Principles and Practices of Financial Management for Kingston Unity Friendly Society With Profits Insurances

1. About this document

This document outlines how Kingston Unity Friendly Society will determine the amount paid out on a with profits insurance and how the Society will set its bonus rates and the distributions payable on branch scheme insurances.

The name of the document is the "Principles and Practices of Financial Management". The document outlines two types of rules of how the Society will manage its with profits insurances:

- "Principles" which the Society believe will be underlying its management of with profits insurances in the long term. Principles will inform all actions of the Board when it exercises its discretion on with profits insurances;
- "Practices" which the Society will currently use in managing with profits insurances. Practices are informed by the Principles but are, by definition, current methods and techniques.

If the Society wishes to change a Practice, the Board will revise this document and place a new version on its website.

If the Society wishes to change a Principle, the Board must inform all members that are affected of the change prior to changing the document and provide new copies of this document.

At all times, current versions of this document will be placed on the Society's website and will be available free of charge from the Society's head office at request.

This document does not override the Rulebook or the terms of insurances. Both of these documents are contractual by nature whereas this document outlines how the Board will exercise its discretion in managing with profits insurances.

The Society has one governing body – its Board of Management. It also maintains a With Profit Committee which advises the Board on how it is managing its with profits business and the exercise of discretion. The Society is advised by both an Actuarial Function Holder whose role is to advise the Board on statutory solvency and on the strategy of the Board and a With Profits Actuary whose role is to advise the Board and the With Profits Committee on the exercise of discretion and on the level of discretionary benefits (or bonuses). Currently, the Actuarial Function Holder and the With Profits Actuary are the same person.

This document is divided into the following sections:

Contents

2. The Investment Strategy of the Society

2.1 Principles

The investment strategy of the Society is to maximise the overall return of the investments of the Society subject to ensuring that the guaranteed benefits are met. These returns will be used for the benefit of the members of the Society. Returns include both increases in capital value as well as income.

Investment may be in any category of asset class including properties, bonds, equities and deposits.

The Society may invest in the office space that it occupies as well as properties held as assets. This will only take place if the saving in rental income and the prospect of future capital growth make investment sense.

2.2 Practices

The investment policy will be controlled by the Board of the Society. The Board will appoint Property Advisers and an Investment Manager to make detailed decisions on purchases and sales.

The Board will lay down an investment matrix that outlines the proportion of total assets within each category on a neutral, maxima and minima position. The investment matrix will also give a term duration split for bond assets again with a neutral, minima and maxima holding in each duration. The Board will also lay down parameters for the maximum that can be with any counter party both by investment asset class and by duration for bonds.

The Property Advisers and Investment Manager will be tasked with maximising the performance of the fund of assets subject to the minima and maxima laid down. They will bear in mind the neutral asset allocations.

The neutral asset allocations are designed to:

- Ensure that bond assets and rental income match the guaranteed liabilities of the fund which equates to the value of guaranteed sums assured and bonuses to date less the value of future contributions;
- Match the bond assets and rental income to the duration of these guaranteed net liabilities.

The minima and maxima are set at the level of risk that the Society can afford to run from mismatching assets against liabilities without placing the solvency of the Society at risk.

Counter party risk levels will be set to avoid over concentration of assets by counter party and possible risks to solvency from a counter party defaulting on an obligation.

The Actuarial Function Holder will provide advice to the Board at least annually on the asset allocation matrix. The Board will seek input from the investment manager on the practicality of the matrix.

The Board will review investment performance of the investment manager at least annually. The choice of investment manager and the basic strategy will be reviewed by the Board triennially.

Deposits will be placed by the treasury function of the Society to achieve the best rate of return whilst ensuring liquidity is present when required.

The Society owns the office space that it currently occupies. The rental outgoing saved and the prospect of future capital growth is reviewed by the Board at least annually on the basis of valuations carried out by a qualified property surveyor at least triennially.

3. Allocation of investment returns between branch schemes and central insurances.

3.1 Principles

The Board will be fair in the allocation of investment returns between returns given to branch schemes and returns given to central insurances. The Board will allow for the fact that allocations of investment return to branch schemes cannot be recalled to central funds.

