

Phoenix

Phoenix & London Assurance Limited

Principles and Practices of Financial Management

January 2010

Phoenix & London Assurance Limited
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Contents

	Page
<i>Introduction and Background</i>	
1. Introduction	3
2. Background to Principles and Practices of Financial Management	5
3. Company Background	7
4. Key Concepts of With-Profits Business	9
<i>Principles and Practices of Financial Management</i>	
5. Principles and Practices – With-Profits Fund	15
<i>Appendices</i>	
1. Glossary	56
2. History of Principles and Practices of Financial Management for Phoenix & London Assurance Limited	61

1. Introduction

This document contains the Principles and Practices of Financial Management of the with-profits business written by Phoenix & London Assurance Limited as at 1 January 2010. Phoenix & London Assurance Limited's assets are divided between a large with-profits fund and a much smaller *Shareholder Fund*.

The *Board* is responsible for managing the with-profits business in the with-profits fund, including setting bonuses.

The Principles and Practices of Financial Management:

- is used in the governance of the with-profits business within the with-profits fund of Phoenix & London Assurance Limited by the *Board* and the *With-Profits Committee*, with particular regard to the use of discretion in managing the funds; and
- provides information on the possible risks and rewards associated with a with-profits policy within the with-profits fund.

The Principles and Practices of Financial Management is prepared in accordance with Section 20.3 of the Conduct of Business Sourcebook which forms part of the Handbook issued by the Financial Services Authority (FSA).

These Principles and Practices have been drawn up in accordance with the law and regulation as Phoenix & London Assurance Limited understands it as at 1 January 2010. Should this understanding prove to have been incorrect, for example as a result of a court or regulatory ruling with retrospective effect, the Principles and Practices will be amended to comply and will be applied as if they had always been so amended.

Section 2 gives more details about the background to Principles and Practices and how and when they can be changed. Appendix 2 gives details of changes to this document since 1 January 2007.

Section 3 provides some background information on Phoenix & London Assurance Limited and its with-profits fund.

Section 4 introduces the key concepts of with-profits business and types of with-profits business. This information is key to understanding the management of the with-profits fund.

Sections 5 documents the principles and practices adopted in managing the with-profits business of Phoenix & London Assurance Limited.

A glossary of terms and a summary of abbreviations used in the document are given in Appendix 1. Words that are defined in the glossary appear in *italics* in the main text.

Sections 1 to 4 of this document and the Appendices are background or explanatory material and therefore neither principles nor practices for the purpose of the FSA rules.

None of the contents of this document forms part of, or varies, the terms or conditions of any policy under which Phoenix & London Assurance Limited is the insurer. In the event of any inconsistency between the contents of this document and any policy, the terms and conditions of the policy prevail.

This document is intended to assist knowledgeable observers to understand the way in which the with-profits business of the Phoenix & London Assurance Limited with-profits fund is conducted and the material risks and rewards involved in effecting or maintaining a with-profits policy in a fund. It is not a comprehensive explanation either of the management of the with-profits business of the fund or of every matter which may affect the business. In addition, no part of the document should be read as a recommendation to policyholders or potential policyholders or their advisers in relation to the effecting or maintaining of a with-profits policy. Accordingly, any person considering whether to effect or maintain a with-profits policy within a fund should seek independent financial advice.

Phoenix & London Assurance Limited ceased to issue with-profits policies to new customers in January 2002 and ceased to issue any type of policy to new customers in December 2002. Existing customers continue to be able to exercise options under their policies, including those to increase premiums payable, to pay additional single premiums, to allow new members into occupational pension schemes or to join group personal pension arrangements and to convert amounts on *maturity* of pension policies into annuities. We do not actively solicit the exercise of any of these options.

Statements in this document in relation to the risks and rewards involved in effecting and maintaining a with-profits policy in a fund are by their nature forward-looking statements that are subject to a variety of uncertainties. Readers of this document should read such forward-looking statements in that context.

The contents of this document may change as the circumstances of Phoenix & London Assurance Limited and the business environment change. The document may also change to reflect changes made by Phoenix & London Assurance Limited to the management of its with-profits business. Phoenix & London Assurance Limited intends to give notice of some changes as explained in section 2 of this document, other changes will be made without notice.

Readers of this document should be aware that reading only selected sections or paragraphs in isolation may result in a misleading impression of the way in which the with-profits business of the funds is conducted and the material risks and rewards involved in effecting and maintaining a with-profits policy with the funds. The principles set out in this document and their associated practices should in particular be read together.

Phoenix & London Assurance Limited is authorised and regulated by the FSA.

2. Background to Principles and Practices of Financial Management

2.1 Principles and Practices

2.1.1 The principles:

- are enduring statements of the overarching standards adopted by Phoenix & London Assurance Limited in managing the with-profits fund; and
- describe the business model used by Phoenix & London Assurance Limited in meeting its duties to with-profits policyholders in the fund and in responding to longer-term changes in the business and economic environment.

2.1.2 The practices set out how the principles are implemented:

- describe Phoenix & London Assurance Limited's approach to managing the fund and to responding to changes in the business and economic environment in the shorter-term; and
- contain sufficient detail to enable a knowledgeable observer to understand the material risks and rewards from effecting or maintaining a with-profits policy in the fund.

There are practices associated with each principle and these are set out below each principle.

2.2 Demonstrating Compliance with Principles and Practices

2.2.1 The *Board* produces an annual report addressed to with-profits policyholders within six months of the financial year end. This report covers Phoenix & London Assurance Limited's compliance with its Principles and Practices of Financial Management and significant matters where discretion has been exercised, in particular where such matters relate to the competing or conflicting interests of policyholders and shareholders. Policyholders will normally be advised of the report as part of their annual statement. The latest annual report is available on the website www.phoenixlifegroup.co.uk.

2.2.2 The *With-Profits Actuary* for the fund produces an annual report for the *Board* on key aspects of the discretion exercised in respect of that fund (including the application of its Principles and Practices of Financial Management).

2.3 Amendments to the Principles

2.3.1 The principles are not expected to change often. However Phoenix & London Assurance Limited may amend any of the principles at any time. Any change will follow formal consultation with and take into account the opinions of the *Head of Actuarial Function*, the *With-Profits Actuary* and the *With-Profits Committee*. Any changes to the principles will be approved by the *Board*.

2.3.2 The FSA will be provided with details of any changes.

2.3.3 Policyholders will normally be provided with 3 months written notice in advance of any changes to the principles. The written notice will set out any proposed changes to the principles.

- 2.3.4 The circumstances and reasons normally leading to such amendments to the principles are likely to include:
- changes in regulations;
 - to improve the management of the with-profits fund;
 - maintaining equity between classes or groups of policyholders; and
 - significant changes in the financial condition of Phoenix & London Assurance Limited.

2.4 Amendments to the Practices

- 2.4.1 The practices are expected to change as Phoenix & London Assurance Limited's circumstances and the business environment change. Any change will follow formal consultation with and take into account the opinions of the *Head of Actuarial Function*, the *With-Profits Actuary* and the *With-Profits Committee*. Any material changes to the practices will be approved by the *Board*.
- 2.4.2 The FSA will be provided with details of any material changes.
- 2.4.3 Policyholders will not be provided with any advance notification of changes to the practices, although they will be informed within a reasonable period after any material changes have been made. This notification will normally be with the next annual statement

2.5 Summary of Amendments Made to Phoenix & London Assurance Limited's Principles and Practices of Financial Management

- 2.5.1 The Principles and Practices of Financial Management will normally be displayed on the www.phoenixlifegroup.co.uk internet site and the version displayed on the internet site will normally be updated shortly after any changes have been implemented.
- 2.5.2 Appendix 2 gives details of amendments previously made to the Principles and Practices of Financial Management since 1 January 2007.

3. Company Background

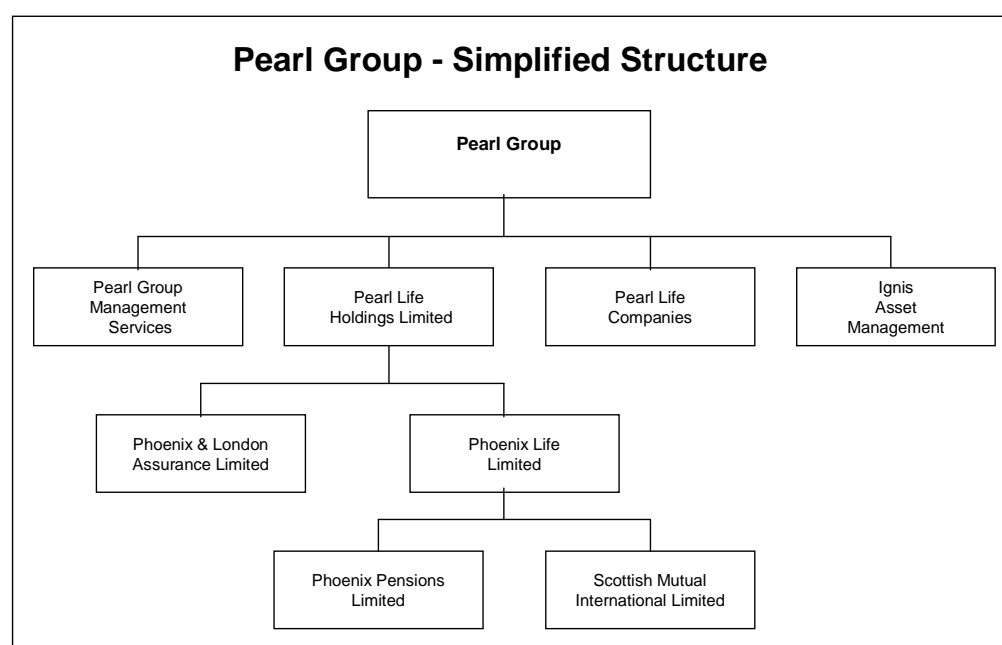
3.1 Company History and Group Structure

3.1.1 Phoenix & London Assurance Limited was previously named Sun Alliance and London Assurance Company Limited and was part of the Royal & Sun Alliance group of companies.

3.1.2 In September 2004, Resolution Life Group Limited bought the UK life operations of Royal & Sun Alliance and subsequently rebranded policies to Phoenix.

Phoenix & London Assurance Limited closed to new business in 2002, although it has continued to issue policies under options on existing policies, including the acceptance of new members to existing pension arrangements and the issue of immediate annuities in respect of vesting pensions.

3.1.3 Phoenix & London Assurance Limited is now part of Pearl Group (formerly Liberty Acquisition Holdings (International) Company). A simplified structure chart of Pearl Group (as at January 2010) is shown below.



3.2 2009 Scheme

On 31 December 2009, a scheme of arrangement under Part 26 of the Companies Act 2006 ('the 2009 Scheme') became effective. Under the terms of the 2009 Scheme, certain with-profits pension policyholders gave up their option to convert the *maturity* value of their pension policy into an annuity on guaranteed rates, in exchange for an immediate increase to the value of their policy and a change to the underlying investment practices for their policy. These policies are referred to as 2009 Scheme policies. The same principles and practices apply to these 2009 Scheme policies as to other policies, except where indicated. In some cases, only parts of a policy were subject to the 2009 Scheme. Where this is the case, the different principles and practices apply only to those parts.

3.3 Main intra group agreements

- 3.3.1 Phoenix & London Assurance Limited has an agreement with Ignis Asset Management to provide investment management services for the with-profits fund. The agreement can be terminated with three years notice or six months if the underperformance termination clause is invoked.
- 3.3.2 Phoenix & London Assurance Limited has an agreement with Pearl Group Management Services (PGMS) to provide management services to the with-profits fund.
- 3.3.3 Phoenix & London Assurance Limited reassures some with-profits business to the Phoenix With-Profits Fund of Phoenix Life Limited.

3.4 Other significant arrangements

- 3.4.1 There is an agreement between PGMS and Unisys Insurance Services Limited (UISL) under which PGMS sub-contracts to UISL some of the services it provides for policies in the with-profits fund. PGMS is not liable for any additional costs of providing these parts of the services which might arise if UISL were to default.

3.5 Management services agreement with PGMS

- 3.5.1 The agreement provides specified policy and corporate administration services associated with business as usual activity in return for specified charges, based on unit charges and policy volumes. The unit charges are subject to annual increases linked to movements in Retail Prices Index excluding mortgage interest (RPIX).
- 3.5.2 There are additional activities that PGMS will provide on request to Phoenix & London Assurance Limited. The charges for these are usually related to the actual costs incurred by PGMS.
- 3.5.3 Costs associated with day to day administrative problems are borne by PGMS. Compensation costs for pensions review and mortgage endowment reviews remain with Phoenix & London Assurance Limited, whilst the costs for undertaking these reviews are met by either Phoenix & London Assurance Limited or PGMS, depending on the cause and the terms of the agreement.
- 3.5.4 The agreement is perpetual.
- 3.5.5 Termination rights are provided based only on certain specific events (such as material or persistent breach, persistent failure to meet service standards, insolvency).
- 3.5.6 Service levels and performance under the management services agreement is regularly reviewed.

4. Key Concepts of With-Profits Business

4.1 Workings of a With-Profits Fund

The premiums paid in respect of each policy go into the fund, which is then used to pay out the policy benefits as defined in the policy conditions. The costs of managing the fund and tax are paid out of the fund, together with an amount each year to the shareholders, where applicable. The fund is invested in a variety of different types of investments and the return earned on these investments increases or decreases the value of the fund.

In order to help the *Board* to determine the level of bonuses to pay and the fair distribution of any surplus arising, *asset shares* are generally calculated. More details are given in section 4.3.

The fund is subject to a number of inherent risks that arise from a range of factors, including product design (for example the provision of guarantees to policyholders), selling and marketing practices, interest rate and market fluctuations and demographic changes. Phoenix & London Assurance Limited makes provisions which it considers to be appropriate for the risks which it identifies in relation to the business within each fund. There can be no assurance that all risks which might emerge have been identified nor that the provisions for identified risks will prove to be adequate. In addition, the risks to which the fund is exposed inevitably change over time.

4.2 Types of With-Profits Business

There are two main types of with-profits business – *traditional* and *unitised*. Details of some of the common features of these are given below. Within Phoenix & London Assurance Limited there are many different types of policies, some of which may operate differently or may have particular or special features, not all of which are referred to below.

4.2.1 Traditional With-Profits Business

Policies are eligible to participate in the distribution of surplus in the fund by the addition of *annual* and *final bonuses*.

Policies can be written as life or pension policies. The former includes endowment assurances and whole life policies. The latter includes retirement annuity policies where the benefit is in the form of an annuity payable from the selected retirement age and endowment type policies where the benefit is in the form of a cash sum at the selected retirement age. Endowment type policies may have an option to convert the cash sum into annuity benefits on fixed terms. On earlier death premiums are refunded either with or without interest, an early termination value may be paid, or there may be no benefit paid, depending on the terms and conditions of the policy.

