Shepherds Friendly

Your modern mutual

# Principles and Practices of Financial Management

## Effective from 16th December 2020

**The Shepherds Friendly Society Limited** Registered Office: Haw Bank House, High Street, Cheadle, Cheshire SK8 1AL.

**Tel:** 0161 428 1212 **Fax:** 0161 428 3666 **Email:** info@shepherdsfriendly.co.uk **Web:** www.shepherdsfriendly.co.uk



2020.12.PPFM

# Contents


1 Introduction . . . . . page 3
2 The Society's Financial Objectives . . . . . page 5
3 How with-profits policies work . . . . . page 5
4 How investments are managed . . . . . page 10
5 How business risk is managed. . . . . . page 11
6 How charges and expenses are applied . . . . . page 12
7 How new business is managed . . . . . page 13
8 How surplus is managed. . . . . . page 14
9 Glossary of terms used . . . . . page 15

# 1 Introduction

1.1 Shepherds Friendly (the "Society") started as a sickness and benefits society in 1826 and has now grown to a membership of over 110,000 providing a range of savings and protection insurance.

1.2 As a mutual, Shepherds Friendly has no shareholders and is owned by its members. As such all profits are available for its members in accordance with the Society's rules

1.3 The Society is authorised by the Prudential Regulation Authority ("PRA") and regulated by the Financial Conduct Authority ("FCA") and the PRA.

## Purpose of this Document

1.4 We are required by the FCA to set out in this document, the Principles and Practices of Financial Management (the "PPFM"), how we conduct with-profits business. It has been approved by the Society's Board of Management ("the Board") at their meeting on 30th June 2020 and effective on 16th December 2020.

1.5 The purpose of this document is to explain the way the Society conducts its with-profits business and the way in which the Board decides how your money should be managed, invested, and returned to you, in the future. Our intention is to express this as clearly as possible so that you understand how the money you entrust to us is managed. If there is anything in this document which is unclear then please ask. You can contact us at **info@shepherdsfriendly.co.uk**.

1.6 "Principles" describe the enduring standards the Society adopts when managing with-profits business and these principles are not expected to change often. They describe the business model we use to respond to longer term changes in the business and economic environment so that we can continue to fulfil our responsibilities to with-profits policyholders. "Practices" on the other hand, describe the Society's day to day approach in managing with-profits business in response to shorter term changes in the business and economic environment. The Practices change more often but remain within the boundaries set by the Principles.

1.7 In each of the following sections we explain the Principles first, followed by the Practices.

1.8 The PPFM applies to the Society's non-Holloway with-profits products. The following table provides a summary of the products covered by the PPFM and the type of business each product is. More detail on how with-profits works for each type of business is given in section 3.

## Which products are covered by this PPFM?

| **Products that are covered by this PPFM** | |
|---|---|
| **Product name** | **Type of business** |
| Bonusplan<br>Lifeplan<br>Junior Moneymaker | Conventional regular premium |
| With-profits Bond<br>With-profits Bond - Series II | Conventional single premium |
| Unitised pension<br>Adult ISA<br>Junior ISA | Unitised single and regular premium |

## Compliance and governance

1.9 The Board of Directors of Shepherds Friendly (the “Board”) has set up a sub-committee of appropriately experienced people to provide governance and oversight of how with-profits business is managed. This is the Fair Member Benefits Committee (the “FMBC”).

1.10 The Board produces an annual report to with-profits policyholders on the Society’s compliance with the PPFM. It is the responsibility of the Board to ensure that the Society manages its with-profits business in accordance with the Principles and Practices set out in this document.

1.11 The annual report to with-profits policyholders is available on the Society’s website.

1.12 A With-Profits Actuary (“WPA”) has been appointed to advise the Board on its exercise of discretion in managing with-profits business. The WPA operates independently from the Society’s management team. A report from the WPA to with-profits policyholders is included within the Board’s annual report.