3.2 Practices

The balances maintained by the branches in the Central Investment Fund (CIF) will be allocated two forms of investment return:

1. Interest on the CIF balance. This will be determined by the rate of investment income earned by the total assets of the Society in the year previous to the allocation reduced by an expense deduction;
2. Reserve allocations. These will be the realised and unrealised gains achieved by the Society in the year previous to the allocation deemed appropriate to release by the Board allowing for smoothing apportioned between the central funds and the branch balances in the CIF reduced by an expense deduction.

Both of these allocations will allow for the solvency of the Society. If the allocation would make the Society insolvent, then a reduced allocation would take place.

The Reserve Allocation also would make allowance for the smoothing deemed suitable for a branch Society to avoid gluts and famines in investment returns allocated to the branches. Years with losses will be carried forward and offset against future gains. Excesses or deficits will be carried by the "Estate" (defined below in Section 9) of the Society. A smoothing account will be maintained for the With Profit Committee of the excesses and deficits of the Reserve Allocation and the With Profit Committee will report on the balance within its report to members each year.

4. Allocation of expenses, investment return and risk costs amongst branch schemes.

4.1 Principles

The Board will aim to ensure equity between branches by avoiding cross subsidy between the branches and between the branch and the central funds of the Society. Broad brush equity will be achieved within the branch between members.

4.2 Practices

Separate accounting funds are established for the insurance business of each branch. Each branch has a separate insurance fund. All of the premiums are allocated to the fund, all of the investment returns are allocated to this fund less the allocation of interest to the Interest Bearing Accounts, all of the expenses are taken from the fund and all of the risk costs are met by this fund. Any profits generated within the fund are then able to be allocated to members' accounts.

The branch will have a management fund which will initially meet the management expenses of the branch. However, this is funded by margins on the premiums of branch schemes and by a first call on the investment returns given to the branch and can, therefore, be considered to be just a subdivision of the insurance fund of the branch.

The risk costs are the actual claim payments made on the insurances in the branch apart from the life cover benefits where the branch pays a risk premium to the Central Funds of the Society and the Central Funds pay any death benefits. This avoids the branch suffering volatility in surplus from death benefits.

The insurance fund is compared against the technical provisions required by the Society for the insurances written by the branch. The surplus is the difference between the accounting balance and the technical provisions. The Board will determine the proportion that should be distributed to members every three years.

The distribution to the individual member is determined by the number of shares held. These are determined by the shares per scheme times the number of complete years membership in the scheme up to a maxima of 10 years.

The distribution is made to the members' Medical Accounts which do not attract interest. The members may use the Medical Account balance to provide medical benefits (dental and optical benefits) and may also transfer over a proportion of their balance to their Interest Bearing Account after each distribution. The proportion that can be transferred is determined by the Branch Committee but cannot be more than 50%.

A proportion of the Medical Accounts may become encashable by members at their 65th birthday. The proportion will be set by the Branch Committee. Interest Bearing Accounts can be drawn down at any time.

5. Allocation of investment return, expenses and risk costs amongst central scheme insurances.

5.1 Principles.

Ultimately, all of the expenses and risk charges suffered by the Society have to be paid for by the members of the Society as there are no shareholders. Equally, all of the investment returns are owned by the members of the Society.

However, if the Society has funds available, it will measure payouts on maturity and surrender against expenses that reflect the charges outlined in its tables and policy documents. The remaining expenses (or any surplus) will be charged (or credited) to the "estate" (see Section 9 below for a definition of estate) of the Society.

Investment returns will be considered to be shared amongst members allowing for the nature of the underlying guarantees on their insurances and the duration of that guarantee.

Risk benefits will be met in accordance with the best estimates of the likely cost suffered.

5.2 Practices.

The Society will calculate individual policy "asset shares". Asset shares are calculated as an accumulation of the contributions paid less the expense deductions less the charges for risk benefits plus the investment returns credited to the insurance.

The asset share will be charged expenses in line with the published table expense deductions.