For life policies, the benefit payable at *maturity* (for endowment assurances) or on death (or, if applicable, terminal illness or critical illness) includes:

- a guaranteed amount, the sum assured;
- *annual bonuses*, which may be added to each year as part of the *annual bonus* declaration and which increase the guaranteed benefit; and
- *final bonus*, which may be added on death (or, if applicable, terminal illness or critical illness) or *maturity* claims.

Some endowment assurances have a guaranteed minimum death benefit which is a minimum amount of benefit payable on death (but not on *maturity*). This guaranteed minimum death benefit is not eligible for bonuses.

For pension policies, the benefit at selected retirement age includes:

- a guaranteed amount, the basic annuity or a sum that will be used to purchase an annuity at retirement;
- *annual bonuses*, which may be added to each year as part of the *annual bonus* declaration and which increase the guaranteed benefit; and
- *final bonus*, which may be added on retirement (either increasing the annuity payable or increasing the cash sum available to purchase an annuity depending on the type of policy).

The death benefit for pension policies generally does not participate in bonuses unless the benefit is based on the early termination value.

At retirement, when the annuity comes into payment, the policy becomes non-profit and currently remains in the with-profits fund.

For both life and pension policies, to receive the benefit, regular premiums must be maintained except for some whole of life assurances where premiums are designed to cease at a specified age, and some policies paid by a single premium. Otherwise if premiums cease and certain criteria (that are explained in the terms and conditions of each policy) have been met:

- a *surrender value* may be paid or a transfer value may be paid to another pension provider; or
- the policy will be made paid up and the benefits due at *maturity*, retirement or earlier death will be reduced. Depending on the policy terms, future bonuses may or may not be added.

If the criteria are not met, then the policy will lapse with no value.

4.2.2 **Life Regular Premium *Unitised* With-Profits Business**

A proportion of each premium less charges buys with-profits units and, where *annual bonus* is declared, the price of the with-profits units increases at the daily equivalent of the current *annual bonus* rate (but subject to any rounding in the unit prices).

The benefit payable at *maturity* or on death (or, if applicable, terminal illness or critical illness) includes:

- the value of the with-profits units; and
- any *final bonus*, which may be added

Some types of policy might have a guaranteed minimum death benefit which is a minimum amount of benefit payable on death (or, if applicable, terminal illness or critical illness), but not on *maturity*. The cost of providing the guaranteed minimum death benefit is met by cancelling units each month based on the sum at risk.

If premiums cease and certain criteria (that are explained in the terms and conditions of each policy) have been met:

- a *surrender value* may be paid; or
- the policy will be made paid up and the guaranteed minimum death benefit will no longer apply.

The *surrender value* may include an element of *final bonus*. On surrender, the value of each with-profits unit and bonus unit may be reduced by the application of a *market value reduction*. If the criteria are not met then the policy will lapse with no value.

4.2.3 **Life Single Premium *Unitised With-Profits Business***

These are similar to the above, except that only one premium is payable at the start of the policy. Policies are whole of life assurance single premium bonds where the benefit is payable on death. Some policies also provide for the benefit to be payable upon surrender at a specified guarantee date or dates. The type of policy and the date at which it was taken out determines the guarantee dates applicable for that policy.

The benefit payable on surrender at a guarantee date is the same as at *maturity* above. Some policies provide for an uplifted benefit to be paid on death.

The *surrender value* (withdrawal value) for claims, at other than a guarantee date, may include an element of *final bonus*. The value of each with-profits unit may be reduced by the application of a *market value reduction*. Any *market value reduction* is calculated by reference to the underlying fair value and in some cases allows for *smoothing*.

4.2.4 **Pension *Unitised With-Profits Business***

Under these policies the benefit is payable at the selected retirement age or earlier death. For some policies a range of dates around the selected retirement age applies. Otherwise they are similar to life *unitised* with-profits business.

Premiums may be single or regular contributions from an employee or employer, payments for policies contracted out of the state second pension or transfers from other pension providers. The business may be split into sections, such as for contributions, for payments as a result of contracting out or for transfers in.

At retirement, the benefit is available to purchase an annuity.

4.3 **Asset Share Methodology**

The purpose of *asset share* calculations is to assess the contribution a policy, or group of policies, has made to the with-profits fund since the policy, or policies, started. The *asset share* calculation is therefore intended to represent the effect of the historical cashflows on the fund as a result of the policy, or group of policies.

Asset shares are not normally calculated for each individual policy. Rather the *asset shares* are calculated for a limited number of specimen policies, or groups of specimen policies, and these are then taken to be representative of the business generally.

Asset shares are calculated by accumulating premiums paid at the rates of investment return earned on the assets, after allowing for charges, such as expenses, mortality and morbidity costs, cost of guarantees, cost of capital, distributions to shareholders and tax as appropriate.

The exact components of *asset share* calculations and practices relating to *asset shares* vary by the type of business. Details of how *asset shares* will be calculated in the future are given in principle 5.4 and the associated practices.

Asset shares are used to guide policy *payouts* and bonus declarations because they provide a good indication of the appropriate level of total *payouts* in respect of a policy or groups of policies.

Asset share methods fall into two main types and, other than the premiums paid and investment returns net of tax, are either based on product charges or based on the actual underlying experience.

Asset shares can decrease as well as increase and, at any time, may be greater or less than the value of the contractual guaranteed benefits due under the policy.

The following table describes the possible elements credited or charged to *asset shares*.

Element		Description of Allowance
(a)	Premiums	Premiums paid under the policy
(b)	Investment return	Investment return on assets backing <i>asset shares</i> (before investment expenses)
(c)	Investment expenses	Investment expenses incurred in maintaining investments
(d)	Initial expenses	Administrative expenses incurred in setting up policies, including commissions
(e)	Renewal expenses	Administrative expenses incurred in maintaining policies and paying claims
(f)	Other expenses	Project and other one-off expenses incurred
(g)	Tax on investment return	Tax charge on investment return
(h)	Tax relief on expenses	Tax relief on expenses
(i)	Mortality & morbidity costs	Costs of providing mortality and morbidity benefits
(j)	Early terminations	Effect of surrender and lapse experience
(k)	Paid-up policies	Effect of policies becoming paid up experience
(l)	Partial and regular withdrawals	Effect of partial and regular withdrawals during policy lifetime
(m)	Surrenders at <i>protected dates</i>	Effect of surrender at guarantee date experience
(n)	Annuity payments	Annuity payments made under the policy
(o)	Charges for the cost of guarantees	Charges for the costs of providing guarantees to both with-profits and non-profit policies in the fund
(p)	Charges for the cost of capital	Charges for the cost of providing capital to support guarantees and new business strain
(q)	Distributions to shareholders	The shareholder share of the distributed surplus
(r)	Tax on distributions to shareholders	The tax associated with the shareholder share of the distributed surplus
(s)	Profit and losses from other business	Effect of experience of other business profits and losses including from non-profit business in the fund
(t)	<i>Estate</i> distribution or charge	Future distributions from or charges to the <i>estate</i>
(u)	<i>2009 Scheme</i> uplifts	For <i>2009 Scheme</i> policies only, uplifts in exchange for giving up guaranteed annuity options

Mortality and morbidity costs reflect that the amounts payable on death or serious illness are generally more than the underlying *asset share*, but this may not always be the case and where the underlying *asset share* exceeds the amount payable, the cost becomes negative and adds to the *asset share*.

Asset shares may take into account profit and losses from the experience of early terminations, such as surrenders and lapses and policies becoming paid up. For example profits occur where the early termination value is less than the underlying *asset share* and conversely for losses.

The precise approach to calculating *asset shares* differs between products within the fund depending upon, amongst other things, the historical practices.

4.4 *Asset Shares*

- 4.4.1 Not all the above items may necessarily apply or have applied at all times for all types of policy in the past. Different practices, often more approximate, may have been used in the past and the practice is generally to continue to use the results of these practices when determining the effect of those years on the *asset shares* of specimen policies.

5. Principles and Practices – Phoenix & London Assurance Limited With-Profits Fund

The Principles and Practices given in sections 5.4 to 5.14 form the Principles and Practices of Financial Management for the Phoenix & London Assurance Limited with-profits fund. Sections 5.1 to 5.3 give background information. Subsequently in this section the use of the term 'the fund' generally means the Phoenix & London Assurance Limited with-profits fund.

5.1 Fund History

The fund closed to new business in 2002, although it continues to issue policies under options on existing policies, including the acceptance of new members to existing pension arrangements and the issue of immediate annuities in respect of vesting pensions.

5.2 Types of Policy

The with-profits contracts in the fund mainly fall into the following categories:

- *traditional* endowments and whole life policies
- *traditional* pension policies funding for cash or a pension
- *unitised* with-profits single premium whole life bonds
- *unitised* with-profits regular premium life policies
- *unitised* with-profits pension policies
- final salary *unitised* with-profits group pension policies

The final salary *unitised* with-profits group pension policies arose from:

- final salary pension schemes which had a Growth Fund policy with Phoenix Assurance Limited prior to 1996 and subsequently transferred to Sun Alliance and London Assurance Company Limited; or
- Retirement Plan policies issued by Sun Alliance and London Assurance Company Limited prior to 1996 which were subsequently converted to a Group Unitised With Profits Pension investment.

5.3 Capital Support to the Fund

The fund currently relies on capital support from the *Shareholder Fund*. As at 31 December 2009, the *Shareholder Fund* provided a contingent loan of £297m (including accrued interest) to the with-profits fund, of which, £158m was deemed repayable. Section 5.12.1 describes the capital support mechanism.

Principle

5.4 Amounts Payable Under a With-Profits Policy

Our aims when determining the amounts payable to with-profits policyholders are:

- to pay all guaranteed benefits when due; and
- to pay discretionary benefits only to an extent that would not unreasonably put at risk our future ability to continue to pay all guaranteed benefits when due, whilst taking account of the need to treat customers fairly relative to their reasonable expectations and to other current and past customers.

Discretionary benefits include future *annual bonuses*, *final bonuses* payable when policies terminate and the values paid on early termination of policies.

The company's assets are divided between a large with-profits fund (in which all policies, both with-profits and non-profit exist) and a much smaller *Shareholder Fund*. We intend if at all possible to meet our aims using only the assets of the with-profits fund. Some or all of the *Shareholder Fund* would be used to enable us to meet our aims if this did not prove to be possible. However, our expectation is that we would release the *Shareholder Fund* assets to the *shareholder* as our liabilities reduce over time.

In putting into practice the aims set out above and in the application of our with-profits principles generally, we apply various degrees of approximation in a number of different areas, the major ones being described in paragraph 5.4.4 of our Practices. We will endeavour to ensure that these approximations:

- are applied consistently;
- have a broadly neutral effect between policyholder and *shareholder* interests;
- where appropriate, have a broadly neutral effect over time (that is between one generation of policyholders and another); and
- for the larger classes of business, are of broadly neutral effect within that class.

This may mean that for some smaller classes of business, a different result would result if less approximate methods were used.

We control the changes to the methods we use to determine the amounts payable under a with-profits policy by:

- requesting and considering the advice of our *Head of Actuarial Function*, of our *With-Profits Actuary* and the opinion of the *With-Profits Committee* before making any changes;
- assigning to the *Head of Actuarial Function* the executive responsibility to continue to apply the currently agreed methods until advised differently; and
- following legal or regulatory requirements to obtain independent expert input where necessary.

We might change any assumptions used in previous years (such as investment returns, charges, allocations of miscellaneous profits and losses) relevant to the methods we use to meet our aims at any time:

- should they be shown to have been incorrect; or
- should legal or regulatory change render it necessary to do so; or
- if their continued application unchanged could put at risk the achievement of our aims as set out above.

Practices

Asset Share Methodology

- 5.4.1 The basic method for *asset share* calculations for with-profits business uses an apportionment of actual investment returns net of tax and the actual underlying experience.

Asset shares are generally not smoothed. In particular the investment returns and experience elements contributing to *asset shares* are generally not smoothed, other than that inherent in the processes used in the derivation of the assumptions or in respect of large profits and losses from other business per paragraph 5.4.2(s).

5.4.2 The following table describes the elements currently credited or charged to *asset shares* for specimen policies.

Element		Description of Allowance
(a)	Premiums	Premiums paid under the policy
(b)	Investment return	Allocated return – note (b)
(c)	Investment expenses	Actual allocated – note (c)
(d)	Initial expenses	Actual allocated – note (d)
(e)	Renewal expenses	Actual allocated – note (e)
(f)	Other expenses	Actual allocated – note (f)
(g)	Tax on investment return	Actual allocated – note (g)
(h)	Tax relief on expenses	Actual allocated – note (h)
(i)	Mortality & morbidity costs	Based on underlying experience – note (i)
(j)	Early terminations	Note (j)
(k)	Paid-up policies	No profits or losses are credited
(l)	Partial and regular withdrawals	No profits or losses are credited other than as described in note (o) below
(m)	Surrenders at <i>protected dates</i>	No profits or losses are credited
(n)	Annuity payments	Not applicable
(o)	Charges for the cost of guarantees	Charged – note (o)
(p)	Charges for the cost of capital	See note (p)
(q)	Distributions to shareholders	Actual incurred – note (q)
(r)	Tax on distributions to shareholders	Not charged
(s)	Profit and losses from other business	Profits or losses are credited – note (s)
(t)	<i>Estate</i> distribution or charge	Distributions from or charges to the <i>estate</i> as determined - note (t)
(u)	<i>2009 Scheme</i> uplifts	For <i>2009 Scheme</i> policies only, uplifts in exchange for giving up guaranteed annuity options - note (u)

The way in which the above items are taken into account is described in the notes below.

Not all the above items may necessarily apply or have applied at all times for all types of policy. Different practices, often more approximate, may have been used in the past and the practice is generally to continue to use the results of these practices when determining the effect of those years on the *asset share* of specimen policies.

(b) Investment return

Each year the total return, income and capital gains/losses, made on the assets of the fund is determined. For equity shares and property (growth investments as described in section 5.9, as appropriate), this is done in aggregate. For fixed interest securities, the returns are sub-divided according to the time to redemption of the security.

The investment strategy currently adopted is described in section 5.9. In accordance with this, generally different proportions of each type of asset are notionally attributed to the specimen with-profits policies depending upon a number of factors, in particular:

- the *term remaining*,
- the anticipated relative size of the guaranteed benefits and the *asset share* at such a date; and
- whether or not the policy is a *2009 Scheme* policy.

The return attributed to each specimen policy is then the weighted average return from each asset type using those proportions.

Generally, the return on fixed interest securities (that do not form part of the growth investments described in section 5.9, as appropriate) will be that of the subclass of such securities issued by the UK government with a duration which matches most closely the *term remaining* of the specimen policy. For *2009 Scheme* policies, the return will be an average of the returns from the subclasses which match the cashflow of the annuity which could be purchased with the maturity value of the specimen policy. For with-profits bonds and *unitised* with-profits pension policies without guaranteed annuity rates, the *term remaining* is adjusted as described in paragraph 5.9.10.