1.13 The FMBC may also include a report to with-profits policyholders within the Board’s annual report if it considers it necessary.

## Changes to the PPFM

1.14 The Society reviews the PPFM at least once a year to make sure it remains accurate and current, and to consider ways in which the PPFM could be made clearer. All changes are overseen by the FMBC.

1.15 If the Society needs to change any of the Principles, we will provide with-profits policyholders with at least three months prior notice. Changes to Practices will also be communicated but do not require prior notice.

1.16 However, where the change is immaterial, or its only aim is to improve understanding then we may make the change without letting you know. The in-force PPFM will be available on the Society’s website. The PPFM can be found at **https://www.shepherdsfriendly.co.uk/your-mutual/about-us/principles-and-practices-of-financial-management**

## Further information

1.17 We publish a range of other information on our website which may be of interest to policyholders who want to know more about how we manage your money. This can be found at www.shepherdsfriendly.co.uk.

1.18 If you have any further queries on your policy, then please do get in touch with us. You can contact us at **info@shepherdsfriendly.co.uk**

## Terminology

1.19 There is a glossary of terms used in the PPFM in section 9.

# 2 The Society's Financial Objectives

2.1 The Society operates within a complex regulatory framework which is defined by law and the rules provided by the PRA and the FCA. This means that although it seeks to manage the with-profits fund in line with this PPFM, there could be situations when the financial objectives listed below, in no particular order, take precedence:

- To meet the contractual obligations to all policyholders (with-profits and non-profit),
- To meet the required tests of solvency as specified by regulatory bodies,
- To treat all policyholders fairly and
- To meet the reasonable expectations of with-profits policyholders.

2.2 Subject to the above objectives and the ability to continue to meet them over the foreseeable future, the Society will seek to maximise the financial returns to with-profits policyholders whilst aiming to ensure that returns do not fluctuate significantly from year to year.

# 3 How with-profits policies work

## Principles

3.1 The concept of with-profits business is that policyholders pay premiums into a general pool of assets. This is called the with-profits fund. Those policyholders benefit from the profits or losses made on that fund over their policy's lifetime.

3.2 The value of this fund changes over time because the Society:

- Can generate investment returns on the assets it holds. Investment returns normally increase the value of assets although this is not certain and will depend on how risky an investment approach is taken.
- Incurs expenses in managing the business. The expenses of running the Society are taken from the pool of assets. The Society tries to keep these expenses as low as possible.
- The Society has some policies ("non-profit" policies) that are not eligible to share in the Society's profits. The profits or losses that are made on non-profit policies are shared with with-profits policyholders.

3.3 The precise way the Society's with-profits policies work depends on the type of product. These are discussed below.

### Conventional regular premium policies

3.4 This applies to the Bonus Plan, Life plan and Junior Money Maker products.

3.5 Policyholders with these policies pay a fixed premium over the term of the policy. In exchange, the Society agrees to pay a guaranteed minimum amount at the end of the policy term or at the time of the policyholder's death if that is earlier. This guaranteed minimum amount is sometimes known as the sum assured.

3.6 The sum assured may be increased each year by an annual bonus. The size of the annual bonus depends upon the level of profits that are being earned by the fund. The annual bonus is normally set at a conservative and sustainable level. However, it is conceivable that the Society might need to reduce future annual bonus levels or decide not to pay any annual bonus at all. Annual bonuses, once added, cannot be taken away at a later date.

3.7 Where circumstances change to such an extent that it would be unfair for existing and new policyholders to share the same rates of bonus, the Board may decide to declare an alternative bonus series, amend the basis for new policies or withdraw the type of policy altogether.

3.8 The actual benefit payable to a with-profits policyholder may then be further increased by a final bonus. This is payable when the policy finishes i.e. on maturity or earlier death. It is normally set at a level that rewards policyholders for the profits earned over the life of the policy that haven't already been reflected in annual bonuses. In other words, it brings the value of the policy up to its "fair value".

