

Healthy Investment Principles and Practices of Financial Management

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1. Introduction

This document outlines the principles and practices that Healthy Investment (the trading name of the Rechabite Friendly Society, which is referred to in this document as “the Society”) follow in the management of its With profits policies. The items under each heading are divided into two groups:

1. Principles. These are overarching statements of what the Society would like to achieve over the long term. They are not likely to change in the short term.
2. Practices. These are the current techniques and methods used by the Society to achieve the principles. They will change over time as new techniques replace older ones and the financial background to the Society changes.

The principles and practices are controlled by the Board of the Society after taking advice from the With Profits Actuary. Practices can and will be changed by Board resolution with all members affected by the change being notified as soon reasonably possible. Principles can be changed by Board resolution but all members affected by the change will be given 3 months notice of the proposed changes.

This document will be available to all members who request it and will be placed on the website of the Society. There may be different versions of this document and it will be clearly stated when the new document is in force. This is:

Version 1.5 of the Principles and Practices of Financial Management which is effective from 20 December 2011

There are 4 previous versions. Version 1.1 was effective 01/12/2006 until 28/02/2008, version 1.2 effective from 01/03/2008 to 19/06/2008, version 1.3 effective from 19/06/2008 until 16/09/2010 and version 1.4 effective from 17/09/10 until 20/12/11.

On 28 October 2011 the Society took over the Coventry Assurance Society. The policies, assets and liabilities of the Coventry assurance Society were transferred to a separate fund within Healthy Investment known as the “Coventry Fund”. This will initially be operated as a separate fund to ensure that the members within the Fund have their policy benefits set by the experience of the Fund. A separate Principles and Practices of Financial management has been produced for this fund, and is available to all members on request, and has also been placed on our website.

This document is divided into various sections:

- 1 This introduction;
- 2 The amounts payable under a With profits policy;
- 3 Investment strategy of the Society;
- 4 Allocation of charges, expenses and investment returns;
- 5 The use of smoothing;
- 6 Business risk and new business decisions;
- 7 Payouts, bonuses and surrender values;
- 8 The estate of the Society.

2 Determining the amounts payable for With profits policies

2.1 Principles

The Society aims to treat its customers fairly, having regard to statements made in marketing literature and communications to policyholders.

The aim of the bonus policy is to provide members with a fair return for their contributions to the Society. The Society does not have any shareholders and therefore all surplus belongs to the members of the Society. The surplus therefore includes surplus from non profit policies and from the estate.

The amount of surplus arising that is distributed each year will be constrained by the need to ensure the sound financial management of the Society.

Bonus is distributed by means of annual additions to the guaranteed benefits, a reversionary bonus and by an additional sum added to the guaranteed benefits when a claim arises, a terminal bonus.

Terminal bonuses are determined so that the total payout on a policy becoming a claim represents a fair reflection of the return on the premiums invested with the Society. The Society will smooth the terminal rates to avoid large fluctuations in the payouts due to sudden changes in market or demographic experience, this is known as smoothing.

The Society aims to ensure that the smoothing of payouts is neutral over the long term. This aim is measured by monitoring the estate (see section 8).

Any changes in bonus policy will be implemented gradually unless this would conflict with the sound financial management of the Society.

Surrender values are set to ensure that exiting members do not disadvantage members who remain within the Society. The Society will aim to smooth the payouts on surrender but may change the basis to reflect the changes in the market values of the assets. Any changes in the basis will relate to the interim reversionary bonus and the terminal bonus for conventional products. For the With profits Bonds and ISAs the changes will relate to the interim reversionary bonus, the terminal bonus and possibly a Market Value Reduction.

2.2 Practices

The Society uses an asset share approach that involves a mixture of asset shares and the bonus reserve method to determine the reversionary and terminal bonuses payable to the With profits policyholders.

Asset shares are calculated as an accumulation of the contributions paid, less the expense deductions less the charges for risk benefits and where appropriate tax, plus the investment returns credited to the insurance.

The bonus reserve valuation method is the present value of all future benefits less future expenses based on the assumptions of the likely experience. The assumptions include future investment returns, expenses and mortality rates.

Asset shares provide a good basis for achieving a fair distribution of surplus between the varied types of policies. Asset shares calculated for each policy are best suited to policies with a pre-determined maturity date. The disadvantages of the asset shares is the volume of historical data needed and the assumptions required in determining the allocation of past experience. For whole life assurances and policies with longer durations an individual policy asset share is not appropriate, so the bonus reserve method is used instead.

The asset share approach therefore combines the results for the asset shares and the bonus reserve method to determine the appropriate amounts payable.

In determining the bonus rates the With profits policies are split into two groups, conventional products and the accumulating With profits products, which consist of the With profits Bonds and ISAs. The bonus rates for each group apply universally to all policies within these groups that are deemed to have the same bonus earning potential by the Board.

For the With profits Bonds and ISAs the asset shares are also examined by the year of entry. For conventional products, the asset shares are examined by duration of the policy in force and by full duration of the policy at maturity date.

The assumptions and methods used for determining the bonuses are reviewed annually by the Board and the With Profits Actuary. Any changes will be investigated by the With Profits Actuary who will report on the implications of the proposed changes. The Board will then decide on whether it should make the proposed changes.