For *unitised* with-profits life regular premium policies, the same asset mix applies to all specimen policies. Also the same fixed interest return applies to all specimen policies and there is no differentiation by *term remaining*.

For final salary *unitised* with-profits group pension policies, the same asset mix applies to all specimen policies. Also the same fixed interest return applies to all specimen policies and there is no differentiation by *term remaining*.

Any difference in return between UK government fixed interest securities and the other fixed interest securities within the *asset share* is applied as a uniform percentage adjustment across the fixed interest part of the *asset shares* of all policies, irrespective of the *term remaining*.

The return on some types of asset, particularly derivative securities, may be attributed to the class of policy, if any, in respect of which they are deemed to have been purchased.

The ratio of overseas equities to UK equities is generally the same for all specimen policies. The ratio of UK government to other fixed interest securities is generally the same for all specimen policies. The exception is the business which is reassured to the Phoenix Life Limited Phoenix With-Profits Fund and this may have different ratios.

For some types of business as described in paragraph 5.9.6 which is reassured to the Phoenix Life Limited Phoenix With-Profits Fund, the investment return credited to *asset shares* is based on the investment return of the Phoenix Life Limited Phoenix With-Profits Fund using the equivalent practices described above.

Different, more approximate, methods have been used in the past to determine the return to attribute for a particular year to specimen policies. Our practice is to

continue to use these returns in the calculation of the *asset share* of those specimen policies.

(c) Investment expenses

Actual investment expenses are charged based on those allocated to the fund in accordance with section 5.11.

The investment expenses are expressed as a percentage charge to be applied to the assets.

(d) Initial expenses

Initial expenses are based on PGMS charges and an uplift to cover direct costs. These are all per policy expenses, allocated in accordance with section 5.11. Commission is also payable to intermediaries on some contracts.

In the past, a proportion of sales expenses for some policy classes have been met from the excess assets in the with-profits fund and so that proportion is not taken into account when calculating the *asset share* of specimen policies of those classes.

(e) Renewal expenses

Renewal expenses are based on PGMS charges and an uplift to cover direct costs. These are all per policy expenses, allocated in accordance with section 5.11.

For those policy classes where there is an explicit policy fee or other charge collected by cancellation of units or other reduction in benefits, only the expenses not covered by these fees or charges, if any, are apportioned to the *asset shares* of the specimen policies for these classes.

For final salary *unitised* with-profits group pension policies a charge for expenses is made each year which is expressed as a proportion of the bonuses added in that year. To the extent that this charge, plus the explicit policy fees or other charges are different from the actual expenses incurred for this business, the difference will increase or reduce the excess assets in the fund.

(f) Other expenses

The cost of compensation to with-profits policyholders provided with incorrect advice has not been deducted from *asset share* calculations for specimen policies.

Compensation costs in respect of unit-linked policies issued by the company but fully reassured to sister company, Phoenix Life Limited, have been met by Phoenix Life Limited.

Project and other one-off expenses incurred are included in the actual renewal expenses charged to *asset shares*.

Significant future project, additional activity and other one-off costs will only be charged to *asset shares* following approval by the *Board*.

(g) Tax on investment return

The tax charged to classes of policy subject to tax is calculated by applying the current rates applicable to life insurance companies in respect of income attributable to policyholders to the different elements of the investment return. Approximate allowance is made for any deferment in tax payment, particularly in

respect of tax on unrealised capital gains (which is charged at a discounted rate to reflect the average expected period until it is payable). If the actual tax incurred differs from the total calculated in this way, the difference will increase or reduce the excess assets in the with-profits fund.

(h) Tax relief on expenses

Tax relief due on the actual expenses charged is allowed for in those classes of business that are subject to tax. Where the tax relief in respect of expenses is deferred this is allowed for in an approximate manner. The rates of tax relief are the average rates applicable.

(i) Mortality and morbidity costs

Amounts to cover the cost of payments in excess of *asset share* on death or illness are deducted.

Where a policy class is designed to pay a benefit on death or illness which exceeds *asset share* at that time, and where no explicit charge for benefit is applicable, an annual charge is made to cover the cost of making those enhanced payments.

Most *unitised* with-profits policies are subject to an explicit charge for such costs. Any differences between the aggregate cost deducted and the total enhancements to payment will increase or reduce the excess assets of the with-profits fund.

For other policies, the estimated annual cost of providing such benefits is determined periodically from an analysis of recent actual mortality and illness rates experienced by policyholders and/or from insurance industry and national statistics. These costs are expressed as rates dependent upon various factors including sex and age.

The charge on each specimen policy in each year is then determined by applying the appropriate rate to the current difference between the benefit payable on death or illness and the *asset share*.

Some pension policies provide either no benefit at all on death or only a return of premiums paid, with or without interest. For the specimen policies representing such classes, a credit to *asset share* is calculated using similar principles.

(j) Early terminations

It is not the current practice to attribute to the *asset share* of specimen policies any differences between the amount paid on the early termination of with-profits policies and their estimated *asset share*.

Prior to 2002, profits from this source were credited to the *asset share* of specimen policies and we continue to take those past profits, expressed each year as an addition to the investment return, into account in the calculation of the *asset share* for specimen policies. However, no such allocations are made to final salary *unitised* with-profits group pension policies.

(o) Charges for the cost of guarantees

The costs of meeting guarantees in the fund are periodically assessed for each class of policy using a prospective test of the future expected cost of guarantees and any change in such expected costs will be allocated to the *asset shares* in that fund in the year of assessment.

For policies other than final salary *unitised* with-profits group pension policies and *2009 Scheme* policies, the charges for guarantees will be:

- an annual guarantee charge of the 'base charge percentage' (B%) (see below) of *asset share*; plus
- an amount retained from *asset share* at *maturity*, death or surrender at a rate of $B * (2015-N)\%$ of *asset share* in each future year (N) until the end of 2014; and
- increased or reduced by charge adjustments so that, subject to rounding:
 - the realistic present value of future expected charge adjustments; plus
 - the actual charge adjustments made since 1 January 2010; plus
 - the increase in value of the assets backing guarantee and smoothing reserves since 1 January 2010 (this amount may be negative);

must not exceed:

- the actual guarantee and smoothing costs incurred since 1 January 2010; plus
- the present value of future expected guarantee and smoothing costs; less
- the present value of future guarantee and smoothing costs at 31 December 2009.

For policies subject to the *2009 Scheme*, no charges for guarantees or smoothing are currently made.

See also paragraph 5.8.2 for the target proportion of *asset share* payable on surrender.

The 'base charge percentage' referred to above is the percentage (B%), rounded to the lower one decimal place, such that at 31 December 2009, in respect of all policies other than final salary *unitised* with-profits group pension policies, the sum of:

- the value of past and expected future amounts retained from *asset share* on *maturity*, death or surrender at a rate of $B * (2015-N)\%$ of *asset share* in each future year (N) until the end of 2014;
- plus the value of past and expected future explicit regular guarantee charges at a rate of B% of *asset share*;
- plus the value of past and expected future differences between surrender values and *asset share* (assuming that the target proportion of *asset shares* on surrender is that specified in paragraph 5.8.2 for policies which are not *2009 Scheme* policies);
- plus or minus the past change in the value of the assets representing reserves for guarantees and smoothing;

does not exceed:

- the past and expected future costs of guarantees and smoothing; less
- £79 million; less
- £19m.

For 2010, the base charge percentage (B%) will be provisionally calculated.

Different practices apply to charges in respect of years prior to 2010.

References to 'past' above refer only to the period since 1 January 2004 as it is assumed that the accumulated value of charges and retentions from *asset share* was equal to the guarantee and *smoothing* costs actually incurred up to that date. All expected future values are calculated on a *market consistent* basis. All past values accumulate with interest from 1 January 2004 or the later date the values are deemed to be paid or received (the amount of £79m accumulates from 1 January 2004 and the amount of £19m from 31 December 2009).

The *Board* will formally consult with and take into account the opinions of the *Head of Actuarial Function*, the *With-Profits Actuary* and the *With-Profits Committee* before making any changes to the charge adjustments.

The cost of meeting guaranteed annuity options (which form part of the cost of guarantees in the above calculations) are, as required by law, not attributed solely to those policy classes with such options. Past and expected future costs of meeting such options, to the extent incurred before or provided for at *market consistent* cost at 31 December 2003, are not taken into account in the above calculations. However, changes in the actual or expected cost of meeting guaranteed annuity options over those expected on 31 December 2003, net of any increase in the value of the assets representing reserves for those options, are included in these calculations.

Changes in guaranteed annuity option costs do not affect policies sold after 30 June 1998 and this is taken into account in the calculations above. Moreover, any proportion of this cost which would otherwise have been attributed to such policies is not taken into account in the above calculations.

As at January 2010, the explicit charges for policies which are not *2009 Scheme* policies, are 1.5% per annum of *asset share*, plus a charge on *maturity* or surrender of 7.5% of *asset share* and currently expected to reduce to zero at the rate of 1.5% per annum over the period to 2015. For policies issued after 30 June 1998 which are not *2009 Scheme* policies, the explicit charges are 1.0% per annum of *asset share*, plus a charge on *maturity* or surrender of 5.0% of *asset share* and currently expected to reduce to zero at the rate of 1.0% per annum over the period to 2015.

Policyholders will be advised in their annual statements of any changes to these charges.

The charge made to *asset shares* in respect of guarantee costs for policies which are not *2009 Scheme* policies, will normally be limited to 1.5% per annum (or an equivalent amount expressed in different terms, for example as a percentage of premium), together with a maximum exit charge of 7.5% of *asset share* in 2010 reducing to nil in 2015 to ensure that all policies in force at the time make a full contribution to the increase in guarantee costs, irrespective of when their policies become claims. However, sometimes larger charges will apply if, in the opinion of the *Board*, the *With-Profits Committee* and the *With-Profits Actuary*, and with the agreement of the FSA, it is necessary to enable the fund to continue to meet the objectives set out in Principle 5.4.

For policies subject to the *2009 Scheme*, charges made to *asset shares* in respect of guarantee costs will not be reintroduced, and the target proportions of *asset share* on surrender referred to in paragraph 5.8.2 will not be reduced, unless, in the opinion of the *Board*, the *With-Profits Committee* and the *With-Profits Actuary*, and with the agreement of the FSA, it is necessary to enable the fund to continue to meet the objectives set out in Principle 5.4.

The exception to the above is incremental premiums on certain Section 226 pension policies which are not *2009 Scheme* policies. These are the only contracts on which the benefits arising from new incremental premiums have an

attaching guaranteed annuity option. For these policies, the *asset share* for the incremental benefit is charged with the full expected cost of providing the guaranteed annuity option on that increment, at the date the increment commenced.

For final salary *unitised* with-profits group pension policies, the actual and expected cost of meeting past and future guarantees (excluding guaranteed annuity options) is estimated from time to time. The charge necessary to recover that cost over time from this class of business is then calculated. This charge is then deducted from the final *asset share* when determining the rate of *final bonus* for all specimen policies in this class. If the actual guarantee cost differs from the total charge collected, the difference will increase or reduce the excess assets in the fund.

(p) Charges for the cost of capital

A reinsurance arrangement was in force between May 2000 and August 2003, the effect of which was to reduce the total capital which the company was required to hold. The premium payable to the reinsurer was, between January 2002 and August 2003, deducted from the *asset shares* of all classes of specimen policy, other than final salary *unitised* with-profits group pension policies. For the earlier part of the period in force, the premium reduced the excess assets of the with-profits fund.

From time to time, one or more loan agreements may be in place. Further details may be found in paragraph 5.12.6 and section 5.14. Interest at a commercial rate will be payable on such loans. Where part of such a loan is required to ensure that the fund can cover its liabilities on a realistic basis (excluding any contingent liabilities), then the interest payable on that part of the loan is not currently charged to *asset shares*. Where part of such a loan is not required to cover the realistic liabilities, or is covering contingent liabilities, then a deduction is currently made from *asset shares* to reflect the excess of the interest payable on that part of the loan above the return achieved by the fund from investing that part of the loan. Prior to 2005 the whole of any interest incurred on loans to the with-profits fund was deducted in *asset share* calculations.

No charge is currently made to the fund for the capital that it is necessary to retain in the *Shareholder Fund* in order that Phoenix & London Assurance Limited continues to have adequate capital. The exception to this is that the with-profits fund will pay the *Shareholder Fund* fees at a commercial rate on loans made to the *Shareholder Fund* but not transferred into the with-profits fund under the arrangements described in section 5.12.

The *asset shares* of specimen policies do not receive any credit for the return earned on excess assets held within the fund.

No charges for cost of capital are applied for final salary *unitised* with-profits group pension policies.

No charge for any cost of capital arising after 31 December 2009 will be deducted from the *asset shares* of specimen policies used to determine the benefits for 2009 *Scheme* policies. Moreover, in respect of 2010 and subsequent years, the effect of the deduction of cost of capital charges from the specimen policies used to determine the benefits of policies which are not 2009 *Scheme* policies will be no more than had the 2009 *Scheme* not been implemented. This practice may only be changed with the agreement of the FSA.

(q) Distributions to shareholders

The cost of distributions to shareholders resulting from the cost of bonus allocated to policies is charged to *asset shares*.

(s) Other business profit or losses

It is the current practice to attribute to the *asset share* of most specimen policies in most classes any other business profits or losses arising in a year, other than the costs of any compensation payable as a result of policies mis-sold or as described in paragraphs 5.4.2(f), 5.4.2(j) and 5.4.2(o), expressed each year as an addition or reduction to the investment return.

The element relating to the initial outsourcing fee payable to UISL is different for life and pension business. Other than this, the adjustment to the investment return percentage is currently uniform for all such policy classes, although it was different in past years in accordance with the then practices.

Some larger business profits or losses may be spread over a number of future years.

No profits or losses are charged to final salary *unitised* with-profits group pension policies.

These practices may be changed if the *Board* consider it necessary to do so to enable the fund to meet the objectives set out in Principle 5.4.

In respect of 2010 and subsequent years, only those business profits or losses arising from the *2009 Scheme* policies will be attributed (and only attributed) to the *asset shares* of specimen policies used to determine the benefits for *2009 Scheme* policies. Moreover, in respect of those years, the effect of the attribution of business profits and losses to the specimen policies used to determine the benefits of policies which are not *2009 Scheme* policies will be no more than had the *2009 Scheme* not been implemented. This practice may only be changed with the agreement of the FSA.

(t) *Estate* distribution or charge

Asset shares may be increased by distributions from the *estate* (excess assets) or reduced by charges to the *estate* (excess assets). Currently no such distributions or charges are being made to *asset shares*.

No distribution or charge is made to final salary *unitised* with-profits group pension policies.