3.9 Final bonuses are more variable than annual bonuses reflecting the variable nature of investment returns and the profits and losses earned on non-profits policies.

3.10 The amount policyholders get back if they decide to surrender their policy early is at the discretion of the Society. Generally, this will be the fair value of the policy, but it may sometimes be less, for example when the Society's financial objectives (see section 2) take precedence.

### Conventional single premium and unitised single and regular premium policies

3.11 This section applies to the Society's with-profits bonds, unitised pension, ISA and Junior ISA products.

3.12 These policies work in the same way as for conventional regular premium policies except that the sum assured is equal to the amount the policyholder has paid into the policy.

3.13 Junior ISA policies have a maturity date on the policyholder's 18th birthday.

3.14 With-profits bonds and ISA policies are whole of life policies which means they do not have a defined maturity date. As a result, guarantees on policy benefits only apply to death claims.

3.15 All other features are the same as that described for conventional regular premium policies.

### Smoothing

3.16 The Society seeks to smooth maturity and death claim pay-outs on policies of a similar type, size and term over different periods of time. This means that when profits from the fund are strong, some profits will be held back and subsequently paid out or used to support bonuses when profits are weak or indeed the fund makes losses.

3.17 Surrender claim pay-outs may be subject to less smoothing. Whilst changes are primarily made to reflect changes in underlying asset values, the Board reserves the right to take other economic and demographic experience factors into account in determining surrender values as well as actions to protect the remaining policyholders who choose not to surrender their policies.

3.18 It is intended that smoothing will have a neutral effect on the fund over time. 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 section 2 are relevant in this respect.

### Process by which bonuses are set

3.19 Several approximations are made in the methods used to determine pay-outs which are in line with the overall aim of sharing fund performance between policyholders. The different approaches reflect the size of the with-profits business, its diversity in terms of policy type and duration, and the historic approach to bonus distribution across different policy types.

3.20 From time to time the Society may wish to make a change to the methods it adopts in determining the amount payable under a with-profits policy. Such changes can be modifications to current methods or the adoption of entirely new methods. Further, the Society may change any assumptions used regarding the historical experience in the light of new information or new techniques to analyse historical information.

3.21 The WPA will undertake a report for the Board setting out the implications of any such changes. This report will first be discussed and debated by the FMBC before being presented to the Board with a recommendation from the FMBC. The Board will then decide whether to implement the proposed change. All methods used, including amendments, are appropriately documented by the Actuary.

## Practices

### Pay-outs

3.22 The way that pay-outs are set is by reference to each policy's fair value. Fair value is measured by each policy's asset share and represents the accumulated value of the policyholder's premium allowing for investment returns, expenses and share of losses and profits on the Society's non-profits business.

3.23 The way that asset shares are calculated is different between those policies that started before 1 January 2005 and those that started after 31 December 2004.

3.24 The asset share of a policy 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,

+ premiums received in the period (including any associated tax relief),

+ the investment return earned by the assets allocated to with-profits policies,

+ a share of profits or less a share of losses arising on the Society's non-profits business,

- the cost of providing life cover or other risk benefits,

- the costs of selling and administering the policy,

- an adjustment for tax appropriate for the class of business.

3.25 The asset share of a policy starting before 1 January 2005 is based on the assessed value of the policy as at 31 December 2004. This assessed value is, except for with-profits bonds and unitised with-profits pensions business, based on a realistic estimate of the benefits each policy could provide on maturity or earlier death having regard to prospective future investment returns, premiums, expenses (as set out in relevant policy documents) and claims. The assessed 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 and Key Information Documents. The calculation of asset share after 31 December 2004 is then based on the approach set out for policies starting after 31 December 2004 and as above.

3.26 On death, for all policies, the pay-out 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 policy had matured at the date of claim.

3.27 On maturity and death, for all policies, the Society guarantees that the pay-out will be no less than the sum assured plus the annual bonuses awarded to the date of the claim. No guarantees apply on surrender.