The risk charge will reflect the best estimates of the likely risk costs in the last year based on advice from the With Profits Actuary to the Board and to the With Profits Committee. This advice will attempt to arrive at a best estimate and will be based on the mortality and morbidity investigation.

Investment returns will be split into two categories: (1) those on assets matching the guaranteed benefits; and (2) those on other assets chosen to maximise the return to members. The first group will be applied to the portion of the asset share representing the present discounted value of the guaranteed benefits less the present discounted value of future contributions subject to no more than the asset share. The second return will be applied to the excess assets in the asset share. This means that the investment return credited to an insurance with low guarantees will reflect the second group of assets more than the first whereas an insurance with high guaranteed benefits (and low remaining discretionary benefits) will have returns more in line with the matching assets. The matching assets will be bonds of the appropriate term and the expected rental income on properties without allowing for any increases in rents in the future and after making an adjustment for risk.

6. The use made of "smoothing".

With profits insurances are not designed to pay the exact amount accumulated within the funds of the Society allowing for the exact investment return on those assets. There are two levels of smoothing applied:

1. Implicit smoothing. The Society has uniform bonus rates between different contribution levels and between different plan types within the same bonus series. Maturity and death benefits will, therefore, not take account of the differences between these two elements other than in the calculation of the original sum assured.

2. Explicit smoothing. This will apply over different time periods whereby the Society will try to avoid payouts moving by a large amount from time to time.

Smoothing will involve the use of the "estate" (see Section 9 below) to carry any deficits or surpluses compared with the unsmoothed asset share.

6.1 Principles

Payouts on surrender will be smoothed to a differing extent from those on maturity or death. The Society allows for the fact that maturity payments or death payments are payments occurring to a member who has made payments for the full term of the insurance and that the member has no choice of the timing of the payout. Surrender payouts are made at the direct control of the member and the member can choose to act against the interests of other members in the timing of the payout.

Maturity and death payouts will be smoothed from one period to the next by avoiding major changes in reversionary bonuses and using the estate to finance this element of smoothing. The Society intends this smoothing to be neutral in cost to the estate in the long term. Any smoothing will also be subject to the need to meet the solvency requirements of the regulator (the Financial Services Authority or its successors).

Surrender payouts will normally be smoothed in the short term but the Board will maintain its discretion to change surrender payouts immediately on any change in the market.

6.2 Practices.

Maturity and death benefits are fixed by bonus declarations and these will be decided by the Board annually following the valuation of the Society's assets and liabilities. The methods employed are outlined in section 8 below.

The amount of smoothing in relation to the asset share and the realistic prospective valuation will be recorded at each annual valuation and will be discussed by the Board and the With Profits Committee. The With Profits Committee will report on this in their report to members each year.

Surrender payouts are outlined in section 8 below and are fixed by asset share calculations allowing for table expenses and risk charges set by the Board and annual investment returns.

7. Business Risk and New Business Decisions

7.1 Principles.

As the Society is owned by the members of the Society, all of the costs and benefits from management taking business decisions will ultimately be shared amongst the members whether in branch insurances or in central insurances.

New insurances tend to require extra capital to cover technical reserves and solvency margins required by the regulator (the Financial Services Authority and its successors). This capital is provided by existing members of the Society who require a return on their investment.

7.2 Practices.

Initially, any costs or benefits from these two sources will come from or be added back to the estate of the Society. The amount of estate is targeted (as stated below) and so ultimately these costs or benefits are smoothed into the asset shares above. These adjustments will be adjustments to the investment returns mentioned in 2.2 above.

If a business risk causes a major cost to the Society (over 5% of total assets), the impact of this loss may be applied immediately to asset shares rather than be smoothed through the estate. Equally, a positive contribution of the same amount will be applied immediately to asset shares.

The Society has to make decisions on whether to remain open to new business and what types of insurances the Society should make available. The Board will make this decision each year from advice provided by the Actuarial Function Holder. New business will only be accepted if it is deemed to give a positive contribution to the value of the existing members insurances over the term of the insurances written allowing for the business plan of the Society on growth in new business.