(u) *2009 Scheme* uplifts

The *asset shares* of specimen policies used to determine the benefits for *2009 Scheme* policies receive an uplift. This uplift is expressed as an additional percentage return in respect of 2009. The uplift differs by policy class, premium mode, inception year and *maturity* year. For 2010, the amounts are provisionally calculated.

- 5.4.3 The specimen policies are either:
- *traditional* with-profits policies which are about to reach *maturity*, either for quinquennial terms or for a wider range of terms; or
 - *unitised* with-profits policies, for every past year (month, in the case of with-profits bonds, quarter for final salary *unitised* with-profits group pension policies) of commencement.

Separate single premium and regular premium specimen policies are used. Policies generally reflect the average size and policyholder age for the year of issue and term. Where *final bonus* rates or *market value reductions* are shared by policies of different years of issue or different premium types, the specimen policies may be grouped or otherwise averaged.

Separate specimen policies are used to determine the benefits for *2009 Scheme* policies and to determine the benefits for policies which are not *2009 Scheme* policies. These may only be changed with the agreement of the *With-Profits Actuary*. Different specimen policies are also used to determine the benefits for standard single premium *2009 Scheme* policies and for National Insurance contribution rebate *2009 Scheme* to policies.

For final salary *unitised* with-profits group pension classes, the specimen policies referred to are tranches of units issued within particular quarterly periods to give *final bonus* rates which are applied to units within the policy issued at the appropriate times.

For other *unitised with-profits* pensions business, regular premium *final bonus* rates and *market value reductions* are set by averaging single premium *final bonus* rates and *market value reductions*. The retirement year of the specimen policies used to set *final bonus* rates and *market value reductions* is chosen to be representative of the underlying business.

Asset shares are not calculated for specimen whole life, paid-up and altered policies. As a result the target ranges described in sections 5.6 and 5.8 do not apply to policies of these types.

- 5.4.4 Various approximations are inherent in the *asset share* method described above and in the general applications of the Principles in practice. These include:
- The assumption that the investment return earned in any year is earned uniformly over that year (except for with-profits bonds, where monthly differences are reflected and final salary *unitised* with-profits group pension policies, where quarterly differences are reflected).
 - The investment return itself is only calculated approximately during the course of a year (by the use of appropriate indices) and is updated after the end of each year to reflect the actual performance earned.
 - The asset mixes used to determine investment returns may not be exactly in line with the actual assets held.
 - Carrying out the calculations (and hence changing *final bonus* rates) only infrequently (such as monthly, half yearly or annually),
 - An inevitable time delay before actual experience is reflected in bonus rates and their application to policies.
 - The application of bonus rates determined using a specimen policy of one type to policies of another type (such as the use of *final bonus* rates determined for standard endowment policies for low start endowments and for whole life policies).
 - Where the premium rate for a specimen policy changed in the middle of a year of issue, the *final bonus* may be based on either the pre or the post change rate.
 - The use of specimen policies will usually mean that small premium policies receive more than *asset share* (as many administration costs are independent of premium size) and large premium policies less.

- The use of specimen policies only for selected terms of policy and the interpolation of *final bonus* rates for intermediate terms will mean that the amounts paid on policies of those intermediate terms will not necessarily equal *asset share*.
- The calculations of *final bonuses* are based on specimen policies with a typical and straightforward premium history and so the bonuses will be only approximate for policies with complex premium histories. Similarly bonuses will be only approximate for policies that have been altered in other ways.
- For policies which have been made paid up, the use of *final bonus* rates applicable to policies which have been premium paying throughout. Or, alternatively, the application to both types of policy of *final bonus* rates calculated using both specimen paid-up policies and specimen premium paying throughout policies.
- Specimen policy calculations generally assume that all policies were subject to standard terms, including sales commission.

Some of these approximations, as well as others not listed, will also be present in the calculations of the excess assets of the fund from time to time.

5.4.5 Items not charged to *asset shares*, the effects of the approximations in the experience assumptions and the effects of other approximations in the methods employed feed through to the *estate* as described in section 5.12.

5.4.6 The procedures have been documented that set out how the *asset share* calculations described above are to be carried out and how the parameters to be used in the calculation are to be derived each year. A permanent record is kept of the historic parameters used. Some of the instructions for the detailed computations are embedded within a number of computer programs.

5.4.7 Any change to the practices used, including those used to determine the excess assets in the fund, would be subject to the procedure described in section 2.

Any material changes to the historical parameters used would, if a result of the identification of a past inaccuracy, be notified by the *Head of Actuarial Function* to the *Board*, the *With-Profits Actuary* and the *With-Profits Committee* at the time of the next recommended change in bonus rates. If considered appropriate, any changes may be phased in over a period rather than implemented at once.

Any proposed changes to the historical parameters for other reasons would be subject to the same processes as a change in practice.

5.4.8 *Asset share* practices are not guaranteed and may be changed in future.

Asset share methodology and processes will be regularly reviewed by the *Board* and may change. This may include changes to the historical aspects of the calculations as a result of a variety of factors, including changes in regulations, improvements in the degree of approximations, maintaining equity between classes and groups of policyholders and significant changes in the financial condition of Phoenix & London Assurance Limited. Any changes will take into the requirements of the *2009 Scheme*.

Bonus Declarations

5.4.9 Bonus declarations are approved by the *Board* or sub-committee of the *Board* or delegated to senior management and then retrospectively approved by the *Board*.

5.4.10 The amount payable (or available to convert to a pension) on most *traditional* with-profits policies on *maturity* is the total of:

- the sum assured;
- the *annual bonuses* added whilst the policy has been in force; and
- *final bonus*, if any.

Exceptions are some pension policies, where the sum assured and bonuses are expressed as annual amounts of pension rather than as cash amounts.

The amount payable (or available to convert to a pension) on most *unitised* with-profits policies on *maturity* is the total of:

- the value of the units; and
- *final bonus*, if any.

Exceptions are some pension policies which may be subject to a full or limited *market value reduction* at *maturity*, where either is allowed under the policy conditions.

Amounts payable on the encashment of policies at times other than *maturity* are determined in different ways.

The rate, if any, of *final bonus* which applies to a particular policy class, date of issue and date of *maturity* is currently determined in most cases with reference to the *asset share* of a representative range of specimen policies.

5.4.11 Bonuses are reviewed regularly at least once a year.

The timing of *annual bonus* reviews is described in section 5.5.5.

The timing of *final bonus* reviews is described in section 5.6.4.

5.4.12 The timing of *final bonus* declarations may be varied.

5.4.13 *Final bonuses* are expected to, but are not guaranteed to, apply until the next planned review date. These bonuses may be reviewed at any time between normal planned review dates. Additional reviews would normally only be in response to exceptional investment market movements.

5.4.14 *Final bonus* reviews also consider the amount of *final bonus* paid on *non-protected exits* (surrenders) for policies where the *surrender value* calculation makes explicit use of the current *final bonus* scale.

5.4.15 Bonuses are declared out of surplus arising in the year or in anticipation of surplus arising. If there is no surplus or no expectation of surplus arising, no bonuses can be declared.

Principle

5.5 **Annual Bonus Rates**

In circumstances where the value of our assets is fairly close to the minimum amount required to enable us to meet our aims described in section 5.4 above, low or nil rates of *annual bonus* are likely to be added for most classes of with-profits policy. Conversely, if the value of our assets is more than reasonably sufficient, higher rates of *annual bonus* are likely to be added for many classes.

We apply separate *annual bonus* rates to different policy classes to reflect the different aspects of the products, including tax treatment, country of issue, form of benefit and extent of guaranteed benefit (although we do not differentiate between policies of the same class with and without guaranteed annuity options other than for *2009 Scheme* policies). Apart from with-profits bonds, we do not currently differentiate between different dates of issue, although we may do so in the future if it helped us to better satisfy the aims described in section 5.4 above.

Although we no longer accept most classes of new business, other than under options on existing policies, we might at some time introduce alternative products into which existing customers could switch their benefits at their discretion, which might receive different bonus rates.

Practices

- 5.5.1 The *Board* makes decisions on *annual bonus* declarations taking into account a number of factors. These factors are set out in paragraphs 5.5.2 to 5.5.7.
- 5.5.2 *Annual bonuses* currently take the form of:
- additions to the sum assured (or equivalent amount) and / or to existing bonuses (*traditional* policies); or
 - increases in the price of units (*unitised* policies).
- 5.5.3 At present, for all classes of policy, very low *annual bonuses* are being declared, in accordance with Principle 5.5 above, because the value of the excess assets is small. For these policies, the *Board* do not expect to be able to increase *annual bonus* rates for a number of years. It may not even be appropriate, in some years, to add any *annual bonus* at all. Only if the value of excess assets relative to the size of liabilities remaining in force has increased substantially would the *Board* expect to make any increases.
- 5.5.4 If *annual bonus* rates can increase in the longer term, they would not be increased above a level which would provide reasonable certainty that at *maturity* (or on any termination in the case of bonds, or on any *normal scheme claim* in the case of final salary *unitised* with-profits group pension policies) there would be for most policies an excess of *asset share* sufficient to pay a *final bonus* equivalent to at least 2% of the guaranteed benefits (sum assured and *annual bonuses* or value of units) for each year the policy had been in force.
- 5.5.5 Currently *annual bonus* rates are reviewed as follows:
- for *traditional* policies, towards the end of each year, with changes taking effect from 1 January; and
 - for *unitised* policies, in time for the new rates to take effect from the 1 March and 1 September.

However, rates may be reviewed at other times should it be considered to be necessary to continue to adhere to the Principles.

- 5.5.6 There is no particular maximum amount by which *annual bonuses* would alter if it was decided that it was necessary or appropriate to change them. However, it is unlikely that *annual bonus* rates would change by more than 2% (such as from 3% to less than 1% or more than 5%) in any 12 month period.
- 5.5.7 For policies which are eligible for an *interim bonus*, this is currently set equal to the last actual rate paid.

Principle

5.6 *Final Bonus Rates*

Final bonus may be added to policies when they terminate or when benefits are encashed for other purposes, with the aim of ensuring, if they do not already do so, that benefits reflect fairly a share in the profits (and losses) which have been generated within the with-profits fund whilst the policy has been in force.

We apply separate *final bonus* rates to different policy classes to reflect the different aspects of the products, including tax treatment, country of issue, form of benefit and extent of guaranteed benefit (although not the presence or absence of guaranteed annuity options other than for *2009 Scheme* policies). For most policy classes, we also differentiate between different dates of issue and different periods in force. On death and on early termination, the *final bonus* added may be higher or lower than indicated above, for reasons explained in our Practices.

Practices

5.6.1 For each specimen policy, we determine a proportion of *asset share*. This proportion will vary from time to time, may be greater or less than 100% and may vary by class of policy, date of issue, *term remaining* to a date at which a guarantee or option applies or other relevant factor.

For each specimen policy the following are compared:

- (i) the appropriate proportion of each specimen policy's *asset share*; and
- (ii) the total of the sum assured and the *annual bonuses* already added to that specimen policy (or the value of units for a *unitised* policy or the value of the annuity benefit for pre 1981 Section 226 retirement annuity policies).

If (i) is the larger, a *final bonus* for the specimen policy is normally set using the methods described below. If (ii) is the larger, no *final bonus* will normally be set for that specimen policy.

The target for the proportion in (i) is 100%. The proportion used for particular specimen policies may be affected by *smoothing* applied to similar representative specimen policies maturing at different times (see section 5.7). The amount of *smoothing* may be constrained to maintain the proportions in (i) within the range 80% and 120% for most specimen policies.

For each specimen policy where a *final bonus* is to be set, the excess of (i) over (ii), after any *smoothing*, is expressed as a percentage of:

- the sum assured only for *traditional* policies which are not *2009 Scheme* policies;
- the sum assured plus *annual bonus* additions for *2009 Scheme* policies (such practice not to be changed without the agreement of the FSA);
- the value of units for *unitised* policies; or
- the value of the annuity, including *annual bonus* additions, for pre 1981 Section 226 retirement annuity policies.

This is then the new *final bonus* rate for all policies of the same type and duration in force as the specimen policy.

Where a rate is not derived for every duration, the rates applicable for other durations are determined by interpolation or extrapolation between the rates derived as above.

5.6.2 *Final bonus* and *market value reductions* do not apply at the same time to any of the policies.

- 5.6.3 *Final bonus* is paid on death claims on *traditional* whole life and endowment policies at the rate that applied to endowment policies which commenced at the same time and reached *maturity* at the date of death.
- 5.6.4 For all classes of policy the *final bonus* rates may be changed at any time. At times when the value of the excess assets in the fund is not changing rapidly, this is likely to mean that changes, if any, are made monthly for with-profits bonds, quarterly for final salary *unitised* with-profits group pension policies and one to two times per year (effective from 1 January and 1 July) for most other classes. However, a sudden change in the value of those excess assets (such as because of a significant change in the value of equity share markets) may cause changes to the *final bonus* rates on other occasions.
- 5.6.5 As the value of assets are changing every day but *final bonus* rates are only recalculated infrequently, there will inevitably often be times when, if the *asset shares* for specimen policies were recalculated, *final bonus* would, in effect, be based on slightly larger or smaller percentages of those *asset shares* than the practices would in theory dictate. Normally an investment return variation of up to 10% compared to that assumed when the *final bonuses* were last reviewed, would be allowed before there would be an additional *final bonus* review. However, where the proportion of *asset shares* at the latest *final bonus* review was near the top or bottom of the range described in paragraph 5.6.1, a lower level of investment return variance may lead to an additional *final bonus* review.

Due to the improved investment conditions, an interim review of final bonuses was made from October 2009, even though the investment return variance compared to that assumed when the July 2009 *final bonuses* were reviewed was less than 10%.

Principle

5.7 **Smoothing**

Smoothing refers to the practice of limiting the change in *final bonus* rates on any one occasion so that the benefits paid to policyholders differ from those which would otherwise apply and also to the practice of limiting the frequency of such changes. *Smoothing* means that the value on similar policies maturing at different times either vary little (between changes in *final bonus* rates) or change by no more than a specified amount over a given period. We apply *smoothing* to all classes of policy which are eligible for *final bonus* and to all types of claim. However, we make more frequent and generally smaller changes to some classes of *unitised* with-profits policies.

We intend *smoothing* to have a neutral effect over time. In other words, if applying the limitation on the changes in rate of *final bonus*, results for a period in different amounts of discretionary benefits than we would otherwise have paid, then in a subsequent period we would adjust discretionary benefits by a broadly equal and opposite amount when circumstances and our practices allow.

Other than on death or early termination, we aim at all times to pay policy benefits that are close to those described under section 5.6. Accordingly, we do not *smooth* very much and *final bonus* rates and total policy benefits may change by relatively large amounts both on any one occasion and over a 12 month or longer period. The cost of *smoothing* is not expected to be material at any time and so we impose no specific upper limit on it.