3.28 In applying the approach outlined above, the Society uses assumptions arrived at by performing appropriate investigations and analyses of the Society's experience and consideration of expectations for future experience.

3.29 The investment return used in the asset share calculations is based on the return earned by the Society's non-CTF assets, except for the period from 1 January 2013 to 31 December 2016, when the returns reflected that earned by the assets the Board allocated to the conventional with-profits policies.

3.30 The Board may, at its discretion, also adjust the return credited to 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-profits policies. The Society's practice in this regard is detailed further in section 5: How business risk is managed.

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

3.32 The allowance for the cost of sales and administration are as set out in section 6: How charges and expenses are applied.

3.33 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 pay-outs reflect the tax status of the relevant policies. 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.

3.34 Where the Society's surplus falls below or exceeds its target range (see section 8 How surplus is managed), some adjustment to asset shares may be made at the discretion of the Board. Typically, this adjustment will emerge as a change in final bonuses. Such changes can only be made where the circumstances permit them and should not be regarded as necessarily repeatable events.

3.35 The Society has discretion to adjust pay-outs on surrender. Pay-outs will normally be in line with smoothed asset shares but pay-outs may be reduced to protect the interests of policyholders remaining in the fund from the losses which might be incurred when funds are withdrawn following a significant fall in the value of underlying assets. The reduction is applied to policies which would otherwise give rise to a gain significantly above that justified by the fair value of the policy and particularly when the volume of withdrawals is relatively large. In certain circumstances, for example when the Society has excess capital see section 8.8 the Society may choose to increase pay-outs.

3.36 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.

### Annual bonuses

3.37 The approach used is to consider the sustainability of bonus rates, so they 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.

3.38 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.

3.39 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. However, annual bonuses already paid cannot be taken away at a later date.

### Final bonuses

3.40 Final bonus rates are declared at the discretion of the Board on the advice of the Actuary, the FMBC and the WPA. Final bonus rates are set such that on maturity and surrender, the Society aims to ensure that at least 90% of all pay-outs are within 80% - 120% of their asset shares.

3.41 Final bonus rates are reviewed at regular intervals, at least annually. More frequent reviews will take place when the asset shares of policies change significantly. This can be the result of changes in investment returns, changes in expected profits and losses arising from the Society's non-profits business or anything else that affects the calculation of the asset share (see sections 3.24 and 3.25).

### Smoothing

3.42 The Society does not operate a formal smoothing algorithm that would determine how quickly pay-outs might change from one bonus declaration to the next.

3.43 The Society's current approach to smoothing is to limit the change in amounts payable under a with-profits policy 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. In economic and demographic circumstances that adversely affect the fund or the solvency of the Society, the Board could adjust payments very rapidly. The views of the WPA will be sought before implementing any such action.

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

3.45 A Market Value Reduction ("MVR") may apply to certain claims under unitised with-profits pensions business, with-profits bonds and ISAs, subject to contractual MVR free events which are outlined in the various policy documents. For example, some with-profits bonds contain a 5% MVR free income withdrawal option. MVRs may still be applied to any withdrawals that exceed the 5% income withdrawal facility.

3.46 Current practice is to set MVRs on all policies independently of any final bonus and so both may apply in the case of some with-profits bond and ISA claims.

3.47 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 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.

# 4 How investments are managed

## Principles

4.1 The overall principle of the Society's investment strategy is to meet the financial objectives stated in section 2.

4.2 The investment strategy is set by the Board having regard to policyholder expectations, the contractual obligations of each particular policy and the Society's overall current and expected future financial position.

4.3 The Society determines the classes and mix of the assets it invests in by considering the nature of the with-profits liabilities and, with its appointed Investment Manager, the performance opportunities of different asset classes at different times. A mix of directly purchased individual assets may be combined with the use of pooled investment vehicles.

4.4 In addition to the standard asset classes of equity shares, government gilts, corporate bonds, property and pooled investment vehicles, the Society may invest in assets which have the potential for higher returns, but which carry more risk, and which may be less liquid in nature.