Any decision to close the Society to new business will require the formulation of a business plan allowing for no new business and showing the run off of the estate to the asset shares of the insurances in force. The Board will also consider winding up the Society and sharing the funds amongst the members. Any decision to wind up will need to allow for providing risk insurances for those members who still require the risk insurance from another provider.

8. Payouts, bonuses and surrender values

The payout on maturity or death of most of the with profit insurances provided by the Society depends on the reversionary bonuses declared to date and the terminal bonus in force at the date of the claim. Surrender benefits depend on the method used to calculate surrender benefits.

Branch insurances are governed by rules that restrict the amount of benefits payable. No surrender value is payable on the insurance itself and the Medical Account is only payable after age 65 or even later depending upon the branch rules.

8.1 Principles.

Members will be paid guaranteed benefits on maturity or death by the Society plus discretionary benefits set by the Board. The most important principle is that discretionary benefits will only be paid if there is adequate free assets after payment of expenses in the view of the Board to afford the discretionary benefits.

Subject to the principle above, payouts on maturity and death will also attempt to reflect fairly the contribution the member has made to the funds in existence. Surrender payouts will not be penalised by the Society but will reflect fully the charges within the tables plus any other expenses deemed necessary and adjusted to reflect the incidence of expenses.

Bonus declarations will be uniform for each bonus series except for terminal bonuses which may vary by duration.

8.2 Practices.

The Board will set a range around 100% for payouts on maturity as compared with the asset shares of the underlying insurances. The current range will be between 70% and 130%. This range will be reviewed annually after advice from the With Profits Actuary.

Bonuses will be set so that a discounted present value on best estimate assumptions of future experience of all benefits, including future bonuses, less premiums, plus expense allowances, provide a reasonable match against the historic asset shares. Reversionary bonuses will be based on investment returns that are sustainable and some part of the additional investment return achieved in the period. Terminal bonus rates will be set to bring the total payout into balance. The value of the estate will also be considered (see below).

The payout on maturity and death must be afforded out of the surplus emerging in the published returns to the regulator. Smoothing may be applied from year to year and this will be reflected in the position of the current payout compared with the target range.

Surrenders will be based on the individual policy asset share times a target range. The target range will be between 85% and 115%. The asset share will be adjusted to allow more closely for the incidence of initial sales costs and for the costs of carrying out the surrender. The target range will be set by the Board subject to annual review and after advice from the With Profits Actuary.

The With Profits Committee will report annually to members on the operation of the target ranges.

9. The estate of the Society.

The estate of the Society provides working capital to allow the Society to (amongst other things) meet any shocks that may occur, smooth experience in to the asset shares and payouts and provide capital to allow the writing of new business. The inherited estate is the realistic value of assets less the realistic value of liabilities.

The realistic value of liabilities is set as:

- the prospective values of future benefits, including reversionary and terminal bonuses, for conventional assurances ;
- the prospective value of branch insurance benefits plus an allowance for future distributions based on the surplus within the relevant branch funds;
- plus the adjusted asset shares for unitised with profit business and ISA's;
- plus the realistic value of any other liabilities.

9.1 Principles.

The estate will be targeted at levels that the Board (after advice from the With Profits Actuary) believe is reasonable given the nature of the liabilities and assets held by the Society.

The aim will be to allow for a reasonable level to cope with smoothing the returns to members without unduly building up excess levels of estate that is not needed.

9.2 Practices.

The With Profits Actuary will give his advice as part of the valuation report to the Board. This advice will include the two calculations for the estate outlined above. The Board will consider:

- the likely financial impact of known events in the future;
- the likely financial impact of volatility of experience in the future;
- the business plans of the Society;
- the level of capital required by regulators;
- the level of smoothing of bonus rates that the Board wishes to achieve.

Currently, the Board believe that the estate should be in the range of 10% to 20% of total assets of the Society excluding any assets for unit linked insurances.

Any movement to return the estate to the target level will be carried out over a 5 to 10 year period and will be based on the business plans of the Society.

Kingston Unity Friendly Society
9 Navigation Court, Calder Park, Wakefield, WF2 7BJ
T: 01924 240164
Email: enquiries@kingstonunity.co.uk
Web: www.kingstonunity.co.uk