Our *smoothing* principles also generally underlie the *market value reductions* which may apply to most *unitised* policies. However, we do not necessarily apply these principles when determining the amount payable on *traditional* policies which are terminated significantly early.

Practices

5.7.1 For with-profits bonds, *smoothing* is applied to policy benefits by means of an adjustment to the credited investment return. However, *smoothing* is only applied when *asset shares* are more than 95% of the *asset share* with the *smoothing* adjustment applied to the investment return. When *smoothing* does apply, *final bonus* rates or *market value reductions* are set in relation to an investment return, including business profits and losses smoothed over three years. The smoothed investment return over the first three years of a specimen policy is calculated in part by reference to a deemed return in respect of the period prior to the commencement of the policy or series. This rate is determined by the *Board* from time to time.

5.7.2 For other *unitised* classes and for *traditional* classes, when *smoothing* is applied, it is done by limiting the change in *final bonus* rates.

For other than final salary *unitised* with-profits group pension policies, the change in *final bonus* rates for a specimen policy is normally limited to an amount which will limit the increase or reduction in total *maturity* or retirement value for similar policies to 15% over any 12 month period and to 7.5% on any one occasion. The similar policies that are used generally have the same term and premium. However for *traditional* with-profits deferred annuity policies in particular, the similar policies are based on the same year of entry.

However, if it is necessary for the fund to continue to meet the objectives set out in Principle 5.4 or to maintain the proportions described in paragraph 5.6.1(i) within the range set out in paragraph 5.6.1 for the majority of specimen policies, larger

changes in *final bonus* rates are sometimes made. When this had been done recently, the resulting changes in *maturity* or retirement values have not exceeded 20% over any 12 month period or 10% on any one occasion.

In light of the exceptional (not normal) investment conditions, for the January 2009 *final bonuses*, an additional 5% reduction in *payout* was allowed before *smoothing* restricted changes in *final bonus* rates. Thus for the January 2009 *final bonuses*, reductions in *payouts* were limited to 12.5% compared to 1 July 2008 and 20% compared to 1 January 2008. In addition, for the July 2009 *final bonuses* a further additional 5% reduction in *payout* was allowed before *smoothing* restricted changes in *final bonus* rates. Thus for the July 2009 *final bonuses*, reductions in *payouts* were limited to 12.5% compared to 1 January 2009 and 25% compared to 1 July 2008.

In light of the exceptional (not normal) investment conditions, for the interim October 2009 *final bonuses*, an additional 5% increase in *payout* was generally allowed before *smoothing* restricted changes in *final bonus* rates. Thus for the interim October 2010 *final bonuses*, increases in *payouts* were generally limited to 12.5% compared to 1 July 2009. For *unitised* with-profits business, reductions in *market values reductions* were not restricted by *smoothing*.

In light of the exceptional (not normal) investment conditions, for the January 2010 *final bonuses*, an additional 5% increase in *payout* was generally allowed before *smoothing* restricted changes in *final bonus* rates. Thus for the January 2010 *final bonuses*, increases in *payouts* were generally limited to 12.5% compared to 1 July 2009. For *unitised* with-profits business, reductions in *market values reductions* were not restricted by *smoothing*.

For final salary *unitised* with-profits group pension policies, changes in the *final bonus* rate or *market value reductions* are normally limited to 5% per quarter. However, if it is necessary for the fund to continue to meet the objectives set out in Principle 5.4 or to maintain the proportions described in paragraph 5.6.1(i) within the range set out in paragraph 5.6.1 for the majority of specimen policies, larger changes in *final bonus* rates (or *market value reductions*) are sometimes made.

- 5.7.3 If no *final bonus* is set for a specimen policy for the reasons described in paragraph 5.6.1, changes to *maturity* or retirement values arising from earlier changes to the rate of guaranteed benefit per £1 of premium will not be subject to the limits described above.
- 5.7.4 In addition, for *traditional* classes, calculations are carried out for specimen policies which are due to reach their *maturity date* in the following few years. If these calculations show a trend in *payouts* which could not be accommodated by following the normal limits on change described above, the *final bonus* rate being determined may be adjusted so that the trend may more easily be accommodated.
- 5.7.5 The period over which *smoothing* will be of neutral effect on a class of policies is indirectly determined by the application of the above practices.
- 5.7.6 Applying *smoothing* does mean that on occasions, particularly for *traditional* policies, payments are more or less than the proportion of *asset share* which it is considered appropriate to pay. This difference will reduce or increase the excess assets of the fund. There is no particular maximum accumulated cost of or benefit to the fund which is allowed, although no *smoothing* accumulation would be allowed to build up which was inconsistent with the achievements of the objectives set out in the Principle 5.4.

- 5.7.7 For *traditional* policies, the approach to *surrender* and transfer values described in section 5.8 depends upon a number of factors. In some cases, changes in these factors may lead to quite large proportionate changes in values for policies with a long time to go to *maturity* or retirement. *Smoothing* is not necessarily applied to these changes. These changes may also take place at different times to the changes in *final bonus* rates. Where the method uses the *final bonus* rates payable at *maturity* or retirement on other policies, the *smoothing* described in this section 5.7 will apply.
- 5.7.8 Other than in the charge described in paragraph 5.4.2(o), for those *unitised* policies which permit small regular withdrawals without a *market value reduction* being applied, the eventual value of the uncashed units takes no account of the extent, if any, to which the withdrawn amounts have exceeded the proportion of *asset share* considered appropriate to pay at the time of each encashment.
- Other than in the charge described in paragraph 5.4.2(o), for final salary *unitised* with-profits group pension policies which permit units to be encashed to meet *normal scheme claims* without a *market value reduction* being applied, the eventual value of the uncashed units takes no account of the extent, if any, to which the withdrawn amounts have exceeded the proportion of *asset share* considered appropriate to pay at the time of each encashment.
- 5.7.9 Any cost to the fund of partial payments under *unitised* policies to which a *market value reduction* does not apply does not affect the remaining value of the policies concerned. Rather, it reduces the value of the excess assets in the fund (although the excess assets will be increased for charges levied in respect of such guarantees).

Principle

5.8 *Surrender Values*

Our aims when determining the amounts payable to with-profits policyholders are to pay discretionary benefits only to an extent that would not unreasonably put at risk our future ability to continue to pay all guaranteed benefits when due, whilst taking account of the need to treat customers fairly relative to their reasonable expectations and to other current and past customers.

Practices

5.8.1 *Non-protected exits* refer to surrenders and transfers for pensions business.

5.8.2 For *traditional* policies that surrender, the aim is to make payments that are, in aggregate and over time, across all specimen policies used in determining surrender bases, a proportion of *asset share* (after any guarantee charge on surrender described in paragraph 5.4.2(o)) that we target.

For policies which are not *2009 Scheme* policies, this is currently 95% for policies with a *term remaining* of 10 years or more, increasing gradually to 100% at *maturity* for policies with less than 10 years remaining. For *2009 Scheme* policies, this is currently 97% for policies with a *term remaining* of 10 years or more, increasing gradually to 100% at *maturity* for policies with less than 10 years remaining. The proportion for *2009 Scheme* policies may only be reduced with the agreement of the FSA.

5.8.3 Actual surrender payments on individual policies will not generally be in line with the target proportion because:

- Individual *asset shares* are not calculated or held on our administration systems for use in *surrender value* calculations. Rather *surrender values* are calculated in a variety of ways for different types of policy. Typically *surrender values* are based on a discounted value of the guaranteed sum at *maturity* or retirement (reduced to allow for non-payment of future premiums for regular premium policies) together with an allowance, where appropriate, for *final bonus*.
- Specimen policies are used to determine the parameters in the *surrender value* calculations. The outcome for a particular individual policy may be different from that of the specimen policy.
- There are a limited number of parameters that may be altered in the surrender formulae for certain products which means that the parameters are set in aggregate across a range of specimen policies.
- As the value of assets are changing every day but the parameters in the *surrender value* formulae are only reviewed infrequently, there will inevitably often be times when, if the *asset share* for the specimen policies were recalculated, *surrender values* would, in effect, be based on slightly larger or smaller percentages of those *asset shares* than the practices would in theory dictate.

5.8.4 For the reasons given above, *surrender values*, when expressed as a proportion of *asset share*, are expected to fall in a wide range around the target proportion. However, the parameters in the *surrender value* bases are reviewed periodically with the aim that the majority of *surrender values* for the range of specimen policies analysed, will fall within the range of 60% to 115% of *asset share* (after deduction of the charge for guarantees on surrender described in paragraph 5.4.2(o) above).

- 5.8.5 In some cases, values in excess of 115% of *asset share* may be payable when policies are surrendered close to *maturity* and the *asset share* of the relevant specimen policy is less than the guaranteed benefits at *maturity*, or the *maturity payout* is in excess of the *asset share* due to *smoothing*. This may also occur if the value of the guaranteed benefits is high relative to *asset share*, due to the effective maximum discount rate used in the surrender bases. The effective maximum discount rates used are currently 8.0% for pensions business and 6.4% for life business.
- 5.8.6 For *traditional* policies, the method used to derive the *surrender* or transfer value may not involve the explicit application of *final bonus*. Where the value paid is larger than the discounted value of the guaranteed sum assured and *annual bonuses* already added, an element equivalent to *final bonus* will be implicit in the value. For the purposes of determining the shareholder's entitlement to profit in respect of any *surrender* or transfer, an appropriate proportion of the value paid is deemed as representing *final bonus*.
- 5.8.7 For *unitised* policies, a *market value reduction* will be applied in most circumstances where the calculation described in paragraph 5.6.1 results in a shortfall of the determined proportion of *asset share* relative to the value of units. The amount of the *market value reduction* will not exceed the amount of the shortfall. Any reduction in *market values reduction* is not restricted by *smoothing*. Most policies contain a date or range of dates on which no *market value reduction* or a limited *market value reduction* will apply. Some policies also allow small regular encashments to be made without a *market value reduction* applying (but otherwise the same *market value reductions* apply to partial as to full encashments). The final salary *unitised* with-profits group pension policies allow that a *market value reduction* will not apply to units encashed to meet *normal scheme claims*.

As the value of assets change every day but *market value reductions* are only reviewed periodically, there will inevitably often be times when, if the *asset share* for the specimen policies were recalculated, *surrender values* would, in effect, be based on slightly larger or smaller percentages of those *asset shares* than the practices would in theory dictate. Normally an investment return variation of up to 10% compared to that assumed when *market value reductions* were last reviewed, would be allowed before there would be an additional *market value reduction* review.

Where bulk surrenders of final salary *unitised* with-profits group pension policies are being made at a time when investment values are falling then *market value reductions* may be reviewed more frequently.

- 5.8.8 The percentages described above may be changed at any time, as may the methods of calculation. However, before any changes are made, the *Board* will formally consult with and take into account the opinions of the *Head of Actuarial Function*, the *With-Profits Actuary* and the *With-Profits Committee*.

Principle

5.9 Investment Strategy

Overall, our strategy will be to invest in fixed interest securities, equity shares ('shares') and commercial property ('property'), either directly or through vehicles such as unit trusts, OEICS or derivatives. Shares and property will only be held to the extent to which this is possible without unduly putting at risk our ability to meet guaranteed benefits as they arise. Some cash or equivalent assets may be held for liquidity purposes.

For certain purposes, including determining the bonus rates applicable to policies, we may take account of assets such as future profits. The investment strategy adopted in respect of the reserves held to meet guarantees is described in paragraphs 5.9.11 and 5.9.12 of our Practices.

We may from time to time rely on assets outside the fund to provide some or all of a margin against future adverse change in investment markets. Our investment strategy is, however, based upon the intention that we will meet our aims using only the assets of the with-profits fund after repayment of any loans or other financial support received.

We may use derivatives from time to time to make changes in our investment dispositions more rapidly or cheaply than could be done directly through the markets. We may also use them from time to time to reduce the risk of loss, for example from share price falls, interest rate changes or exchange rate fluctuations.

There is no direct link between individual policies and specific assets. The proportion of shares and property used indirectly to determine the bonuses applicable to different policies may differ between different products, dates of issue or *term remaining* to reflect the different risks to both the specific policyholders and to policyholders and the *shareholder* more generally. For some with-profits policies with relatively high guaranteed benefits, this may mean that few or no shares and property will be deemed to be held.

Non-profit, non-linked policies are backed by fixed interest securities of appropriate duration.

Index-linked and unit-linked liabilities are either backed to the extent possible with close-matching assets or, in the case of unit-linked policies, reinsured to a sister company, which does so.

We aim to restrict the maximum loss which we could suffer from the complete default of any one external counterparty, whether through reinsurance, direct investment or derivatives by dealing with a wide range of counterparties. In some cases, additional precautions such as daily *marking to market* or *deposit back* are used.

Larger, unprotected exposures are permitted to sister companies (regulated UK life insurers) through internal reinsurance arrangements.

From time to time our investments may include a small number of properties which are occupied by the company or by a related company and which we would not expect to trade.

Practices

- 5.9.1 There are no formal procedures in place for assets to be transferred permanently from the *Shareholder Fund* to the with-profits fund. Formal loan arrangements as described in paragraphs 5.4.2(p) and 5.12.6 and section 5.14 may be in place from time to time but would not normally be considered as permanently irrecoverable at any time.
- 5.9.2 The investment strategy is kept constantly under review. In particular, reports from the *investment managers*, the *Head of Actuarial Function*, the *With-Profits Actuary* and the *With-Profits Committee*, and recommendations for change are considered and, if appropriate, implemented.
- 5.9.3 All the guarantees to policyholders and liabilities to other creditors are not completely matched with assets which provide a similar guarantee or payment. In particular, often a proportion of the assets is invested in equity shares and commercial property because it is considered that, over most longer periods of time, a better return will result. Separate investment strategies are followed for assets equal in amount to the estimated aggregate *asset shares* of policies and for assets representing additional provisions for liabilities under non-profit policies, for guarantees on with-profits policies, for other liabilities and for the capital margins and excess capital. Each of these strategies is described in more detail below.
- 5.9.4 It is not possible to implement the strategies described below with absolute precision and any difference between the actual outcome and the theoretical outcome will be treated as described in paragraph 5.4.2(s).
- 5.9.5 Investment returns allocated to the *asset shares* of specimen policies will reflect the actual mix of assets held, should this be different from the theoretical mix calculated according to paragraphs 5.9.6 to 5.9.10.

Asset Shares

- 5.9.6 Firstly, the appropriate asset mix for a large number of specimen policies of different types, *term remaining* and commencement dates is determined.

For final salary *unitised* with-profits group pension policies, the asset mix for 2010 is currently expected to be approximately 34% in equity shares, 11% in commercial property and approximately 55% in fixed interest securities.

The asset mix for all other classes of policy is determined by the successive application of a number of rules:

- (i) For policies which are not *2009 Scheme* policies, the asset mix for 2010 is currently approximately 25% in equity shares, 25% in commercial property and approximately 50% in fixed interest securities with a small balance invested in cash and / or other assets such as future profits.