4.5 The Society may invest overseas.

4.6 The Society permits investment in non-quoted companies.

4.7 The Society may use derivatives and other instruments for the purposes of efficient portfolio management or to hedge specific liabilities. Any such derivatives are not for speculation.

4.8 The Society only invests in assets which it can identify, measure, monitor, control and report and appropriately take into account in assessing its surplus (this is known as the prudent person principle).

4.9 As well as investing in tradeable assets, the Society also uses the with-profits fund to invest in developing and selling non-profit policies. The profits or losses from writing non-profit policies are added to the with-profits fund. These non-profit policies can last for many years and the future profits and losses emerge over the duration of the policy. These future profits are held as an asset of the with-profits fund and are known as the Present Value of Future Profits ("PVFP").

4.10 The Society does not allocate specific matched assets to the non-CTF with-profits liabilities. This is a process sometimes known as hypothecation. However, the Society does recognise the need to broadly reflect the liability type and the policyholder's reasonable expectations, in how it decides on its mix of asset classes.

## Practices

4.11 The majority of the Society's non-CTF related investments of the with-profits fund are invested in a pooled fund which is targeted to provide a stable return of 4% p.a. in excess of the return that would be earned by investing in cash. If the Society were able to invest in money markets and earn 0.5% p.a., it is expected that the pooled fund would be able to earn 4.5% p.a.

4.12 The returns the Society earns on its non-CTF related investments are all allocated to with-profits policyholders. These returns are in the form of investment income, realised and unrealised gains or losses. These returns may be adjusted by the effect of any losses or profit the Society makes on its non-profits business (see section 5). The returns credited to with-profits policyholders are reviewed no less frequently than annually.

4.13 Investment returns on CTF related investments are allocated to the Society's CTF policyholders.

4.14 The Society aims to ensure that the value of the non-CTF assets of the with-profits fund will be greater than 90% of the aggregate of the value of the Society's with-profits policies.

4.15 Asset allocation is also assessed from the viewpoint of the Society's financial objectives see section 2. Regard is paid to the likely future development of solvency under a range of scenarios. This is also used to help the Society set its investment risk appetite and assets are selected to operate within those limits.

4.16 Where solvency may be threatened, robust monitoring and risk management procedures are in place to establish if and the extent to which investments need to be sold to protect solvency. Implicit in the assessment is the requirement to meet any short to medium term policy payments with suitably matched assets.

4.17 Cashflow projections are carried out to ensure that the Society has enough liquidity to cover its expected cash outflow.

4.18 The Society reviews investment strategy no less frequently than annually and monitors investment performance monthly. More intense monitoring is undertaken in times of stressed market conditions.

4.19 The Board reviews the suitability of non-tradeable assets no less frequently than annually to ensure they remain appropriate.

4.20 The Society carries out a detailed risk assessment of any and every investment opportunity in an unquoted business, including analytical input by a range of professional advisers. All such investments must be approved by the Board.

4.21 The Board must approve investment in any new type of investment instrument. Before making any such investment regard is given to the prudent person principle (see section 4.8).

# 5 How business risk is managed

### Principles

5.1 As a mutual insurer undertaking long term insurance business, all activities of the Society potentially impact the amounts payable to with-profits policyholders.

5.2 Material business risks are always assessed, both individually and in the aggregate, by the Board as part of their role to set the strategic objectives of the Society. Part of this process is to conduct, at least annually, an Own Risk Solvency Assessment ("ORSA") and as part of that the Society's risk appetite is established.

5.3 The Board will only approve business risk provided the expected benefits are no worse than the expected benefits available from alternative investment opportunities. This is assessed through scenario tests of the impact of different business strategies as part of the ORSA process.

5.4 The risk assessment and management procedures in place covering both existing and new risks are designed to ensure that the Society can meet its key financial objectives on an on-going basis.