3 Investment strategy of the Society

3.1 Principles

The investment strategy of the Society is to maximise the overall return on 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 bonds, equities, properties and deposits. The Society may also invest in derivatives of these asset categories.

The Society has an ethical investment strategy which precludes knowingly investing directly in firms that are involved in the following trades: arms; alcoholic beverages; tobacco.

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.

3.2 Practices

The investment policy is controlled by the Board of the Society. The Board will appoint investment managers to make detailed decisions on purchases and sales.

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

The investment managers will be tasked with maximising the performance of the fund of assets subject to the parameters laid down. They will bear in mind the neutral asset allocations.

The neutral asset allocations are designed to:

- Ensure that bond assets 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 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 of mismatch against liabilities without placing the solvency of the Society at risk.

Counterparty risk levels are set to avoid over concentration of assets by counterparty and possible risks to solvency from a counterparty 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 managers on the practicality of the matrix.

The Board will review the performance of the investment managers at least quarterly and a major review of the investment policy will be carried out annually. The choice of Investment Manager and the basic strategy will be reviewed by the Board triennially or sooner if thought necessary.

The Society will maintain two bankers for immediate liquidity to avoid any late payment problems caused by a banker becoming insolvent. 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 costs 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.

4 Allocation of charges, expenses and investment return

4.1 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 8 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 Boards best estimate of likely experience over the year. The additional risk costs (or surpluses) will be charged (or credited) to the estate.

4.2 Practices

The Society calculates individual policy asset shares which will be charged expenses in line with the published table expense deductions.

The risk charge will reflect the Boards estimates of the likely risk costs based on advice from the With Profits Actuary. 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 duration.

Bonus reserve valuation:

The assumptions for future investment returns, expenses and mortality, used in calculating the bonus reserve valuation will be the Society's best estimate of future experience.

These assumptions are reviewed annually by the Board and the With Profits Actuary. Any changes will be investigated by the With Profits Actuary who will report on the implications of the proposed changes. The Board will then decide on whether it should make the proposed changes.

5 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.

Explicit smoothing is achieved by managing the estate of the Society.

Whilst smoothing helps protect members from short term fluctuations in the stock market, it will not protect against long term and sustained falls in the value of stocks and shares.

5.1 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 or death payouts are payments occurring to a member who has made all their contributions for the full term of the policy 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 terminal or 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.

5.2 Practices

Maturity and death benefits are fixed by bonus declarations and these will be decided by the Board at least annually following the valuation of the Society's assets and liabilities. The methods employed are outlined in section 7 below.

The amount of smoothing in relation to the asset shares and the bonus reserve value of the liabilities will be recorded at each valuation and will be discussed by 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 7 below and are set using asset share calculations allowing for table expenses and risk charges agreed by the Board and annual investment returns. The asset shares may be adjusted to reflect the incidence of expenses and risk costs.

6 Business risk and new business decisions

6.1 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.

New policies 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.

6.2 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 3.2 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 being smoothed through the estate. Equally, a positive contribution of the same amount may 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 and the With Profits Actuary. 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.

7 Payouts, bonuses and surrender values

The payout on maturity or death of most of the With profits policies 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 values will be calculated based on asset share.

7.1 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 are adequate free assets after payment, 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 will vary by duration.

7.2 Practices

The Board will set payouts on maturity in relation to the asset shares and the bonus reserve value of the liabilities.

The Board has set the range for the payouts to be within 70% to 130% of asset share, for regular premium plans and between 80% and 120% for the single premium Bond and the ISAs. The range is reviewed annually after advice from the With Profits Actuary.

The method used to smooth the payouts is to set the bonuses such that the discounted present value, on best estimate assumptions of future experience of all benefits including future bonuses less premiums plus expense allowances, provides 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).

Surrender values will be calculated on a target range based around the individual policy asset share. 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 is set by the Board and is reviewed at least annually, after advice from the With Profits Actuary. The Board has set the range to be within 60% to 130% of asset share for regular premium plans and between 70% and 120% for the Single Premium Bond and the ISAs.

A Market Value Reduction (MVR) may be applied to a withdrawal or surrender of a With profits Bond or ISA. This is a reduction in the value of the investment to bring the overall payout closer to the asset share when the underlying value of the assets in our fund is lower.

Our series 3 Investment Bonds (which are all bonds issued after 1 November 2003) and our adult ISAs have an MVR free period, where you can withdraw your investment without an MVR being applied, even if the stock market has fallen in value and we are applying MVRs on withdrawals. This is on the 10th anniversary of the investment and every 5th anniversary thereafter.

Our Junior ISA also includes an MVR free guarantee. The first MVR free date is the child's 18th birthday or 5 years after commencement if later and every subsequent 5th anniversary of the first MVR free date.

8 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 into the asset shares and payouts and provide capital to allow the writing of new business.

The 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 future reversionary and terminal bonuses, for conventional assurances or the bonus reserve method liability for other types of policies
- plus the adjusted asset shares for With profits Bonds and ISAs
- plus the realistic value of any other liabilities.

8.1 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.

8.2 Practices

The With Profits Actuary will give their 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 believes 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.

ETHICAL SAVINGS AND INVESTMENTS

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