For *2009 Scheme* policies, the target asset mix for 2010 is approximately 45% in equity shares, 25% in commercial property and 30% in fixed interest securities with any balance (such balance not to exceed 10%) invested in cash and / or other assets such as future profits. From time to time, on the advice of the *investment manager* for the purposes of increasing the expected return for policyholders and subject to the approval of the *With-Profits Actuary* (such approval not to be given unless it is unlikely to have a materially adverse affect on the interests of holders of *2009 Scheme* policies), other assets may be held instead of part of the above proportions of equity shares and commercial property. Otherwise, the asset mix for *2009 Scheme* policies may only be changed with the agreement of the FSA.

For policies reassured to the Phoenix Life Limited Phoenix With-Profits Fund (see below), the asset mix is currently expected to be approximately 70% in growth investments and approximately 30% in fixed interest securities with a small balance invested in cash and/or assets such as future profits and other assets. Growth investments will normally consist of equity shares and commercial property. However, the *investment manager* may also choose to hold other types of investment within the growth investment category including corporate bonds, cash, total return funds, derivatives, currencies and commodities.

Unless

- (ii) There are less than nine years of *term remaining*, when the mixes are changed as the *term remaining* reduces. For policies which are not *2009 Scheme* policies, the mixes change proportionately until they are 10% in equity shares, 7.5% in commercial property and 82.5% in fixed interest securities with one year or less of *term remaining*. For policies subject to the *2009 Scheme*, the mix changes proportionately until they are 22.5% in equity shares, 12.5% in commercial property and 65% in fixed interest securities with one year or less of *term remaining*. For policies reassured to the Phoenix Life Limited Phoenix With-Profits Fund, the mixes change proportionately until they are 29.2% in growth investments and 70.8% in fixed interest securities with one year or less of *term remaining*.

Unless for policies which are not *2009 Scheme* policies

- (iii) The rate of return required from equity shares and commercial property (or growth investments as appropriate) for the *asset share* of that specimen policy to grow over the *term remaining*, after the deduction of retentions and charges, to equal the projected guaranteed benefits at the *maturity date* is more than 5% per annum gross, when the equity and property proportions above are reduced according to the table below (and the proportion in fixed interest securities increased to balance).

Rate of return required*	Reduction applied
5% - 7.5%	33%
7.5% - 10%	67%
10% or more	100%

(* For *terms remaining* of seven years or less, the dividing points of 7.5% and 10% are higher, rising to 11% and 17% respectively for terms remaining of one year or less).

For the purpose of determining the exposure to equity shares and property (or growth investments, as appropriate), the *term remaining* for a with-profits bond will be taken as:

- for bonds with a future guarantee date upon which no *market value reduction* will apply on surrender, the time to that guarantee date; or
- for bonds which have passed the date upon which such a guarantee applied, 10 years.

For *unitised* with-profits life regular premium policies, the mix in (i) applies to all specimen policies and the rules in (ii) and (iii) do not apply to these policies.

The investment return credited to *asset shares* of the policies which are reassured to the Phoenix Life Limited Phoenix With-Profits Fund is based on the investment return of the Phoenix Life Limited Phoenix With-Profits Fund. The following *unitised* with-profits policies are reassured to the Phoenix Life Limited Phoenix With-Profits Fund:

- *unitised* with-profits bonds written after September 1997;
- Executive pension plan;
- Company pension scheme;
- Company additional pension scheme;
- Individual personal pension plan;
- Group personal pension plan; and
- Personal additional pension plan.

5.9.7 The parameters defining the asset mix of policies which are not *2009 Scheme* policies may be changed from time to time. When doing so, account will be taken of the results of stochastic modelling calculations which demonstrate the range of reasonable parameter sets that satisfy the aims described in Principle 5.9. From within this range, one is selected which is considered to best balance the interests of all policyholders.

The parameters defining the asset mix for *2009 Scheme* policies may only be changed with the agreement of the FSA or changes may be made to the parameters on the advice of *the investment manager* and with the agreement of the *With-Profits Actuary* (as referred to in paragraph 5.9.6(i)).

For policies reassured to the Phoenix Life Limited Phoenix With-Profits Fund, it is our current intention to increase the 29.2% in growth investments set out in paragraph 5.9.6(ii) to 35% over 2010. However, this is dependent on the Phoenix Life Limited Phoenix With-Profits Fund having sufficient excess assets at the time. In anticipation that such increases will be made, the proportionate reduction for policies with less than nine years *term remaining* will be adjusted.

5.9.8 The actual proportions of different assets held will vary slightly from the specified parameters as asset value change, although the specified mixes will be restored at least annually. The target proportions of different assets for *2009 Scheme* policies may not be achieved immediately upon the *2009 Scheme* coming into effect on the advice of the *investment manager* and the approval of the *With-Profits Actuary* (such approval not to be given unless it was unlikely to have a materially adverse affect on holders of *2009 Scheme* policies).

5.9.9 Phoenix & London Assurance Limited has given two undertakings to the High Court in relation to the asset mix for *2009 Scheme* policies as specified in paragraph 5.9.6.

The first undertaking is that if:

- (i) the proportion of assets invested in equity shares and commercial property for *2009 Scheme* policies referred to in paragraph 5.9.6(i) should fall below a threshold of 65% (and below 65/70ths of the lower percentages applicable for *2009 Scheme* policies with less than nine years of term remaining as referred to in paragraph 5.9.6(ii)) ('the Threshold'); or
- (ii) Phoenix & London Assurance Limited intends to take any action which might reasonably be expected to cause the proportion of assets invested in equity shares and commercial property for *2009 Scheme* policies to fall or remain below the Threshold;

then, Phoenix & London Assurance Limited shall:

- (iii) immediately notify the FSA of the fall and the cause in relation to paragraph 5.9.9(i) and / or the intended action and the reason in relation to paragraph 5.9.9(ii); and
- (iv) in the event of a fall, put in place actions to restore the asset mix to above the Threshold as soon as reasonably practicable (and inform the FSA of those actions); or
- (v) in the event of an intended action, not to take that action until the *Board* has consulted with the *With-Profits Committee* and the *With-Profits Actuary* and has obtained the FSA's non objection to the action.

The second undertaking is that:

- immediately following 31 December 2009, and until the proportion of assets invested in equity shares and commercial property has exceeded the Threshold for the first time, it will keep the FSA regularly informed of progress towards that Threshold.

Either of the above High Court undertakings is capable of being amended by agreement between Phoenix & London Assurance Limited and the FSA. No such agreement will be effective to amend either undertaking unless produced in writing and signed on behalf of Phoenix & London Assurance Limited and the FSA, but for the avoidance of doubt, no amendment that is in fact produced in writing and signed will require High Court approval.

- 5.9.10 All policies are grouped according to the specimen policy which most closely represents them and the total *asset share* for each group is determined. That total is then invested in the proportions determined for the specimen according to the rules in 5.9.6.

For policies, other than *2009 Scheme* policies, the term of the fixed interest securities reflect the *term remaining*.

For *2009 Scheme* policies, the term of the fixed interest securities reflects the calendar years over which a pension bought with the proceeds of the specimen policy would be paid and this shall not be determined in any different way unless legislative change makes it appropriate to assume that the majority of the holders of *2009 Scheme* policies who retire under their policies will no longer take benefits predominantly in annuity form and such change in assumption is approved by the *With-Profits Actuary* (such approval not to be given unless it was unlikely to have a materially adverse affect on holders of *2009 Scheme* policies). Otherwise, the term of the fixed interest securities for *2009 Scheme* policies may only be changed with the agreement of the FSA.

For the purpose of determining the duration of the fixed interest investments, the *term remaining* for a *unitised* with-profits bond will be taken as:

- for bonds with a future guarantee date upon which no *market value reduction* will apply on surrender, the time to that guarantee date; or
- for bonds which have passed the date upon which such a guarantee applied, five years.

For *unitised* with-profits pension business without guaranteed annuity rates which are reassured to the Phoenix Life Limited Phoenix With-Profits Fund, the fixed interest duration is frozen once a policy has reached nine years of *term remaining*. For these policies with less than nine years of *term remaining* at 1 January 2008, the fixed interest duration is fixed based on the *term remaining* at 1 January 2008.

For *unitised* with-profits business that is reassured to the Phoenix Life Limited Phoenix With-Profits Fund, the term of any fixed interest securities which form part of the growth investments per paragraph 5.9.6(i) do not reflect the *term remaining*.

Guarantee Reserves

- 5.9.11 Firstly, the *market consistent* cost of the guarantees inherent in the with-profits policies is calculated. How this cost, net of the value of expected future guarantee charges and early termination profits, will change as the prices of equity and property prices rise and fall and as *volatility*, *credit spreads* and interest rates change is then calculated. A mix of assets which will broadly change in line with the change in the net cost of the guarantees is identified. This asset mix may require a *short position* in equities and property to be adopted and a *long position* in fixed interest securities or cash. It may also require the purchase or sale of financial instruments such as equity options, credit derivatives or the holding of fixed interest securities with an average term which is otherwise different.

This calculation may be done in respect of specimen policies in some cases and the results aggregated and in other cases a more approximate method is used.

As the equity and property prices, interest rates, credit spreads and *volatility* change, and in any case periodically, the appropriate asset mix for the guarantee reserve will be reassessed.

- 5.9.12 For guaranteed annuity options, two strategies are adopted.

To the extent that the *asset share* of the specimen policy with the option is invested in equities and property (or growth investments as appropriate), according to paragraphs 5.9.6 and 5.9.10, then currently the guarantee reserve is invested in fixed interest securities of duration appropriate to the guaranteed annuity rate assuming that the option is exercised, together with sterling *receiver swaptions* to protect against interest rates falling further. Additionally investments may be made in ways that mitigate the increase in guarantee costs if equity and property prices increase.

To the extent that the *asset share* is invested in fixed interest securities, then fixed interest securities of duration appropriate to the guaranteed annuity rate are invested in assuming that the option is exercised, together with sterling *payer swaptions* to protect against interest rates being at such a level that the option is not worth exercising.

Irrespective of the fixed interest assets actually held, the *asset share* of specimen policies with guaranteed annuity rates will, to the extent that they are deemed to be invested in fixed interest securities, be credited with the return on securities of duration appropriate to the *maturity* date of the specimen policy.

Non-Profit Policies, Other Liabilities and Capital

- 5.9.13 Assets representing the reserves for non-profit policies are invested in fixed interest securities of appropriate duration. Assets representing unit-linked liabilities which are not wholly reinsured are invested in the assets used to determine the value of the unit liability. Assets representing RPI-linked liabilities or expense reserves are invested in index-linked securities. Assets representing short-term liabilities are invested in cash or short-term debt. Assets representing capital, whether or not required to enable the fund to meet its objectives or to meet regulatory requirement, are mainly invested in fixed interest securities.

Current Asset Policy

- 5.9.14 Other than for the business reassured to the Phoenix Life Limited With-Profits Fund, for the fixed interest securities, the current benchmark is for 52.5% in UK government securities and 47.5% in non-UK government securities. For the non-UK government securities, the investment guidelines do not allow more than 3% of securities to be issued by bodies with credit ratings of less than BBB.

For the business reassured to the Phoenix Life Limited Phoenix With-Profits Fund, for the fixed interest securities, the current benchmark is 50% in UK government securities and 50% in non-UK government securities. For the non-UK government securities, the investment guidelines do not allow more than 3% of securities to be issued by bodies with credit ratings of less than BBB.

- 5.9.15 Investments are also made in sterling interest rate *swaps* to enable closer matching of fixed interest income and outgo requirements. All *swaps* and *swaptions* are regularly *marked to market* to minimise exposure to counterparty default.

- 5.9.16 Other than for the business reassured to the Phoenix Life Limited With-Profits Fund, of the equities, approximately two thirds are UK equities with the remainder being issued overseas, but these proportions will vary from time to time due to market movements and active management decisions taken by the *investment managers*. All but a small minority are quoted and regularly traded on a recognised stock exchange. Equities are actively managed relative to recognised index benchmarks. Individual stock selection is carried out by the investment managers based on their expert assessment of the relative prospects of available alternatives.

For the business reassured to the Phoenix Life Limited Phoenix With-Profits Fund, the growth investments are currently split about two thirds equity and one third property. Of the equities, approximately two thirds are UK equities and the remainder were issued overseas, but these proportions will vary from time to time due to market movements and active management decisions taken by the *investment managers*. All but a small minority are quoted and regularly traded on a recognised stock exchange. Equities are actively managed relative to recognised index benchmarks. Individual stock selection is carried out by the *investment managers* based on their expert assessment of the relative prospects of available alternatives.

- 5.9.17 Other than for the business reassured to the Phoenix Life Limited With-Profits Fund, currently, property investment is primarily through collective investment vehicles but direct holdings or other methods of exposure to property may also be held from time to time.

For the business reassured to the Phoenix Life Limited Phoenix With-Profits Fund, property investments include both directly owned properties and those held via collective investment vehicles.

- 5.9.18 Sufficient assets are disposable at short notice without material loss in value to meet foreseeable additional liquidity demands.

- 5.9.19 The fund does not hold any assets which are not normally traded.

- 5.9.20 The proportion of different assets described in this section may vary from time to time due to market movements and active management decisions taken by the *investment managers*.

The current expectation is that the equity and property exposure for final salary *unitised* with-profits group pension policies will reduce over time.

New Investment Types

- 5.9.21 Before investing in new or novel investment instruments, the *Board* will obtain the advice of the *Head of Actuarial Function* and the *investment managers* on the benefits and risks of the proposition. This would include an analysis of the nature and proportion of future outcomes in which the instrument would prove materially disadvantageous relative to more traditional alternative investments. If the instrument is to be held in material amounts in respect of with-profits policies, the *Board* will also seek the opinion of the *With-Profits Actuary* and the *With-Profits Committee*.

Principle

5.10 Business Risks

As well as investment performance and counterparty exposure, and amounts transferred to the *Shareholder Fund* (see section 5.12), our future ability to continue to pay all guaranteed benefits when due, and the amounts of *annual* and *final bonus*, will be affected by a number of other factors, 'business risks', that may arise from our existing portfolio of with-profits and non-profit business. These are listed, together with the controls which apply, in our practices.

In some cases, we will anticipate the effect of future profits or losses (such as the increasing longevity of annuitants) and reflect any changes in expected outcome immediately in discretionary payments. This reduces the likelihood that excessive business risk exposures will apply to the longest remaining with-profits policyholders, which is otherwise a particular risk because with-profits policies are expected to run off more quickly than non-profit policies.