5.5 It is the Society's objective to pursue business risks which can be funded by its surplus (see section 8). Losses or profits emerging from business risks will be shared with the Society's with-profits policyholders. In this context losses will include any compensation payable to members of the Society.

### Practices

5.6 Any new venture involving a material investment, resource or risk will be subject to a full cost benefit justification and risk assessment and full Board approval.

5.7 A material investment is one where it would be in excess of 5% of the Society's total non-CTF assets either:

- as a standalone investment or,
- in conjunction with investments already made in similar assets.

5.8 The aim is to ensure that the projected benefits of the investment from the perspective of the with-profits policyholders are competitive as against alternative investment opportunities and with an acceptable level of risk.

5.9 Entering any new and material area of business risk requires the approval of the Board who will also consider the advice of the Actuary, the FMBC and the WPA in any material investment decision.

5.10 Current business risk within the Society includes sales of non-profits policies. The expected profitability of these new policies is assessed no less frequently than annually to ensure that the expected returns are in line with the Society's financial objectives.

5.11 Profitability assessments are applied both to existing non-profits business and potential new non-profits business. The Society has various ways to mitigate the insurance risks associated with these policies e.g. premiums may be increased to cover adverse claims experience, transferring risk by using reinsurance. The financial impact of any risks that cannot be mitigated may be charged to with-profits policyholders as decided by the Board.

5.12 Losses or profits arising from business risks arising from new and existing policies accrue as surplus for the benefit of all with-profits policyholders at the point at which a surplus is identified. This includes compensation costs payable to members of the Society.

5.13 The Society currently reviews losses or profits arising within the fund as a whole based on the advice of the WPA. Current practice is to allocate half of such amounts to with-profits policyholders spread evenly over a five-year period from the point at which those amounts accrue. These amounts are reviewed no less frequently than annually.

# 6 How charges and expenses are applied

### Principles

6.1 As the Society is a mutual with a single fund, all the expenses incurred by the Society are taken from the with-profits fund's pool of assets. The Society tries to keep these expenses as low as possible.

6.2 The Society covers its expenses from a contribution made from each of the Society's non-profit policies and by applying a charge to with-profits policies.

6.3 The charges that are applied to with-profits policies may change if there is a major change in how the business is operated e.g. large-scale outsourcing of activities or a significant downsizing or upscaling of business operations or if there is a significant difference between the expenses incurred by the Society and the charges that are applied to with-profits and non-profits policies to cover expenses.

### Practices

6.4 The charge for expenses that are applied to the Society's with-profits policies will normally be those set out in the illustrations that policyholders received when they took their policy out. These may be found in the policy terms and conditions, key features document, key illustration document or other similar document.

6.5 The contribution from the Society's non-profit policies is based on the costs that have been allocated to those classes of business.

6.6 The Society monitors the actual expenses it incurs relative to the charges applied to with-profits policies.

6.7 Expenses include those incurred in the acquisition of business, including commission, and the maintenance of existing business. Maintenance related activities include administration, investment management, regulatory fees, retention and communication activities as well as other infra structure costs.

6.8 All expenses incurred by the Society are charged to the fund at cost.

6.9 If the Society's expenses are higher than the charges applied to with-profits policies, the difference is covered by the Society's surplus (see section 8).

6.10 Where there is a significant item of expenditure and where the benefits of such an expense will be in the future or over a number of years, then the Society will ensure that the impact of the expenditure is spread across the policies that will benefit from the expense.

6.11 The Society reviews, at least annually, major outsourced service providers. Currently, a material outsourced arrangement exists for the Society's investment management services with Royal London Asset Management. This arrangement is monitored for performance against agreed service levels.

6.12 As a mutual, the Society has no shareholders. As such no judgement is needed in applying charges and apportioning expenses between policyholders and shareholders.

## 7 How new business is managed

### Principles

7.1 The Society will only accept new business if, in the opinion of the Board, that business is unlikely to have an adverse impact on the interests of the existing with-profits policyholders.

