.

Practices

6.6 The surplus will be a separately identifiable part of the single fund with its own risk appetite and investment strategy as outlined in 3.14.

6.7 In accordance with the sub fund investment strategy policy each separate sub fund will seek to deliver policyholder expectations with an added wish to exceed them if possible.

6.8 The allocation of separate sub fund surpluses is as follows:

- To the Traditional with-profits and Holloway income protection sub fund in respect of any excess of surplus distribution;

- To the Pure income protection, non-profit whole of life and unit-linked CTF sub funds to the extent those funds require capital support.

6.9 Transfers into the surplus sub fund will arise from any surpluses arising from the pure income protection, non-profit whole of life and unit-linked CTF sub funds.

6.10 The investment strategy for the surplus sub fund is outlined by terms as stated in 3.14.

6.11 The Board currently aims for its Solvency Ratio to be within a range of 150% to 250% of the Society's solvency capital requirement. This means that for every £1 million of regulatory capital required, the surplus would have to be between £1.5 million and £2.5 million.

6.12 Where the Solvency Ratio falls outside the range referred to in 6.11, the aim would be to restore the position to within the range over a maximum 5 year timeframe provided this did not lead to the material unfair treatment of policyholders. The Society undertakes regular investigations into the projected surplus position under a range of scenarios using results of dynamic solvency testing. The results and conclusions from these investigations are used to decide upon appropriate actions to maintain the range and to decide if the Solvency Ratio has reached to a point where an adjustment to asset shares should be made.

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

Principles

7.1 The approach to setting the volume of new business across the Society's sub funds has regard to a number of different aspects. It must first be determined that it is in the interests of with-profits policyholders for the Society to remain open to new business and that such new business is expected to generate a reasonable rate of investment return.

7.2 The primary consideration in the setting of new business volumes is the level of resource (both in terms of capital and processing capacity) required. A report that contains projections is used to establish any maxima in terms of limitations of the Society's financial capacity to take on new business where this becomes an issue. It would also take into account the business mix if appropriate.

7.3 Consideration would also be given to the nature of the products being sold, their potential suitability for customers, the financial and business risks associated with the products and the methods and terms upon which they are sold as compared with the market.

7.4 Should the Society determine that it is not in the interests of with-profits policyholders to remain open to new business, it will develop a closure plan. This will include a strategy for managing the closed book of business and how the Society's surplus will be distributed over the expected lifetime of the with-profits contracts.

Practices

7.5 The Society currently reviews its new business volumes by reference to the expected impact on its solvency position assessing both the point at which too much business may have an adverse impact on its ability to remain solvent as well as the point at which too little business makes it difficult to justify remaining open to new business. The Society is able to manage its flow of new business to remain within the set boundary limits.

7.6 Business mix is monitored and regularly reviewed.

8. Glossary

Actuary
The person who from time to time is the actuary appointed as the "Chief Actuary" or "With-Profits Actuary" to the Society under the Prudential Regulation Authority (PRA). Note that more than one actuary may be thus appointed. In this case, the context determines which actuary is being referred to.

Algorithm
A procedural model for undertaking calculations.

Annual bonus
A method of distributing surplus. The bonus is declared each year but is not paid until a policy becomes a claim.

Asset share
In relation to a policy, the accumulated value of premiums paid with deductions for expenses, mortality costs and any tax, where the accumulation rate is the rate of return achieved by the assets assumed to back the asset shares in question. Adjustments may be made for the cost of guarantees, capital and miscellaneous profits or losses if deemed appropriate.

Board
The Board of Management from time to time of the Society.

Bonus recommendation
The process by which the Actuary recommends regular and final bonus rates for approval and declaration by the Board.

Bonus series
A group of policies considered separately in the bonus recommendation.

Capital adequacy
The requirement for a firm to hold sufficient capital to ensure its short and long term solvency having regard to the risks it is undertaking.

Conduct of Business sourcebook ("COBS")
Produced by the Financial Conduct Authority (FCA) and containing the COBS rules and guidance covering the information to be included in this PPFM.

Counterparty
An individual or company in which the Society has made investments or against which it has rights under a contract.

Demographic experience
The experience factors driving movements in the fund such as mortality, sickness, withdrawals, expenses, tax etc. but excluding economic factors such as those pertaining to investments.

Derivative instruments
Includes options, futures contracts and contracts for differences and includes contracts under which the amount payable by either counterparty is calculated by reference to the value of any other asset.

Final bonus
A method of distributing surplus, whereby the bonus is only declared when a policy becomes a claim.

Financial Conduct Authority ("FCA") and Prudential Regulation Authority ("PRA")
The bodies responsible for the regulation of long term insurance business carried on in the United Kingdom.

Friendly Society
A friendly society is a mutual organisation, whose main purpose is to provide various types of insurance and savings services, and to assist members, usually financially, during sickness or unemployment.

Guaranteed basic benefits
The amount specified under the policy as being payable on death or on survival to the end of the term of a policy.

Holloway contract
A with-profits contract that combines both sickness and savings benefits.

Interim bonus
The bonus declared in respect of the period since the last declaration of regular bonus to the date of claim.

Long term business fund (or "fund")
The long term fund of the Society comprising life assurance, pensions, and other similar business within the definition of "long term insurance business" in the Glossary to the PRA Handbook.

Market value reduction ("MVR")
A downward adjustment that may be made to certain claims under unitised with-profits pensions business and with-profits bonds to help ensure fair treatment and protect the interests of policyholders remaining within the fund. It is sometimes (alternatively) known as a market value adjustment or MVA.

Membership Activities
The activities and services the Society provides to members that do not fall within the main long term business activities and services.

Miscellaneous profits or losses
Profits or losses other than arising from investment returns, mortality costs, tax and expenses.

Mortality costs
Excess of benefits on death over asset shares.

Mutual
A firm engaged in long term insurance business whose constitution does not include shareholders. The firm is, therefore, owned by its members.

Non-profit contract
Any contract which does not confer on the holder a right to share in the profits of the Society.

ORSA – Own Risk and Solvency Assessment
The ORSA is the Society's Own Risk and Solvency Assessment. It is a forward looking assessment of the Society's solvency position taking into account the specific risks to which it is exposed.

Stocks & Shares individual savings account
A with-profits government backed tax efficient savings plan.

Solvency Capital Requirement
The amount of capital the Society's regulator (PRA) requires it to maintain to support prudent management of the business.

Smoothing
The process by which the fluctuations in policy pay-outs as between types of policy and over time are moderated.

Society
The Shepherds Friendly Society Limited.

Solvency
The excess of the value of the assets over the liabilities.

Solvency Ratio
The surplus expressed as a percentage of solvency capital requirements.

SUP
The Supervision Manual issued by PRA and FCA.

Surplus
The excess of the realistic value of assets over the realistic value of liabilities determined in line with regulatory rules.

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