Any profits made or losses incurred as a result of a business risk will normally be met by the fund, except where the business and the risk was wholly reinsured to another Pearl Group subsidiary. However, the costs of any compensation payable as a result of policies mis-sold by the company or its agents will not affect the reasonably expected benefits payable to policyholders. Costs specified by FSA rules as being the responsibility of the *Shareholder Fund* (such as regulatory fines) will be met by that fund.

We do not currently envisage that we would take on any business risks in addition to those to which we are already exposed although we may, if it appears to be potentially beneficial to policyholders to do so, increase our exposure to risks to which we are already exposed (such as by cancelling reinsurance arrangements). If we did take on or increase business risk, we would only do so if the reward was expected to be better than that from other investments with broadly equivalent risks (such as investing in shares or property). We would formally consult and take account of the opinions of our *Head of Actuarial Function*, our *With-Profits Actuary* and the *With-Profits Committee* before doing so.

We will annually review existing business risk exposures as part of the formal *Internal Capital Assessment* and take appropriate measures to limit risk to amounts to which it is fair for the with-profits business to remain exposed.

Practices

- 5.10.1 The main business risks of the fund, and the controls that are applied to those that Phoenix & London Assurance Limited can influence, include:
- Expenses of management – controlled mainly by outsourcing all business activities, including policy administration and investment management. Normal activities are outsourced on an agreed pricing basis. The main residual costs not subject to an agreed pricing basis are project activity and certain direct costs and fees.
 - Failure of non-group outsourced services provider – part of the administration services provided by PGMS are sub-contracted to UISL, however PGMS is not liable for any additional cost of providing these services which might arise if UISL were to default - controlled by having exit plans and/or financial guarantees from the provider's ultimate parent.
 - Meeting minimum guaranteed policy benefits (where these costs are reasonably attributable to the fund) and the cost of *smoothing* – controlled by having an appropriate rate of *annual bonus*, limiting the extent of *smoothing* and investing primarily to meet the guarantees, all whilst ensuring that customers continue to be treated fairly.

- Fluctuations and long-term trends in death or sickness rates – fluctuations are constrained by the use of reinsurance contracts to limit exposure on any one insurance policy but significant risks remain from improvements in longevity on existing annuities, deferred annuities and from future annuities under guaranteed options, though the latter risk has been significantly reduced by the *2009 Scheme*.
- Changes in taxation.
- Profits or losses from investments backing non-profit business or other liabilities and from investments which represent additional capital.
- The cost of guaranteed annuity options – risks from varying interest rates are controlled by investing in appropriate hedging assets but significant exposure remains in respect of improving longevity.
- Profits or losses from the early or late termination of policies – a significant increase in the persistency of policies with onerous guarantees could cause a significant reduction to other policy values.
- Provision of compensation for past legal or regulatory infringements, especially due to inadequate sales practices – controlled in part by ensuring that compensation is only paid where a legal entitlement exists.
- The cost of additional capital needed to be held for regulatory purposes or for the optimal management of the business – controlled by regularly reviewing the excess capital being held and by ensuring that only a commercial cost for capital is being paid.
- Profits or losses may arise from the reassurance of with-profits business.
- Failure of reinsurers – the reassurance credit risk is monitored.

5.10.2 In paragraph 5.4.2, how and to what extent business profits and losses are incorporated in the *asset share* calculations for specimen policies are described and so how each, if at all, affects the amounts payable under with-profits policies.

5.10.3 As a result of the approach described in paragraph 5.4.2(s), the effect of other business profits and losses on the amounts payable under with-profits policies will be implicitly smoothed as described in paragraph 5.6.4 and in section 5.7.

Also, as explained in paragraph 5.4.2(s), if a particularly large business profit or loss in any one year is experienced or identified, its incorporation may be spread in *asset share* calculations over a number of future years to avoid excessive impact on policy values in the short-term.

5.10.4 The outcome from all the business risk of the fund is currently mainly pooled across all with-profits policies in the fund, although this has not always been the practice in the past. Any exceptions are highlighted elsewhere in this document.

5.10.5 The risks of managing the policies borne by the fund include unanticipated costs due to errors resulting in payments made in excess of agreed scales. Such costs will only be charged to the fund to the extent that they can be met from the excess assets in the fund.

Principle

5.11 Expenses and Charges

Our overall aim when applying charges and apportioning expenses when determining the bonus rates to apply to different with-profits policies is to reflect the actual costs incurred. Costs include

- sales, marketing and administration costs, including commission to intermediaries in respect of new and existing business;
- investment management costs;
- charges for mortality, sickness and other insurance benefits; and
- charges for guarantees.

Costs may be recovered from policies directly, for example by the cancellation of units of *unitised* policies, or indirectly via bonuses and early termination values.

Where indirect costs are specific to a class of policy then, taking into account the approximations referred to in section 5.4, such costs will be taken into account in assessing the bonuses added to that policy class and in assessing the early termination value payable.

Where indirect costs are not specific to a single policy class, they will be apportioned across the policy classes to which they are relevant in a reasonable manner, as is explained in our practices.

Implicit charges for mortality, sickness and other benefits will generally reflect our own or insurance industry actual claims experience. Explicit charges for such benefits will be determined in line with policy conditions; where this requires periodic reviews in the light of experience, such reviews will be carried out and charges adjusted accordingly.

In some cases, policy conditions restrict the type and amount of charges that may be levied.

Some costs relevant to the company are incurred collectively at various levels within the Pearl Group hierarchy (such as general management, internal audit and IT). A share of these costs is attributed to the company on an appropriate and objective basis (such as time spent, headcount, salary and system usage).

We would change the way in which charges were apportioned between or allocated to policies or classes of policy and between different subsidiary companies if we considered that this was necessary to enable us to continue to treat customers fairly. The apportionment method may also change if it was possible to do so without ceasing to treat customers fairly and to do so assisted in meeting one of Pearl Group's other corporate objectives.

Charges for guarantees or *smoothing* may be made annually or by a retention from *maturity* or early termination values (or by a combination of both methods). The basis on which the charges will be determined are described in paragraph 5.4.2 of our practices.

Practices

- 5.11.1 The main expenses that are apportioned to the *asset shares* of specimen with-profits policies relate to the fees paid to PGMS in connection with all business activities. These charges are mainly expressed as an annual amount per policy, irrespective of type (other than for non-profit annuities, for which the fee is lower), increasing each year by more than the increase in the Retail Prices Index excluding mortgage interest (RPIX). For group pension plans, the fee is per

member rather than per policy. For policies with more than one benefit, including premium increments, the charge is only made once. They are apportioned on this basis.

Additional fees are payable for certain other one-off activities and developments. Such costs are generally apportioned in proportion to the PGMS fees.

Fees are also payable to the *investment managers* in connection with the management of the investments. These amounts are expressed as a percentage of the investments under management. Where investments are via a collective investment vehicle operated by the *investment manager*, the total fees payable to the *investment manager* are not materially different than if those investments were directly held.

Commission is also payable to intermediaries on some contracts.

- 5.11.2 Prior to 1 January 2005, the policy administration services only were outsourced to UISL. Both annual fees and an initial fee were paid to UISL over the period 2003 to 2005 and the proportion of these fees attributable to with-profits policies was apportioned to *asset shares*.

The lump sum administration fee payable to UISL is being taken into account as if it was spread evenly over a five year period.

- 5.11.3 The outsourcing agreement for investment management is with Ignis Asset Management and can be terminated on a rolling 3 year basis. The outsourcing agreement for policy administration and other business activities is a perpetual agreement and is not expected to be renegotiated. Both agreements can however be terminated early for a material failure to meet service standards / investment targets or other non compliance with the agreement. We regularly monitor service standards and achieved investment returns.

- 5.11.4 Other than to the extent that expenses are apportioned to non-profit business or to certain activities the expenses of which are not apportioned to *asset shares* (such as mis-selling compensation) or to the extent described in paragraph 5.4.2, the totality of expenses allocated to the fund will be taken into account via the *asset share* calculations for specimen policies. Costs attributable to the fund that are not apportioned to *asset shares* or non-profit business will reduce the excess assets of the fund.

It is not intended to include expenses at other than cost to *asset share* calculation, other than as described in paragraph 5.4.2.

Principle

5.12 Management of Excess Assets

We aim to manage the size of the excess of the value of the assets over the amount we consider necessary on *market consistent* assumptions to enable us to meet the aims we described in section 5.4, so that the excess provides at all times an adequate but not excessive margin against an adverse outcome compared with the assumptions. The excess can be made up of assets within the with-profits fund and assets within the *Shareholder Fund*.

We intend to maintain the excess at the targeted level by:

- controlling the addition of *annual bonuses* to policies;
- only paying *final bonuses* or other discretionary benefits in line with the principles set out earlier;
- maintaining an appropriate investment strategy;
- limiting, where possible, the business risks we face;
- exercising discretion in other areas with moderation;
- releasing *Shareholder Fund* assets to the *shareholder*, or
- as a short-term measure, drawing on additional financial support from the *shareholder* in the form of loans to the with-profits fund or otherwise.

We expect that by around 2030, there will be relatively few with-profits policies remaining in force. However, a substantial volume of non-profit pensions in payment (annuities) is expected still to remain, most of which will have been purchased with the proceeds of with-profits policies. It is our intention to ensure that a sufficient proportion of the excess assets is retained within the with-profits fund as would enable the remaining with-profits policyholders at that time to be protected from reasonable foreseeable subsequent losses without reliance on the *Shareholder Fund* or other external assets.

It may be possible to reinsure or sell these policies at some future time to one or more other companies. If so, some of the excess assets referred to above which would otherwise have arisen may need to be passed over as part of the transaction(s). However, the future liability for those policies would then be either removed completely or limited to counterparty exposure to one or more reinsurance companies. Any excess assets not passed over would then be treated as described above.

Practices

- 5.12.1 The main use of the excess assets is, in conjunction with the *Shareholder Fund*, to assist the company to demonstrate sufficient capital.
- 5.12.2 Certain costs are also charged directly to the excess assets in the with-profits fund. The main class of costs which are currently charged this way are the costs of compensation for past inadequate sales advice. See also paragraph 5.11.4.
- 5.12.3 Actual regulatory penalties (fines) are paid and compensation payments relating to events which occurred after 31 July 2009, directly from the *Shareholder Fund* and so will impact neither *asset shares* nor the excess assets in the with-profits fund.
- 5.12.4 In paragraph 5.4.2 how certain other costs have or may directly reduce the excess assets in the with-profits fund is described.
- 5.12.5 The investment strategy for the excess assets in the with-profits fund is described in section 5.9.

- 5.12.6 Agreements are in place under which loans will be advanced to the company by *Pearl Life Holdings Limited* or another company in the Pearl Group. These loans will be made to the *Shareholder Fund*. Such loans are made with the aim that, when added to the assets of the with-profits fund, the total at least equals a target amount of the larger of:
- the *Capital Resources Requirement* under the rules of the FSA (but the calculation of such amount for this purpose shall be performed on the basis that any requirement under the relevant rules or actuarial standards to recognise as a liability the requirement to distribute any realistic basis surplus shall be disregarded); and
 - the amount the *Board* consider necessary, having taken the advice of the *Head of Actuarial Function* and taken into account any *Individual Capital Guidance* issued by the FSA, to enable the company to meet the objectives set out in Principle 5.4.

plus an additional amount, currently £50 million.

- 5.12.7 Except if the company was being wound up, such loans are only repayable if the company considers that, following the making of the repayment, it will have excess capital of at least the size described. Interest is only payable under these loans if these conditions are met. The liabilities under the loans are *subordinated* to the claims of all *unsubordinated* creditors, including policyholders.

- 5.12.8 The assets, liabilities and regulatory capital requirements are monitored on an ongoing basis and loans can be requested at any time. There are notice periods for repayment of any loan.

The total amount of *shareholder* support available from *Pearl Life Holdings Limited* is currently £280 million. This support can only be accessed if the financial position is such that the support is triggered. The £280 million is expected to reduce in future as the amount of business in the fund runs down and the need for *shareholder* support reduces. As at 31 December 2009, £270m of the support has been provided to the company.

- 5.12.9 In addition, arrangements exist for monies to be transferred from the *Shareholder Fund* to the with-profits fund with the aim that the amount of assets in the fund exceeds regulatory minima by at least £25 million (but the calculation of such amount for this purpose shall be performed on the basis that any requirement under the relevant rules or actuarial standards to recognise as a liability the requirement to distribute any realistic basis surplus shall be disregarded). Transfers back to the *Shareholder Fund* will be made whenever emerging surplus in the fund, after the cost of bonuses (including *shareholders'* share), permits.

As at 31 December 2009, the *Shareholder Fund* provided a loan of £297m (including accrued interest) to the with-profits fund, of which, £158m was deemed repayable.

- 5.12.10 If at any time in the future,
- the fund no longer relies on support from the *shareholder* ;
 - the excess value of the assets (*estate*) is more than considered necessary on *market consistent* assumptions to enable us to meet the aims described in section 5.4; and
 - the excess provides at all times an adequate but not excessive margin against an adverse outcome compared with the assumptions,
- the proportions of *asset share* will gradually be increased from those otherwise useable using the mechanism described in paragraph 5.4.2(t), other than for final salary *unitised* with-profits group pension policies.

The *Board* will formally consult with and take into account the opinions of the *Head of Actuarial Function*, the *With-Profits Actuary* and the *With-Profits Committee* before doing so.

- 5.12.11 The exercise of discretion in respect of with-profits policies will be managed with the aim that the amounts transferred to the fund will be repaid to the extent that is possible whilst still meeting the aims in Principle 5.4. In determining benefits under with-profits policies, any liability to transfer such amounts back to the *Shareholder Fund* will be disregarded to the extent that this is necessary to treat customers fairly (that is in accordance with these Principles and Practices).

Principle**5.13 New Business**

Apart from as a result of the exercise of options under existing policies, contractual increments and new entrants to stakeholder, occupational and group personal pension plans, we no longer accept new business. The future business risk from this source is expected to be small.

Practices

5.13.1 The fund is no longer actively seeking new business, but continues to write a small amount of new business relating to policy options under existing contracts.

Currently there are no plans to reopen the fund to new business.

Principle

5.14 Equity Between the With-Profits Fund and *Shareholders*

The transfer of profits in any year from the with-profits fund to the *Shareholder Fund* is restricted by our articles of association to a maximum of one ninth of the value of bonuses we add to policies in that year.

If we were considering making changes to our articles of association to increase this percentage, we would first request and consider the advice of our *Head of Actuarial Function* and take into account the opinions of our *With-Profits Actuary* and the *With-Profits Committee*. If we still decided to proceed, we would notify policyholders at least three months in advance. We would also need to seek the agreement of Pearl Group and, if required, the High Court to make such a change.

From time to time, for some classes of business, we may transfer less than the permitted maximum from the with-profits fund to the *Shareholder Fund*.