7.2 All new business written is within the Society's single fund.

7.3 The Society will develop a closure plan if it considers that it is not in the interests of with-profits policyholders to remain open to new business. The closure plan will consider how the business should be managed and how the Society's surplus should be distributed over the remaining lifetime of with-profits policies.

### Practices

7.4 The Society is open to new business and writes the following types of insurance business:

- With-profits - life e.g. ISAs and JISAs.
- With-profits - health e.g. Young Saver.
- Non-profits - life e.g. Over 50s.
- Non-profits - health e.g. Simply IP.
- Unit-linked.

7.5 The Society reviews, no less frequently than annually, the expected profitability of both existing and potential new business. All business is expected to make a positive contribution to the Society's surplus.

7.6 The Society undertakes sensitivity analyses of the effect particular volumes of new business are likely to have on the Society's current and expected future surplus. The results from this analysis are used to help the Society determine a preferred range of new business volume and mix and form part of the Society's strategic objectives.

7.7 The Society reviews, no less frequently than annually, actual new business volumes and mix. This is monitored monthly.

# 8 How surplus is managed

## Principles

8.1 The Society is a mutual insurance company. As such it has no shareholders and its members are the ultimate owners of the business. The Society will manage the surplus for the benefit of all of its members.

8.2 The Society only has the single fund, so the surplus provides the Society with its working capital.

8.3 The Society has a preferred range of surplus as measured by the amount of surplus as a percentage of the Solvency Capital Requirement ("SCR").

8.4 The surplus is not earmarked or allocated to particular products, classes of business or members.

8.5 There are no constraints on the Society's freedom to distribute the surplus to the current generation of members.

8.6 As the Society has no shareholders, there are no issues over how to allocate the surplus between policyholders and shareholders.

## Practices

8.7 The surplus is used by the Society to, in no particular order:

- Ensure that the Society has enough money to cover its SCR.
- Give the Society the flexibility to increase or decrease the amount of risk it takes in managing its with-profits business e.g. how much investment risk it considers appropriate to generate the returns that with-profits policyholders expect.
- Invest in the Society's capacity to take on new business.
- Provide funds to allow the Society to smooth investment returns.
- Meet business risks, including any compensation costs that may be payable.
- Cover the costs of any expenses if they are greater than the charges applied to with-profits policies and the contribution received from non-profits policies.
- Cover the cost of any investment guarantees including those on with-profits policies.
- To allow the Society to smooth the pay-outs on with-profits policies.

8.8 The Board aims for its surplus to be within a range of 150% to 250% of the Society's SCR. If the surplus were to fall below the lower end of the range, the Society will seek to restore the solvency to within the range over a timeframe within 12 months. If the surplus were to exceed the upper end of the range, the Society will consider making further distributions to with-profits policyholders to restore solvency to within the range over a five-year timeframe.

# 9 Glossary of terms used

The following is a summary of the meaning of some of the terms used in this PPFM.

| Term used | Meaning |
|---|---|
| **Actuary** | The person who is the actuary appointed as the Chief Actuary to the Society under the PRA rules. An actuary is a business professional with an expertise in the management of risk and uncertainty. |
| **Annual bonus** | The amount by which the sum assured is increased each year reflecting the profits arising in the fund. The annual bonus is normally set at a conservative and sustainable level. |
| **Asset share** | This is the fair value of a with-profits policy. This represents the accumulated value of the policyholder's premiums allowing for investment returns, expenses and share of losses and profits on non-profits business. |
| **Board** | The Board of Directors, or Board, has overall responsibility for the control of the business of the Society in order to ensure that it achieves its objectives. The Board is responsible for the direction of the Society's current and proposed business, including oversight of its subsidiaries, and having regard to its members, acts in the Society's best interests. |
| **Bonus recommendation** | The process by which the Society's WPA 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. |
| **Conventional** | Conventional with-profits contracts have a basic sum assured to which bonuses may be added. |
| **CTF** | This refers to Child Trust Funds. These are unit-linked liabilities where the investment returns are based on the FTSE All-Share Index. |
| **Demographic experience** | This means the mortality, sickness, withdrawal and surrender experience of the Society. |
| **Derivatives** | This includes options and future 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. |

| Term used | Meaning |
|---|---|
| **Final bonus** | This is the increase, over and above the sum assured and annual bonuses, paid out to a with-profits policyholder. This may be payable when the policy finishes i.e. on maturity or earlier death. |
| **FCA** | This means the Financial Conduct Authority. This is one of the Society's regulators. The FCA monitors the Society's conduct. |
| **FMBC** | This refers to the Fair Members Benefit Committee. The FMBC advises the Board on the exercise of discretion in the management of with-profits and non-profits business. It is chaired by a non-executive director of the Society. This may be referred to by the PRA and FCA as the With-Profits Committee. |
| **Friendly Society** | A friendly society is a mutual organisation whose main purpose is to provide insurance benefits. |
| **Holloway policy** | This is a with-profits policy that combines both sickness and savings benefits. |
| **ISA** | This means Individual Savings Account. |
| **JISA** | This means Junior Individual Savings Account. |
| **MVR** | This means Market Value Reduction. An MVR is a method we use to ensure that members who continue to hold investments with us are not unfairly disadvantaged when other members leave during periods of poor market performance. When applied it is a downward adjustment made to certain surrender claims or withdrawals. The MVR ensures that if some members do make a withdrawal in adverse market conditions, all members have a fair share of the with-profits fund. It may be known as a Market Value Adjustment or MVA. |
| **Mutual** | A firm engaged in insurance business whose constitution does not include shareholders. |
| **Non-CTF assets** | Those assets held by the Society that are not used to support the Society's CTF liabilities. The value of these assets excludes the value of any future profits that could emerge from non-profit policies. |
| **Non-profits policy** | Any insurance policy that does not confer the policyholder with a right to share in the losses or profits of the Society. |

| Term used | Meaning |
|---|---|
| **ORSA** | This refers to the Society's Own Risk and Solvency Assessment. This a process the Society goes through to assess the material risks facing the business. It is a forward-looking assessment of how much capital it needs to cover the risks in the business. The assessment is shared with the PRA at least annually. |
| **PPFM** | Principles and Practices of Financial Management |
| **PRA** | This means the Prudential Regulation Authority. This is one of the Society's regulators. The PRA monitors the Society's ability to pay its claims as they fall due for payment. |
| **Smoothing** | The process by which fluctuations in policy pay-outs as between types of policy and over time are moderated. |
| **Society** | This refers to The Shepherds Friendly Society Limited. |
| **SCR** | Insurers like the Society have to set aside enough money to withstand the effects of adverse financial events e.g. stock market losses. This is known as a Solvency Capital Requirement. The PRA specifies the rules around how to calculate this SCR amount. |
| **Solvency ratio** | This is the amount of the Society's surplus expressed as a percentage of the Society's calculated SCR. |
| **Sum assured** | This is the minimum amount that the Society guarantees to pay at the end of the policy term or at the time of the policyholder's death if that is earlier. This guaranteed minimum amount is sometimes known as the sum assured. |
| **Surplus** | This refers to the difference between the value of the Society's assets and a realistic assessment of its liabilities. The rules the Society uses to work these values out are those required for larger firms subject to the Solvency II regime and are prescribed by the PRA. |
| **Unitised with-profits** | A form of with-profits where the policyholder buys units which increase in value in line with annual bonuses and to which a final bonus may be added when the policy pays out. |
| **With-profits policy** | Any insurance policy that confers a right to the policyholder to share in the losses or profits of the Society. |
| **WPA** | This refers to the Society's With-Profits Actuary. The WPA is responsible for advising the FMBC and Board on the discretion the Society can apply in the way with-profits business is managed. |