The with-profits fund may from time to time receive financial support directly from *Pearl Life Holdings Limited* or from another member of Pearl Group, whether in the form of a loan or otherwise, if such support is needed to enable the company to meet the aims set out in section 5.4. The terms on which such support is provided will be on a commercial basis which is fair and reasonable to both parties, taking into account prevailing market conditions and the risks involved. If such support forms part of the with-profits fund, then it will be treated as if it was part of the *Shareholder Fund* for the purposes of the management of the excess assets and the implementation of these principles.

Practices

- 5.14.1 For *traditional* policies, the value of *annual bonus* added to policies, discounted at the current yield on appropriate dated government bonds, is determined. One ninth of that value is transferred to the *Shareholder Fund* together with one ninth of the discounted value of any *interim bonus* and one ninth of any *final bonus*. This means that the transfer to the *Shareholder Fund* is 10% of the distributed surplus.
- 5.14.2 For *unitised* business, currently only five ninety-fifths of the face value of *annual* or *final bonus* added is attributed. This means that the transfer to the *Shareholder Fund* is broadly equivalent to 5% of distributed surplus.
- 5.14.3 For *unitised* business where a *market value reduction* is applied on claims, which has the effect of reducing the *annual bonus* previously added, then there is a corresponding reduction in the transfer to the *Shareholder Fund*.
- 5.14.4 Transfers to the *Shareholder Fund* on pension business are reduced by an amount reflecting the expected additional tax arising on those transfers. Hence the net amounts transferred to the *Shareholder Fund* for pension policies are lower than the 10% and 5% referred to above.
- 5.14.5 The relative apportionment of value between *shareholder* and policyholder will not be affected by changes in the discount rate, as shareholder transfers are discounted at market rates.
- 5.14.6 Additional tax arising from transfers to shareholders is allocated to the fund (but is not charged to *asset shares*).
- 5.14.7 The *Board* are not aware of any external or internal factors which, if they were to change, would have a material affect on the apportionment of surplus as described above.

5.14.8 There are no classes of business which are significantly and systematically reducing the value of the excess assets of the fund as a result of the shareholder transfer in respect of that class.

Appendix 1

Glossary

Glossary of Terms

2009 Scheme	The Scheme in 2009 under which certain with-profits pension policyholders gave up their option to convert the <i>maturity</i> value of their pension policy into an annuity on guaranteed rates, in exchange for an immediate increase to the value of their policy and a change to the underlying investment practices for their policy. These policies are referred to as <i>2009 Scheme</i> policies. See section 3.2.
Annual Bonus	A bonus which may be added to a with-profits policy which increases the guaranteed benefits. Once added, <i>annual bonuses</i> cannot be taken away. Sometimes referred to as a regular or a reversionary bonus and interest additions.
Asset Share	Retrospective accumulation of premiums paid at the rates of investment return earned, after allowing for charges, such as expenses, mortality costs, guarantee costs, tax and other charges. It is described more fully in section 4.3.
Board	The governing body of Phoenix & London Assurance Limited with the final authority in decision making. It may consist of executive and non-executive directors.
Capital Resources Requirement (CRR)	The minimum amount of capital which Phoenix & London Assurance Limited must possess to satisfy the rules of section 2.2 of the FSA General Prudential Sourcebook. This is also referred to as the Pillar 1 basis.
Credit Spread	The excess of the yield on a fixed-interest security not issued by the UK government over the yield on a fixed-interest security of the same term issued by the UK government (may be negative).
Deposit Back	Where the company makes a large payment to a counterparty to provide it with future benefits (such as under a reinsurance policy), some of the premium is returned to the company to hold on behalf of the counterparty, releasing it only as the benefits are delivered.
Estate	The estimated realistic value of the assets less the estimated realistic value of the liabilities. It is calculated using realistic assumptions and generally accepted methodologies on a basis determined by the <i>Board</i> .
Final Bonus	A bonus which may be payable when a with-profits policy becomes a claim such as on death or <i>maturity</i> , and paid in addition to the guaranteed benefits and any <i>interim bonus</i> .
Head of Actuarial Function	The actuary who provides guidance to the <i>Board</i> on actuarial matters.
Individual Capital Assessment (ICA)	An annual determination of the capital required by Phoenix & London Assurance Limited to ensure it can meet its obligations in all reasonably foreseeable future circumstances. This assessment is not published but is submitted to the FSA. This, together with any <i>ICG</i> , is referred to as the Pillar 2 basis.

Individual Capital Guidance (ICG)	Private guidance provided by the FSA on the amount of capital, if any, which it considers appropriate for Phoenix Life Limited to have in excess of the <i>ICA</i> .
Interim Bonus	A bonus which may be payable when a with-profits policy becomes a claim. It is paid in addition to the guaranteed benefits, allowing for the accrual of <i>annual bonus</i> since the previous <i>annual bonus</i> declaration.
Investment Managers	The firm or persons appointed from time to time to manage the investments of a fund. This is currently Ignis Asset Management.
Long Position	Where an investor purchases investments in excess of those which it strictly needs; often using the proceeds of a <i>short position</i> in a different type of investment to give a combined effect which may be suitable for matching liabilities for policy guarantees.
Marked to Market / Marking to Market	Where the value of an exposure to a counterparty (such as a derivative contract) increases, this is a mechanism whereby the counterparty deposits with the company an amount to cover the increase in value.
Market Consistent	A value placed on a guarantee or policyholder option on a with-profits policy by identifying an asset (such as a financial option) for which a price is available from financial markets and which exactly or closely resembles the guarantee or policyholder option. The price of the asset is then used as a proxy for the value of the guarantee or policyholder option.
Market Value Reduction (MVR)	A percentage reduction to the value of units on a <i>unitised</i> policy which applies on encashment except in certain circumstances specified in the policy document. Sometimes referred to as a market value adjuster.
Maturity (Date)	<ul style="list-style-type: none"> • for a <i>traditional</i> endowment policy, the date on which the sum assured and bonuses will be paid; • for a <i>traditional</i> pensions policy, the selected retirement age; • for a <i>unitised pension</i> policy, the period around the selected retirement age during which the value of units may be used to provide retirement benefits without the application of a <i>market value reduction</i> or with the application of a restricted <i>market value reduction</i>; • for a <i>unitised</i> endowment, the date on which the value of units will or can be taken in full without the application of a <i>market value reduction</i> or with the application of a restricted <i>market value reduction</i>; or • for a <i>unitised</i> bond, there is no maturity date.
Non-Protected Exits	Claims occurring at other than a <i>protected date</i> . Policy benefits to be paid are not generally guaranteed. These are typically surrenders or withdrawals, transfers for pensions business and early retirements.
Normal Scheme Claims	Amounts payable under final salary <i>unitised</i> with-profits group pension policies in respect of benefit payments to scheme members but excluding any amounts payable on full or partial scheme discontinuance or special benefit enhancements.
Payer Swaptions	<i>Swaptions</i> in which the underlying <i>swap</i> is to pay a fixed rate and receive a variable rate.

Payout	The total amount paid in the event of a claim including bonuses, both <i>annual bonuses</i> and <i>final bonuses</i> and any <i>market value reduction</i> (where applied).
Payout Ratio	The amount paid in the event of a claim (policy <i>payout</i>) as a percentage of the <i>asset share</i> .
Pearl Life Holdings Limited	<i>Pearl Life Holdings Limited</i> is the immediate parent company of Phoenix & London Assurance Limited.
Protected Date	<p>A date (sometimes called a guarantee date) on which policy benefits are either guaranteed to be paid without any reductions, or some other minimum amount applies. Such dates are described in the terms and conditions of each policy, and may include death, <i>maturity</i> or retirement at selected retirement age.</p> <p>For <i>traditional</i> with-profits business, the claim value paid at a <i>protected date</i> will normally be the sum assured together with any <i>annual, interim</i> and <i>final bonus</i>.</p>
Receiver Swaptions	<i>Swaptions</i> in which the underlying <i>swap</i> is to receive a fixed rate and pay a variable rate.
Shareholder	Phoenix & London Assurance Limited is ultimately owned by Pearl Group.
Shareholder Fund	This fund is not part of the <i>long-term business fund</i> of Phoenix & London Assurance Limited and consists of assets owned by the <i>shareholders</i> of Phoenix & London Assurance Limited. Phoenix & London Assurance Limited is ultimately owned by Pearl Group.
Short Position	Where shares or other assets are sold which the investor does not own (but has, for example, borrowed).
Smoothing	Process applied to reduce the <i>volatility</i> of <i>payouts</i> for with-profits business. Typically, but not restricted to, the <i>smoothing</i> of the effects of volatile investment returns.
Subordinated	Creditors whose debts are only repayable after other <i>unsubordinated</i> creditors have been paid.
Surrender Values	This includes all <i>non-protected exits</i> where premiums cease or the policy is surrendered except on <i>protected dates</i> .
Swaps	Contracts to exchange fixed interest rates for variable interest rates for specified periods or vice versa.
Swaptions	Contracts giving the holder the option but not the obligation to enter into <i>swaps</i> at future dates.

Term Remaining	The <i>term remaining</i> on a policy to its <i>maturity date</i> . Also refers to <i>term remaining</i> on fixed interest investments to their redemption date.
Traditional (With-Profits) Policy	A with-profits policy under which guaranteed policy benefits are fixed when the policies are taken out in return for payment of either a single premium or annual premiums over the term of the policies. The guaranteed policy benefits are typically expressed as a sum assured or an annuity. Bonuses may be added. Sometimes referred to as a conventional (with-profits) policy. See section 4.2.
Unitised (With-Profits) Policy	<p>A with-profits policy under which each premium purchases a number of units and either:</p> <ul style="list-style-type: none"> • the price of the units increases daily at the daily equivalent of the current <i>annual bonus</i> rate (but subject to any rounding in the unit prices); or • the price remains constant and <i>annual bonuses</i> purchase additional units. <p>On encashment, the value of the units at the then price is paid (possibly subject to a <i>market value reduction</i>). See section 4.2.</p>
Unsubordinated	Creditors whose debts are repayable before those of <i>subordinated</i> creditors.
Volatility	A measure of the past or expected future rate of change in asset prices. It is an important parameter in the pricing of financial options and in the <i>market-consistent</i> valuation of liabilities.
With-Profits Actuary	An actuary who is appointed by the <i>Board</i> and who under FSA rules is required to provide advice to Phoenix & London Assurance Limited on the implications of certain matters for with-profits policyholders. The <i>With-Profits Actuary</i> has certain obligations in relation to the ongoing requirements of the <i>2009 Scheme</i> .
With-Profits Committee	<p>Phoenix & London Assurance Limited has established a <i>With-Profits Committee</i> which comprises of a majority of non-executive members together with the Chief Executive of the company. The Chairman of the committee is a non-executive member.. The committee normally meets around six times a year. The committee's role includes:</p> <ul style="list-style-type: none"> • reviewing bonus recommendations; • reviewing ongoing compliance with the Principles and Practices of Financial Management; and • considering issues that may have an impact on treating customers fairly.

Abbreviations Used

Capita	Capita Business Services Limited (includes Capita Hartshead and Capita Life and Pensions)
CRR	Capital Resources Requirement
FSA	Financial Services Authority
ICA	Individual Capital Assessment
ICG	Individual Capital Guidance
LTICR	Long-Term Insurance Capital Requirement
MVR	Market Value Reduction
OEICS	Open ended investment companies
PALAL	Phoenix & London Assurance Limited
PGMS	Pearl Group Management Services Limited
PLL	Phoenix Life Limited
PPFM	Principles and Practices of Financial Management
PPL	Phoenix Pensions Limited
RPI	Retail Prices Index
RPIX	Retail Prices Index excluding Mortgage Interest Payments
UISL	Unisys Insurance Services Limited
WPBR	With-Profits Benefit Reserve
WPICC	With-Profits Insurance Capital Component

Appendix 2 History of Principles and Practices of Financial Management for Phoenix & London Assurance Limited since 1 January 2007

1. The Principles and Practices of Financial Management have been republished to reflect changes in Phoenix & London Assurance Limited's circumstances and the business environment.
 - 1.1 The Principles and Practices of Financial Management was republished in March 2007. The main change was to correct the principles to reflect that the transfer of any profits in any one year from the with-profits fund to the Shareholder's fund is restricted by our articles of association to a maximum of one ninth of the value of the bonuses added to policies in that year.
 - 1.2 The Principles and Practices of Financial Management was republished in January 2008. The main changes to the practices were due to:
 - *Final bonus* reviews normally being twice a year from 1 January and 1 July (previously reviews were three times a year).
 - Increasing the maximum change allowable in *maturity payouts* when final bonus rates change to reflect that reviews are now only twice a year.
 - Updating the description for calculating *final bonuses* to reflect the increase in charges for guarantees.
 - Update for 2008 values and asset mixes.
 - Other minor amendments.

We also made some presentational changes to the Principles and Practices of Financial Management document itself which do not affect how we manage the business. These were due to:

- The presentation of the Principles and Practices of Financial Management was made more consistent with that of our sister company Phoenix Life Limited.
- Clarified how the investment strategy applies to some types of policies.
- Clarified in the background section how the Principles and Practices of Financial Management applies to particular types of policies.

- 1.3 The Principles and Practices of Financial Management was republished in July 2008.

The main change was in the presentation of the Principles and Practices of Financial Management document itself. This was to make the style and structure more consistent with that of our sister company Phoenix Life Limited. These changes do not affect how we manage the business.

The other main changes to the practices were due to:

- Pearl Group Limited acquired Resolution plc.
- Updated for July 2008 guarantee charges.
- Updated for latest capital support position.
- Clarified how *final bonuses* apply to certain types of policy.
- Clarified how the investment strategy applies to some types of policies.

1.4 The Principles and Practices of Financial Management was republished in January 2009.

The main change was to cover the *unitised* with-profits group pension business that was previously reassured to the Phoenix Life Limited 100% With-Profits Fund.

The other main changes to the practices were due to:

- Updated asset mixes and year end values.
- Update for latest guarantee charges.
- Update for Resolution Asset Management becoming Ignis Asset Management.
- Update for how *smoothing* had applied for the January 2009 *final bonus* review and to provide further clarification.
- Update on the investment return variances that would lead to an additional bonus review.
- Update on the target proportion range for *final bonuses*.
- Other minor amendments.

1.5 The Principles and Practices of Financial Management was republished in July 2009. The main changes to the practices were due to:

- Updated asset mixes.
- Final 2008 year end capital / loan support positions.
- Updates for how *smoothing* has applied for the July 2009 *final bonus* review.
- Clarification of final bonus calculations with respect to the use of an assumed year of retirement for some *unitised* with-profits pensions business.
- Other minor amendments.

1.6 The Principles and Practices of Financial Management was republished in January 2010.

The main change was to incorporate the *2009 Scheme*.

The other main changes to the practices were due to:

- Updates for the October 2009 interim *final bonus* review.
- Updates for how *smoothing* has applied for the October 2009 and January 2010 *final bonus* review.
- Final 2009 year end capital / loan support positions.

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